Best Planning Ideas for 2019

(excerpted from
Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications)

Steven B. Gorin
Thompson Coburn LLP
St. Louis, MO
sgorin@thompsoncoburn.com
phone 314-552-6151
http://www.thompsoncoburn.com/people/steve-gorin

Note to attendees: You do not need to bring this with you to be able to follow our discussion. This is intended for some general background from the following parts (see table of contents):

- II.E. Entity structuring in light of 2017 tax law changes. This includes details from the proposed regulations under Code § 199A. A free 90-minutes webinar is Planning Using the Proposed Regulations under IRC §§ 199A and 643(f).
- II.H. Basis step-up strategies. Clary Redd did a great job at our December Estate Planning Council meeting. This is intended to supplement his work.
- II.J. Fiduciary income tax planning. The Uniform Principal & Income Act was rewritten as the Uniform Fiduciary Income & Principal Act (UFIPA), which now needs to be adopted by various states. So far, my materials mainly touch on more flexibility with the power to adjust. A free webinar on February 12 will provide a refresher as you plan distributions to be made by March 6 that you can elect to count as 2018 distributions. For details (or to listen to last year's webinar), check out https://www.thompsoncoburn.com/insights/blogs/business-succession-solutions (2/12/2019 webinar won't be posted for several weeks).
- II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure. This is very relevant to the topic of trustees monitoring life insurance policies.

This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 12/28/2018), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work. To receive quarterly a link to the most recent version, please complete http:\www.thompsoncoburn.com\forms\gorin-newsletter.

TABLE OF CONTENTS

Page

Best Planning Ideas for 2019

by Steven B. Gorin[*]

I. Introduction

This document is excerpted from "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,700 pages of material in a fully searchable PDF that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must have a physical mailing address, even though delivery is electronic. Please also add ThompsonCoburnNews@tcinstitute.com to your "trusted" list so that your spam blocker will not block it. Send any inquiries to the author at sgorin@thompsoncoburn.com and not to ThompsonCoburnNews@tcinstitute.com, which is not the author's email address but rather is an address used to transmit newsletters.

---

[*] Steve Gorin is a partner in the Private Client practice group of Thompson Coburn LLP. He is a past chair of the Business Planning group of committees of the Real Property, Trust & Estate Law Section of the American Bar Association. Steve is a member of the Business Planning Committee of the American College of Trust and Estate Counsel. He is a past chair of the Business Law Section of the Bar Association of Metropolitan St. Louis. In addition to helping clients directly with their needs, Steve serves as a consultant to other attorneys in various areas of the country, primarily regarding the subject matter of these materials. For more details about the author, see http://www.thompsoncoburn.com/people/steve-gorin. He would welcome any questions or comments the reader might have regarding these materials; please email him at sgorin@thompsoncoburn.com. For those who wish to use part of these materials for presentations for professional organizations, Steve might prepare an excerpt that the presenter can use, with full attribution and without charge.

 This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time (in fact, the author does not systematically refresh citations), so some parts may be less current than others. The author invites suggested changes, whether substantive or to point out typos (the author does not have a second set of eyes reviewing the author's work). The views expressed herein reflect the author's preliminary thoughts when initially written and are not necessarily those of Thompson Coburn LLP (or even of the author). Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 12/27/2018), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work.

You might also check out the author's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

II.E. Recommended Structure for Entities

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on calculations shown in Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships. The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

<u>Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale.</u> For a discussion of the extent to which that is true and how choice of entity affects exit strategies, see part II.E.2.a Transferring the Business.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both. Also note that individuals or trusts owning pass-through businesses will be able to deduct little or no of the state income tax on their business income, whereas C corporations are not subject to such limitations.[617]

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for

[617] See text accompanying fn 21 in part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.

deducting losses[618] than is an S corporation[619] or C corporation.[620] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[621] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would otherwise have been taxed at a higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[622] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[623] However, C corporations provide better fringe benefits.[624]

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[625] However, if a C corporation receives a dividend from another corporation, only part of that dividend is taxed,[626] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

In addition to taxes on annual operations, consider:

---

[618] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.c.ii Basis Limitations for Partners in a Partnership.

[619] See part II.G.4.c.i Basis Limitations for S corporation Owners Beyond Just Stock Basis.

[620] See parts II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.4.c.iii Comparing C Corporation Loss Limitations to Those for Partnership and S corporation Losses.

[621] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.

[622] See parts II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[623] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[624] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

[625] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

[626] See fns. 10-14 in part II.A.1.a C Corporations Generally.

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[627] (if qualified dividends)[628] and the 3.8% tax on net investment income.[629]

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax. See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top

---

[627] Code §§ 1(h)(3), 1(h)(11)(A).

[628] Code § 1(h)(11)(B) provides the following parameters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.

(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).

(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
  (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
  (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.20.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

[629] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.312% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[630] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[631]

[630] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships, text accompanying fn 633-635. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[631] See fns. 93-95 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[632]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

[632] See fn 4050 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

II.E.1.b. Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($128,400 in 2018 and $132,900 in 2019),[633] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[634] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[635]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[636] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[637] or stock[638] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S corporations. However, an S corporation that distributes property triggers tax on the gain,[639] which gain is taxed at its shareholders'

---

633 See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.

634 See fns 2804-2806 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

635 Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

(1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.

(2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

636 As to SE income being excluded from NII, see fn 1895 in part II.I.5 What is Net Investment Income Generally.

637 Code § 705.

638 Code § 1367.

639 See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

respective income tax rates and in many cases does not qualify for favorable capital gain rates.[640]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[641] and restrictions on types of businesses do not apply to modest income taxpayers)
- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)
- 5% state income tax.

II.E.1.c. Code § 199A Pass-Through Deduction for Qualified Business Income

For taxpayers other than C corporations,[642] Code § 199A provides a deduction for taxable years beginning after December 31, 2017 but not beginning after December 31, 2025.[643] When applying Prop. Regs. §§ 1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the Code § 199A deduction is determined by the trust or estate under the rules of Prop. Reg. § 1.199A-6.[644] The Proposed Regulations and preamble are found at https://www.federalregister.gov/documents/2018/08/16/2018-17276/qualified-business-income-deduction.

In the case of a partnership or S corporation, Code § 199A applies at the partner or shareholder level.[645] In the case of an S corporation, an allocable share is the shareholder's pro rata share

640 See parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
641 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
642 Code § 199A(a).
643 Code § 199A(i).
644 Prop. Reg. § 1.199A-1(a)(2)
645 Code § 199A(f)(1)(A)(i).

of an item.[646] The deduction does not reduce one's basis in one's partnership interest or S corporation stock.[647]

Grantor trusts are of course disregarded and their activity attributed to their deemed owners, but estates and nongrantor trusts compute their distributive net income ("DNI") with considering the Code § 199A deduction. Then they allocate each Code § 199A item to the trust and the beneficiaries according to their respective shares of DNI. The trust uses its taxable income for its Code § 199A calculation, and each beneficiary uses his or her taxable income for his or her own Code § 199A calculation. See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

The IRS is to "prescribe such regulations as are necessary to carry out the purposes of" Code § 199A, including regulations:[648]

> (A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and
>
> (B) for the application of this section in the case of tiered entities.

The proposed regulations implementing subparagraph (A) follow the definitions below. Prop. Reg. § 1.199A-1(f), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (f)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.
>
> (2) *Exception for non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

Reg. § 1.199A-1(f)(2) allows a fiscal year estate (including a qualified revocable trust electing taxation as such)[649] that distributes income to its beneficiaries to convert 2017 income into QBI. For example, suppose an S corporation issues a K-1 to an estate for calendar year 2017, and the estate elects a calendar year ending September 30, 2018. That K-1 is reported on the estate's return for a taxable year that begins before January 1, 2018 and ends after December 31, 2017, meaning that the K-1 will pass through QBI, W-2 wages and UBIA to the

---

[646] Code § 199A(f)(1)(A) (flush language).

[647] Prop. Reg. § 1.199A-1(e)(1) provides:

> *Effect of deduction*. In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The section 199A deduction has no effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

[648] Code § 199A(f)(4).

[649] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

extent that the estate is an RPE.[650] The estate is an RPE only to the extent QBI is allocated to beneficiaries on K-1s issued to them.[651] The government is not disturbed by this conversion of 2017 income to QBI.[652] However, the RPE conducting the qualified trade or business may be – it might not have been expecting to compute QBI, W-2 wages and UBIA for 2017! Nevertheless, I believe that they are required to report this information, because S corporations[653] and partnerships[654] must separately report any items that affect an owner's tax return differently than the entity's overall taxable income.

The rules described in the various subparts of this part II.E.1.c apply to pass-throughs, but similar rules apply to any "specified agricultural or horticultural cooperative."[655]

Prop. Reg. § 1.199A-1(b) provides the following definitions for Code § 199A and Prop. Regs. §§ 1.199A-1 through 1.199A-6:

(1) Aggregated trade or business means two or more trades or businesses that have been aggregated pursuant to § 1.199A-4.

(2) Applicable percentage means, with respect to any taxable year,100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(3) Phase-in range means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

---

[650] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction, text accompanying fn 834.

[651] See part II.E.1.f.ii.(a) How Qualified Business Income Flows to Beneficiaries.

[652] The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

> Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017.

[653] See fns 849-851 in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

[654] Using language similar to regulations referred to in fn 654, Reg. § 1.702-1(a)(8)(ii) provides:

> Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Instructions for Form 1065 (2017), pages 34-35 provide much detail on how partnerships report items relating to Code § 199, which Code § 199A replaced.

[655] Code § 199A(g) describes qualified entities and the related deduction. The Senate report said (note that the Conference Committee reduced the deduction from 23% to 20% and pushed up the effective date by one year):

> For taxable years beginning after December 31, 2018 but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of 23 percent of the cooperative's taxable income for the taxable year or 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

(4) 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).

(5) QBI component means the amount determined under paragraph (d)(2) of this section.

(6) Qualified PTP income is defined in § 1.199A-3(c)(3).

(7) Qualified REIT dividends are defined in § 1.199A-3(c)(2).

(8) Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(8), the excess amount is 20 percent of QBI over the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

(9) Relevant passthrough entity (RPE) means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

(10) Specified service trade or business (SSTB) means a specified service trade or business as defined in § 1.199A-5(b).

(11) Threshold amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017] for "calendar year 2016] in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code. For taxable years beginning in 2019, the threshold amount is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for single and head of household returns.[656]

(12) Total QBI amount means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

(13) Trade or business means a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the

[656] Rev. Proc. 2018-57, § 3.27.

rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

(14) Unadjusted basis immediately after acquisition of qualified property (UBIA of qualified property) is defined in § 1.199A-2(c).

(15) W-2 wages means a trade or business's W-2 wages properly allocable to QBI as defined in § 1.199A-2(b).

Various items described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds are to be allocated pursuant to fn 648 above. Accordingly, Prop. Reg. § 1.199A-2(a) provides:[657]

(1) *In general*. This section provides guidance on calculating a trade or business's W-2 wages properly allocable to QBI (W-2 wages) and the trade or business's unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property). The provisions of this section apply solely for purposes of Section 199A of the Internal Revenue Code (Code).

(2) *W-2 wages*. Paragraph (b) of this section provides guidance on the determination of W-2 wages. The determination of W-2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. In the case of W-2 wages paid by an RPE, the RPE must determine and report W-2 wages for each trade or business conducted by the RPE. W-2 wages are presumed to be zero if not determined and reported for each trade or business.

(3) *UBIA of qualified property*. Paragraph (c) of this section provides guidance on the determination of the UBIA of qualified property. The determination of the UBIA of qualified property must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. In the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified property held by a partnership which does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property held by an S corporation which does not produce tax depreciation during the year, each shareholder's share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business.

[657] See parts II.E.1.c.vi.(a) W-2 Wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Prop. Reg. § 1.199A-2(b) and (c) are described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds. For now, let's delve into how those items get reported to the ultimate individual or trust. Note that the sentence describing S corporation UBIA is simplistic compared to part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation.

Prop. Reg. § 1.199A-6(b) describes computational and reporting rules for a relevant passthrough entity (RPE). It provides:

(1) *In general*. An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their Section 199A deduction.

(2) *Computational rules*. Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their Section 199A deduction under § 1.199A-1(c) or (d):

(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of § 1.199A-5.

(ii) Second, the RPE must apply the rules in § 1.199A-3 to determine the QBI for each trade or business engaged in directly.

(iii) Third, the RPE must apply the rules in § 1.199A-2 to determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly.

(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in § 1.199A-3(c)(1) earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP income as defined in § 1.199A-3(c)(2) earned directly or indirectly through investments in PTPs.

(3) *Reporting rules for RPEs*—

(i) *Trade or business directly engaged in*. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE--

(A) Each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business, and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i)(A) of this section is an SSTB.

(ii) *Other items*. An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends or qualified PTP income or loss received by the RPE (including through another RPE).

(iii) *Failure to report information*. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any items described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

Paragraph (3)(i), (ii) above is consistent with reporting requirements for partnerships in Code § 702(a)(7) and Reg. § 1.702-1(a)(8)(iii) and for S corporations in Code § 1366(a)(1)(A).

This RPE paradigm means that each RPE is treated as a stand-alone taxpayer for purposes of evaluating the nature of the business. This has negative consequences for real estate owners[658] and for those conducting tiered partnerships.[659]

The preamble, REG-107892-18 (8/16/2018), comments in part VI.A., "Computational steps for RPEs and PTPs," starts with a description of RPE reporting requirements:

> Although RPEs cannot take the Section 199A deduction at the RPE level, each RPE must determine and report the information necessary for its direct and indirect owners to determine their own Section 199A deduction. Proposed § 1.199A-6(b) follows the rules applicable to individuals with taxable income above the threshold amount set forth in § 1.199A-1(d) in directing RPEs to determine what amounts and information to report to their owners and the IRS, including QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses are SSTBs. RPEs must also determine and report qualified REIT dividends and qualified PTP income received directly by the RPE. Proposed § 1.199A-6(b)(3) then requires each RPE to report this information on or with the Schedules K-1 issued to the owners. RPEs must report this information regardless of whether a taxpayer is below the threshold. The Treasury Department and the IRS request comments whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the threshold amount, the RPE does not need to determine and report W-2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. Although such a rule would relieve an RPE of an unnecessary burden, the RPE would need to have knowledge of the ultimate owner's taxable income.

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A describes when taxpayers may combine QBI, W-2 wages, and UBIA from multiple businesses. It does not, however, change the fundamental concept that whether an activity rises to the level of a trade or business is tested only for the RPE and is not tested across RPEs:

- For example, if a triple-net lease does not qualify for special relief due to common ownership and would not rise to the level of a trade or business,[660] one cannot consider the fact the owners have 100 different RPEs with triple-net leases, which together add up to one big trade or business. Instead, the owners would need to have one master partnership with multiple single-member LLCs that are disregarded for income tax purposes. Presumably

---

[658] See fn 660.
[659] See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure.
[660] Part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business, text accompanying fns 810-782.

owners could have special allocations to adjust for any economic distortions of holding the various properties in one master partnership.

- Suppose the activities are conducted within one or more S corporations (which is unusual for real estate but not other activities). An S corporation could use as a subsidiary disregarded entity either an LLC or another corporation. For the latter, see part II.A.2.g Qualified Subchapter S Subsidiary (QSub). As part II.A.2.g discusses, unless there is a good state income tax or other reason, I tend to prefer single member LLC subsidiaries over QSubs.

II.E.1.c.i. What Kind of Deduction; Maximum Impact of Deduction

II.E.1.c.i.(a). Summary of Impact of Deduction

The deduction is not allowed in computing adjusted gross income[661] but also is not an itemized deduction,[662] so it is in its own category of deduction.

The deduction applies for income tax but not for net investment income tax[663] or self-employment tax[664] purposes.[665]

When calculating alternative minimum taxable income under Code § 55, qualified business income is determined without regard to any adjustments under Code §§ 56-59.[666]

Although wage income is not qualified business income,[667] in computing withholding allowances and employee may take into account the estimated deduction under Code § 199A.[668]

With a top regular income tax bracket of 37%, the deduction's maximum relief is the equivalent of a 7.4% (20% of 37%) rate reduction, reducing the effective regular income tax rate to 29.6% (37% minus 7.4%).

---

[661] Code § 62(a).
[662] Code § 63(d)(3).
[663] Net investment income tax, described in part II.I 3.8% Tax on Excess Net Investment Income (NII), is provided by Code § 1411, which is Chapter 2A.
[664] Self-employment tax, described in part II.L Self-Employment Tax (FICA), is provided by Code §§ 1401-1403, which is Chapter 2.
[665] Code § 199A(f)(3) provides:

> DEDUCTION LIMITED TO INCOME TAXES.—The deduction under subsection (a) shall only be allowed for purposes of this chapter.

Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.
Prop. Reg. § 1.199A-1(e)(2), "Self-employment tax and net investment income tax," provides:

> The deduction under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

[666] Code § 199A(f)(2). Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.
Prop. Reg. § 1.199A-1(e)(4), "Coordination with alternative minimum tax," provides:

> For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59).

[667] See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[668] Code § 3402(m)(1).

However, the rate reduction may be thought of as being somewhere between zero and 7.4%, for the following reasons:

- Each trade or business the entity runs needs to be separately subjected to the limitations described below.

- Some income does not qualify for the deduction at all, although generally business activities qualify if the taxpayer's taxable income is below certain thresholds. See parts II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction and II.E.1.c.v.(a) Taxable Income "Threshold.

- An activity that does qualify may have its deduction limited if it has insufficient wages and not enough investment to make up for insufficient wages, although this limitation does not apply if the taxpayer's taxable income is below certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds regarding those particular items and part II.E.1.c.v Calculation of Deduction Generally showing how they affect the deduction.

- Deducting a net operating loss may in some situations cause the taxpayer to lose part or all of the benefit of the Code § 199A deduction.[669]

II.E.1.c.i.(b). Other Effects of Code § 199A Deduction

When determining how much Code § 172 net operating loss is applied, the Code § 199A deduction is disallowed.[670]

Claiming the Code § 199A deduction makes the taxpayer more susceptible to the penalty for understatement of income tax.[671]

The Code § 199A deduction does not reduce income when computing the percentages of income used in calculating the individual income tax charitable deduction.[672]

It does not reduce taxable income in computing the taxable income limitation for percentage depletion under Code § 613(a) or 613A(d)(1).

The Code § 199A deduction also has some interaction with the dividends-received deduction that I have not yet tried to analyze,[673] which is unexpected in that the dividends-received

[669] See part II.E.1.c.i.(b) Other Effects of Code § 199A Deduction, fn. 670.
[670] Code § 172(d)(8). See part II.G.4.i.iii Code § 172 Net Operating Loss Deduction.
[671] Prop. Reg. § 1.199A-1(e)(5), "Imposition of accuracy-related penalty on underpayments," provides:

> For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, see section 6662(d)(1)(C).

Code § 6662(d)(1)(C) provides:

> (C) *Special Rule For Taxpayers Claiming Section 199A Deduction*. In the case of any taxpayer who claims the deduction allowed under section 199A for the taxable year, subparagraph (A) shall be applied by substituting "5 percent" for "10 percent."

[672] Code § 170(b)(2)(D)(vi).
[673] Code § 246(b)(1).

deduction applies only to corporations; presumably this applies to a specified agricultural or horticultural cooperative.[674]

II.E.1.c.ii. Types of Income and Activities Eligible or Ineligible for Deduction

II.E.1.c.ii.(a). Generally; List of Items Included in QBI

QBI means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer;"[675] see part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. It does not include any "qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income."[676] (Note that the Code § 199A separately takes into account qualified cooperative dividends in addition to QBI.)

In the case of a partnership or S corporation, each partner or shareholder takes into account such person's allocable share of each qualified item of income, gain, deduction, and loss.[677] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[678]

To be a qualified item of "income, gain, deduction, and loss," the item must be a U.S.-source item[679] and "included or allowed in determining taxable income for the taxable year."[680] Prop. Reg. § 1.199A-3(b)(2)(i) provides:

---

[674] See fn 655.

[675] Code § 199A(c)(1).

[676] Code § 199A(c)(1). Code § 199A(e)(3) provides:

> QUALIFIED REIT DIVIDEND.—The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which—
> (A) is not a capital gain dividend, as defined in section 857(b)(3), and
> (B) is not qualified dividend income, as defined in section 1(h)(11).

Code § 199A(e)(4) provides:

> QUALIFIED PUBLICLY TRADED PARTNERSHIP INCOME. The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of—
> (A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus
> (B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

[677] Code § 199A(f)(1)(A)(ii).

[678] Code § 199A(f)(1)(A) (flush language).

[679] Code § 199A(c)(3)(A)(i) requires the item to be:

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting 'qualified trade or business (within the meaning of section 199A)' for 'nonresident alien individual or a foreign corporation' or for 'a foreign corporation' each place it appears)"

I think this really just means that the individual seeking the Code § 199A deduction needs to be tested, because a literal plugging in of this language makes no sense:

> In the case of a qualified trade or business (within the meaning of section 199A) engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2),

In general. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are—

(A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

(B) Included or allowed in determining taxable income for the taxable year.

See part II.E.1.c.ix QBI and Effectively Connected Income.

Prop. Reg. § 1.199A-3(b)(1) provides:

In general. For purposes of this section, the term qualified business income (QBI) means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in paragraph (b)(2) of this section, provided the other requirements of this section and Section 199A are satisfied (including, for example, the exclusion of income not effectively connected with a United States trade or business).

(i) *Section 751 gain*. With respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI.

(ii) *Guaranteed payments for the use of capital*. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI; however, the partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(iii) *Section 481 adjustments*. Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and Section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017.

(iv) *Previously disallowed losses*. Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year

---

(3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

However, Code § 199A(f)(1)(C)(i) provides:

In General. In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

[680] Code § 199A(c)(3)(A)(ii).

are taken into account for purposes of computing QBI. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(v) *Net operating losses*. Generally, a deduction under section 172 for a net operating loss is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent that the net operating loss is disallowed under section 461(l), the net operating loss is taken into account for purposes of computing QBI.

Comments submitted October 12, 2018 by the American Bar Association's Section on Taxation asserted that Prop. Reg. § 1.199A-3(b)(1)(ii) above incorrectly takes the position that guaranteed payments for the use of capital (GPUC) are per se not QBI.[681] However, if the government changes that rule, note that, to the extent that GPUC is viewed as the equivalent of an interest payment,[682] that characterization may disallow part or all of the GPUC.[683]

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B), which is reproduced in full in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

---

[681] After making several arguments, the comments said (footnotes omitted):

> A plain reading of the statute would indicate Congress's intent to include GPUCs as QBI. There is no provision in section 199A that excludes a guaranteed payment (either for services or for the use of capital) from being a Qualified Item. Although guaranteed payments for services can be Qualified Items, they are specifically excluded from QBI under section 199A(c)(4)(B). Notably, there is no exclusion of GPUCs from QBI. This suggests that a GPUC may be QBI because a guaranteed payment may be a Qualified Item, but a guaranteed payment may not be included in QBI if it is paid with respect to services rendered by the partner to the partnership's trade or business. In fact, if all guaranteed payments failed to be Qualified Items, then section 199A(c)(4)(B) would be superfluous because QBI only includes Qualified Items. The statutory silence with respect to GPUCs could suggest that Congress had no intention to exclude GPUCs from QBI because Congress clearly contemplated guaranteed payments under section 707(c) and chose only to exclude from QBI those guaranteed payments that are made for services rendered with respect to the trade or business.
>
> On balance, there are strong arguments that a GPUC is treated as a partner's distributive share, and therefore as the payee partner's allocable share of the partnership's Qualified Items, for purposes of section 199A. We believe treating a GPUC as a Qualified Item to the extent of a partnership's Qualified Items most furthers the intent of section 199A. Therefore, we recommend that final guidance allow GPUCs under section 707(c) to be a Qualified Item and included in QBI to the extent of the partnership's Qualified Items, determined without regard to the GPUC expense.
>
> If the Final Regulations follow the Proposed Regulations and preclude GPUCs from being included in QBI, then we recommend that the Final Regulations also exclude from QBI any expense related to guaranteed payments for the use of capital. Otherwise, the existence of a GPUC arrangement would reduce (inappropriately, in our view) the section 199A benefit afforded with respect to the QBI of a partnership.

[682] See part II.I.8.d.iii Treatment of Code § 707(c) Guaranteed Payments under Code § 1411.

[683] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

"Qualified trade or business" means any trade or business other than:[684]

(A) a specified service trade or business,[685] or

(B) the trade or business of performing services as an employee.[686]

II.E.1.c.ii.(b). Trade or Business of Being an Employee (Excluded from QBI)

Code § 199A(d)(1)(B) excludes from a "qualified trade or business" the trade or business of performing services as an employee.

Prop. Reg. § 1.199A-5(a)(3), "Trade or business of performing services as an employee," provides:

> The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, loss, or deduction from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and § 1.199A-3. No taxpayer may claim a section 199A deduction for wage income, regardless of the amount of taxable income.

The preamble, REG-107892-18 (8/16/2018), provides in part V.B.:

> **B. Trade or Business of Performing Services as an Employee**
>
> Under section 199(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. Unlike an SSTB, there is no threshold amount that applies to the trade or business of performing services as an employee. Thus, wage or compensation income earned by any employee is not eligible for the Section 199A deduction no matter the amount.
>
> **1. Definition**
>
> An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the usual common law and statutory rules applicable in determining the employer-employee relationship. Guides for determining employment status are found in §§ 31.3121(d)-1, 31.3306 (i)-1, and 31.3401(c)-1. As stated in the regulations, generally, the common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the direction and control of the employer not only as to what shall be done but how it shall be done. In this connection it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

[684] Code § 199A(d)(1).
[685] See part II.E.1.c.iv Specified Service Trade or Business.
[686] See part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

In addition, the regulations and section 3401(c) state, generally, that an officer of a corporation (including an S corporation) is an employee of the corporation. However, an officer of a corporation who does not perform any services or performs only minor services in his or her capacity as officer and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. Whether an officer's services are minor is a question of fact that depends on the nature of the services, the frequency and duration of their performance, and the actual and potential importance or necessity of the services in relation to the conduct of the corporation's business. See Rev. Rul. 74-390.

To provide clarity, proposed § 1.199A-5(d) provides a general rule that income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1). If an individual derives income in the course of a trade or business that is not described in section 3401(a), § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)), or § 1.6041-2(b)(1), that individual is not considered to be in the trade or business of performing services as an employee with regard to such income.

2. Presumption for Former Employees

Section 199A provides that the trade or business of providing services as an employee is not eligible for the Section 199A deduction. Therefore, taxpayers and practitioners noted that it may be beneficial for employees to treat themselves as independent contractors or as having an equity interest in a partnership or S corporation in order to benefit from the deduction under Section 199A.

Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Public Law 96-167, section 1(a) of Public Law 96-541, and section 269(c) of Public Law 97-248, provides a prohibition against regulations and rulings on employment status for purposes of employment taxes. Specifically, section 530(b) provides that no regulation or revenue ruling shall be published before the effective date of any law clarifying the employment status of individuals for purposes of the employment taxes by the Treasury Department (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes. Section 530(c) of the Revenue Act of 1978 provides that, for purposes of section 530, the term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1954, and the term 'employment status' means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship as an employee or as an independent contractor (or other individual who is not an employee). These longstanding rules of section 530 of the Revenue Act of 1978 limit the ability of the IRS to impose employment tax liability on employers for misclassifying employees as independent contractors but do not preclude challenging a worker's status for purposes of Section 199A, an income tax provision under subtitle A of the Code.

Therefore, proposed § 1.199A-5(d)(3) provides that for purposes of Section 199A, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification. This issue is particularly important in the case of individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee. However, it would not be appropriate to provide that someone who formerly was an employee of an employer is now 'less likely' to be respected as an independent contractor. Such a rule would not treat similarly-situated taxpayers similarly: two individuals who have a similar relationship with a company and each claim to be treated as independent contractors would be treated differently depending on any prior employment history with the company. Therefore, proposed § 1.199A-5(d)(3) does not provide any new or different standards to be properly classified as an independent contractor or owner of a business. Instead, proposed § 1.199A-5(d)(3) contains a presumption that applies in certain situations to ensure that individuals properly substantiate their status.

Specifically, proposed § 1.199A-5(d)(3) provides that, solely for purposes of Section 199A(d)(1)(B) and the regulations thereunder, an individual who was treated as an employee for Federal employment tax purposes by the person to whom he or she provided services, and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that, under Federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities. This presumption is solely for purposes of Section 199A and does not otherwise change the employment tax classification of the individual. Section 199A is in subtitle A of the Code, and this rule does not apply for purposes of any other subtitle, including subtitle C. Accordingly, this rule does not implicate section 530(b) of the Revenue Act of 1978. Proposed § 1.199A-5(d)(3)(ii) contains three examples illustrating this rule.

Prop. Reg. § 1.199A-5(d), "Trade or business of performing services as an employee," provides:

(1) *In general*. The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, loss, and deduction from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and § 1.199A-3. Except as provided in paragraph (d)(3) of this section, income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1).

(2) *Employer's Federal employment tax classification of employee immaterial*. For purposes of determining whether wages are earned in a capacity as an employee as provided in paragraph (d)(1) of this section, the treatment of an employee by an employer as anything other than an employee for Federal employment tax purposes is immaterial. Thus, if a worker should be properly classified as an employee, it is of no consequence that the employee is treated as a non-employee by the employer for Federal employment tax purposes.

(3) *Presumption that former employees are still employees*.

(i) *Presumption*. Solely for purposes of section 199A(d)(1)(B) and paragraph (d)(1) of this section, an individual that was properly treated as an employee for Federal employment tax purposes by the person to which he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

(ii) *Examples*. The following examples illustrate the provision of paragraph (b)(3)(i) of this section. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

Example (1). A is employed by PRS, a partnership, as a fulltime employee and is treated as such for Federal employment tax purposes. A quits his job for PRS and enters into a contract with PRS under which A provides substantially the same services that A previously provided to PRS in A's capacity as an employee. Because A was treated as an employee for services he provided to PRS, and now is no longer treated as an employee with regard to such services, A is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to his services performed for PRS. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including the common-law employee classification rules), A is not an employee, any amounts paid by PRS to A with respect to such services will not be QBI for purposes of section 199A. The presumption would apply even if, instead of contracting directly with PRS, A formed a disregarded entity, or an S corporation, and the disregarded entity or the S corporation entered into the contract with PRS.

Example (2). C is an attorney employed as an associate in a law firm (Law Firm 1) and was treated as such for Federal employment tax purposes. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform legal services for Law Firm 1. Therefore, in form, C is now a partner in Law Firm 2 which earns income from providing legal services to Law Firm 1. C continues to provide substantially the same legal services to Law Firm 1 and its clients. Because C was previously treated as an employee for services she provided to Law Firm 1, and now is no longer treated as an employee with regard to such services, C is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services C provides to Law Firm 1 indirectly through Law Firm 2. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including common-law employee classification rules), C's distributive share of Law Firm 2 income (including any guaranteed payments) will not be QBI for purposes of section 199A. The results in this example would not change if, instead of contracting with Law Firm 1, Law Firm 2 was instead admitted as a partner in Law Firm 1.

Example (3). E is an engineer employed as a senior project engineer in an engineering firm, Engineering Firm. Engineering Firm is a partnership and structured such that after 10 years, senior project engineers are considered for partner if certain career milestones are met. After 10 years, E meets those career milestones and is admitted as a partner in Engineering Firm. As a partner in Engineering Firm, E shares in the net profits of Engineering Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner. E is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services E provides to Engineering Firm. However, E is able to rebut the presumption by showing that E became a partner in Engineering Firm as a career milestone, shares in the overall net profits in Engineering Firm, and otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

The closing parenthetical to Prop. Reg. § 1.199A-5(d)(1) refers to statutory employees under Code § 3121(d)(3) as not being in the trade or business of being an employee. Code § 3121(d)(3) is reproduced in the text preceding fn 748 in part II.E.1.c.vi.(a) W-2 Wages under Code § 199A.

II.E.1.c.ii.(c). Items Excluded from Treatment as Qualified Business Income Under Code § 199A

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B) lists those nonqualified items, originally providing:

> *Exceptions*. The following investment items shall not be taken into account as a qualified item of income, gain, deduction, or loss:
>
> (i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.
>
> (ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).[687]

[687] [My footnote – not from the statute:] Code § 954(c)(1)(G) refers to "payments in lieu of dividends which are made pursuant to an agreement to which" Code § 1058 applies. Code § 1058(b) requires an agreement to:

(1) provide for the return to the transferor of securities identical to the securities transferred;
(2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).[688]

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

The Senate report said that the statute excludes "specified investment-related income" such as "any item taken into account in determining net long-term capital gain or net long-term capital loss:"[689]

---

during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;

(3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and

(4) meet such other requirements as the Secretary may by regulation prescribe.

[688] [My footnote – not from the statute:] Code § 954(c)(1)(F)(i) provides that foreign personal holding company income" includes the portion of the gross income which consists of "net income from notional principal contracts." Code § 1221(a)(7) provides that "capital asset" does not include:

> any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)…

Code § 1221(b)(2)(a) provides that "hedging transaction" is "any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily:"

(i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,

(ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or

(iii) to manage such other risks as the Secretary may prescribe in regulations.

[689] The Senate report said:

> *Treatment of investment income*
>
> Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains

However, the Consolidated Appropriations Act, 2018 amended Code § 199A(c)(3)(B) to delete "investment," clarifying that an item does not have to be derived from an "investment" to be excluded from QBI.

Code § 199A(c)(4) provides that QBI does not include:

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

The Senate report made it apparent that subparagraph (A) was aimed at reasonable compensation paid by an S corporation. Thus, the reasonable compensation exception means that wages paid to an owner-employee of an S corporation are not themselves QBI. See also part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI). However, those wages would increase the QBI-related deduction to the extent that the wage limitation is a concern.[690]

The preamble, REG-107892-18 (8/16/2018), provides:

> **vii. Exclusion from QBI for certain items**
>
> **a. Treatment of section 1231 gains and losses**
>
> Section 199A(c)(3)(B)(i) provides that QBI does not include any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss. The Treasury Department and the IRS have received comments requesting guidance on the extent to which gains and losses subject to section 1231 may be taken into account in calculating QBI. Section 1231 provides rules under which gains and losses from certain involuntary conversions and the sale of certain property used in a trade or business are either treated as long-term capital gains or long-term capital losses, or not treated as gains and losses from sales or exchanges of capital assets.
>
> Section 199A(c)(3)(B)(i) excludes capital gains or losses, regardless of whether those items arise from the sale or exchange of a capital asset. The legislative history of Section 199A provides that QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss. Conference Report page 30. Accordingly, proposed § 1.199A-3(b)(2)(ii)(A) clarifies that, to the extent gain

over foreign currency losses from section 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (*i.e.*, not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not include any item of deduction or loss properly allocable to such income.

690 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, the impact of which may be reduced or eliminated under part II.E.1.c.v.(a) Taxable Income "Threshold.

or loss is treated as capital gain or loss, it is not included in QBI. Specifically, if gain or loss is treated as capital gain or loss under section 1231, it is not QBI. Conversely, if section 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, Section 199A(c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met).

b. Interest Income.

Section 199A(c)(4)(C) provides that QBI does not include any interest income other than interest income that is properly allocable to a trade or business. The Treasury Department and the IRS believe that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, and therefore should not be included in QBI, because such interest income, although held by a trade or business, is simply income from assets held for investment. Accordingly, proposed § 1.199A-3(b)(2)(ii)(C) provides that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business. In contrast, interest income received on accounts or notes receivable for services or goods provided by the trade or business is not income from assets held for investment, but income received on assets acquired in the ordinary course of trade or business.

c. Reasonable compensation

Section 199A(c)(4)(A) provides that QBI does not include “reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business.” Similarly, guaranteed payments for services under section 707(c) are excluded from QBI. The phrase “reasonable compensation” is a well-known standard in the context of S corporations. Under Rev. Rul. 74-44, 1974-1 C.B. 287, S corporations must pay shareholder-employees “reasonable compensation for services performed” prior to making “dividend” distributions with respect to shareholder-employees’ stock in the S corporation under section 1368. See also *David E. Watson, P.C. v. United States*, 668 F.3d 1008, 1017 (8^{th} Cir. 2012). The legislative history of Section 199A confirms that the reasonable compensation rule was intended to apply to S corporations.

The Treasury Department and the IRS have received requests for guidance on whether the phrase “reasonable compensation” within the meaning of Section 199A extends beyond the context of S corporations for purposes of Section 199A. The Treasury Department and the IRS believe “reasonable compensation” is best read as limited to the context from which it derives: compensation of S corporation shareholders-employees. If reasonable compensation were to apply outside of the context of S corporations, a partnership could be required to apply the concept of reasonable compensation to its partners, regardless of whether amounts paid to partners were guaranteed. Such a result would violate the principle set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership cannot be an employee of that partnership. There is no indication that Congress intended to change this long-standing Federal income tax principle. Accordingly, proposed § 1.199A-3(b)(2)(ii)(H) provides that QBI does not include reasonable compensation paid by an S corporation but does not extend this rule to partnerships. Because the trade or business of performing services as an employee is not a qualified trade or business under Section 199A(d)(1)(B), wage income received by an employee is never QBI. The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI.

d. Guaranteed payments

Section 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in section 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed § 1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners. Section 199A(c)(4)(B) does not limit the term "partner" to an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be an RPE. Accordingly, proposed § 1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

e. Section 707(a) payments

Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of Section 199A, payments under section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier RPE receives a section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, proposed § 1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. The Treasury Department and the IRS request comments on whether there are situations in which it is appropriate to include section 707(a) payments in QBI.

Prop. Reg. § 1.199A-3(b)(2)(ii), "Items not taken into account," provides:

Notwithstanding paragraph (b)(2)(i) of this section and in accordance with Section 199A(c)(3)(B), the following items are not taken into account as a qualified item of income, gain, deduction, or loss:

(A) Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, including any item treated as one of such items, such as gains or losses under section 1231 which are treated as capital gains or losses.

(B) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) is not treated as described in this clause.

(C) Any interest income other than interest income which is properly allocable to a trade or business. For purposes of Section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

(D) Any item of gain or loss described in section 954(c)(1)(C) (transactions in commodities) or section 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting "trade or business" for "controlled foreign corporation."

(E) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (income from notional principal contracts) determined without regard to section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7).

(F) Any amount received from an annuity which is not received in connection with the trade or business.

(G) Any qualified REIT dividends as defined in paragraph (c)(2) of this section or qualified PTP income as defined in paragraph (c)(3) of this section.

(H) Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(I) Any guaranteed payment described in section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(J) Any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

My best guess is that the exclusion of Code § 707(a) and (c) payments from QBI was intended to prevent the service provider from attributing the partnership's QBI to any Code § 707(a) or (c) payment. If the service provider is in the trade or business of providing those services, the Code § 707(a) or (c) payment may be QBI as to that trade or business. Presumably, holding a small partnership interest in a service recipient should not disqualify a person in the trade or business of supplying such services to many businesses. For example, a company manages many properties for their owners. Management fees would be QBI. However, if the company becomes a partner in a landlord partnership, then the management fees would be payments under Code § 707(a) if an independent contractor relationship or under Code § 707(c) is provided as a partner. To me, becoming a partner should disqualify the management fees from being QBI as relates to the landlord's trade or business status but should not disqualify them as to the management company's own status. Unfortunately, Prop. Reg. § 1.199A-3(b)(2)(ii)(I) provides no relief from the Code § 707(a) or (c) disallowance.

Instead of making Code § 707(c) guaranteed payments to service partners, consider granting them a preferred profits interest. See part II.M.4.f Issuing a Profits Interest to a Service Provider. Consider whether doing so would, from a financial viewpoint, be relatively safe or relative risky for the service partners.

For details on the references Code § 707(a) and (c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.E.1.c.iii. "Trade or Business" for Code § 199A

How do we delineate what is a "trade or business" to which we apply these rules?

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A allows taxpayers to count as part of a trade or business activities that might not otherwise qualify under part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

Segregating gross receipts from one trade or business from another may be critically important if any significant portion of the gross receipts is from a Specified Service Trade or Business (SSTB). See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

II.E.1.c.iii.(a). General Standards for "Trade or Business" for Code § 199A

Prop. Reg. § 1.199A-1(b)(13) provides:[691]

> Trade or business means a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A explains Prop. Reg. § 1.199A-4.

The preamble to Prop. Reg. § 1.199A-1, REG-107892-18 (8/16/2018), explains the general definition:

> Proposed § 1.199A-1(b) also defines trade or business for purposes of Section 199A and proposed §§ 1.199A-1 through 1.199A-6. Neither the statutory text of Section 199A

[691] The second sentence is referred to in Prop. Reg. § 1.199A-4(d), Examples (8) and (9), reproduced in full in the text before and after fn 709 in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A.

nor the legislative history provides a definition of trade or business for purposes of Section 199A. Multiple commenters stated that section 162 is the most appropriate definition for purposes of Section 199A. Although the term trade or business is defined in more than one provision of the Code, the Department of the Treasury (Treasury Department) and the IRS agree with commenters that for purposes of Section 199A, section 162(a) provides the most appropriate definition of a trade or business. This is based on the fact that the definition of trade or business under section 162 is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries. Thus, the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of Section 199A and which taxpayers have experience applying and therefore defining trade or business as a section 162 trade or business will reduce compliance costs, burden, and administrative complexity.

The proposed regulations extend the definition of trade or business for purposes of Section 199A beyond section 162 in one circumstance. Solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). It is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental property from operating businesses. This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property under proposed § 1.199A-4 if all of the requirements of proposed § 1.199A-4 are met. In addition, this rule may prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income that is eligible for a Section 199A deduction.

II.E.1.c.iii.(b). Aggregating Activities for Code § 199A

This part II.E.1.c.ii.(b) describes optional aggregation that allows taxpayers to combine wages and UBIA from separate (but related in some manner) businesses. However, each RPE separately determines whether its activity qualifies as a trade or business. Owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[692]

Although these rules are optional, parts II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount and II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction show how aggregation is beneficial in most cases. Whether or not a taxpayers aggregates, real estate rented to a commonly controlled business also receives relief; see part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.[693]

In contrast to optional aggregation under this part II.E.1.c.ii.(b), part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules shows how businesses closely tied to a specified service trade or business (SSTB) may lose part or all of their QBI solely because of that connection.

[692] See text accompanying fn 660, which also mentions the possibility of using QSubs when the master RPE is an S corporation.
[693] Especially the text accompanying fns 810-812.

The preamble to Prop. Reg. § 1.199A-4, REG-107892-18 (8/16/2018), explains optional aggregation:

IV. Proposed § 1.199A-4: Aggregation Rules

A. Overview

The proposed regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of Section 199A. A taxpayer can have more than one trade or business for purposes of section 162. See § 1.446-1(d)(1). However, in most cases, a trade or business cannot be conducted through more than one entity.

The Treasury Department and the IRS have received comments requesting that the regulations provide that taxpayers be permitted to group or "aggregate" trades or businesses under Section 199A using the grouping rules described in § 1.469-4 (grouping rules). Section 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. Section 469 uses the term "activities" in determining the application of the limitation rules under section 469. In contrast, Section 199A applies to trades or businesses. By focusing on activity, the grouping rules may be both under and over inclusive in determining what activities give rise to a trade or business for Section 199A purposes.

Additionally, section 469 is a loss limitation rule used to prevent taxpayers from sheltering passive losses with nonpassive income. The Section 199A deduction is not based on the level of a taxpayer's involvement in the trade or business (that is, both active and passive owners of a trade or business may be entitled to a Section 199A deduction if they otherwise satisfy the requirements of Section 199A and these proposed regulations). Complicating matters further, a taxpayer's section 469 groupings may include specified service trades or businesses, requiring separate rules to segregate the two categories of trades or businesses to calculate the Section 199A deduction.

Therefore, the grouping rules under section 469 are not appropriate for determining a trade or business for Section 199A purposes. Accordingly, the Treasury Department and the IRS are not adopting the section 469 grouping rules as the means by which taxpayers can aggregate trades or businesses for purposes of applying Section 199A.

Although it is not appropriate to apply the grouping rules under section 469 to Section 199A, the Treasury Department and the IRS agree with practitioners that some amount of aggregation should be permitted. It is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. Trades or businesses may be structured this way for various legal, economic, or other non-tax reasons. The fact that businesses are operated across entities raises the question of whether, in defining trade or business for purposes of Section 199A, section 162 trades or businesses should be permitted or required to be aggregated or disaggregated, and if so, whether such aggregation or disaggregation should occur at the entity level or the individual level. Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under Section 199A. If such aggregation is not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. Therefore, proposed § 1.199A-4 permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

The Treasury Department and the IRS are aware that many commenters were concerned with having multiple regimes for grouping (that is, under sections 199A, 1411, and 469). Accordingly, comments are requested on the aggregation method described in proposed § 1.199A-4, including whether this would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to Section 199A.

B. Aggregation rules

Under proposed § 1.199A-4, aggregation is permitted but is not required. However, an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in proposed § 1.199A-4(b)(1) are satisfied. First, consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in § 1.199A-1(b)(13).

Second, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Proposed § 1.199A-4(b)(3) provides rules allowing for family attribution. Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate. The Treasury Department and the IRS considered certain reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest. Due to the complexity and potential burden on taxpayers of such an approach, proposed § 1.199A-4 does not provide such a reporting requirement. The Treasury Department and the IRS request comments on whether a reporting or other information sharing requirement should be required.

Third, none of the aggregated trades or businesses can be an SSTB. Proposed § 1.199A-5 addresses SSTBs and trades or businesses with SSTB income.

Fourth, individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

C. Individuals

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through RPEs. Individual owners of the same RPEs are not required to aggregate in the same manner.

An individual directly engaged in a trade or business must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual has aggregated two or more trades or businesses, then the combined QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses is used for purposes of applying the W-2 wage and UBIA of qualified property limitations described in proposed § 1.199A-1(d)(2)(iv).

D. RPEs

RPEs must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business. An RPE must provide its owners with information regarding QBI, W-2 wages, and UBIA of qualified property attributable to its trades or businesses.

The Treasury Department and the IRS considered permitting aggregation by an RPE in a tiered structure. The Treasury Department and the IRS considered several approaches to tiered structures, including permitting only the operating entity to aggregate the trades or businesses or permitting each tier to add to the aggregated trade or business from a lower-tier, provided that the combined aggregated trade or business otherwise satisfied the requirements of proposed § 1.199A-4(b)(1) had the businesses all been owned by the lower-tier entity. The Treasury Department and the IRS are concerned that the reporting requirements needed for either of these rules would be overly complex for both taxpayers and the IRS to administer. In addition, because the Section 199A deduction is in all cases taken at the individual level, it should not be detrimental, and in fact may provide flexibility to taxpayers, to provide for aggregation at only one level. The Treasury Department and the IRS request comments on the proposed approach to tiered structures and the reporting necessary to allow an individual to demonstrate to which trades or businesses his or her QBI, W-2 wages, and UBIA of qualified property are attributable for purposes of calculating his or her Section 199A deduction.

E. Reporting and consistency

Proposed § 1.199A-4(c)(1) requires that once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years. Proposed § 1.199A-4(c)(1) provides rules for situations in which the aggregation rules are no longer met as well as rules for when a newly created or acquired trade or business can be added to an existing aggregated group.

Proposed § 1.199A-4(c)(2)(i) provides reporting and disclosure requirements for individuals that choose to aggregate, including identifying information about each trade or business that constitutes a part of the aggregated trade or business. Proposed § 1.199A-4(c)(2)(ii) allows the Commissioner to disaggregate trades or businesses if an individual fails to make the required aggregation disclosure. The Treasury Department and the IRS request comments as to whether it is administrable to create a standard under which trades or businesses will be disaggregated by the Commissioner and what that standard might be.

Prop. Reg. § 1.199A-4(a), "Scope and purpose, provides:[694]

> An individual or Relevant Passthrough Entity (RPE) may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). This section sets forth rules to allow individuals to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). Trades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers is not required.

Prop. Reg. § 1.199A-4 applies to taxable years ending after the date the Treasury decision adopting it as a final regulation is published in the Federal Register, but taxpayers may rely on it until the date the Treasury decision adopting it as final regulations is published in the Federal Register.[695]

Prop. Reg. § 1.199A-4(b)(1), "General rule," provides that, except as provided in Prop. Reg. § 1.199A-4(b)(3) (family attribution), trades or businesses may be aggregated only if an individual can demonstrate that-

> (i) The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;
>
> (ii) The ownership described in paragraph (b)(1)(i) of this section exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income;
>
> (iii) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;
>
> (iv) None of the trades or businesses to be aggregated is a specified service trade or business (SSTB) as defined in § 1.199A-5; and

[694] The reference to Prop. Reg. § 1.199A-1(d)(2)(iv) is to part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, with Prop. Reg. § 1.199A-1(d)(2)(iv)(A) reproduced in fn 740 in that part.

[695] Prop. Reg. § 1.199A-4(e)(1), which is expressly subject to Prop. Reg. § 1.199A-4(e)(2), "Exception for non-calendar year RPE," which provides:

> For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

(v) The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

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

(B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

(C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

These aggregation rules are very different than the passive loss rules under parts II.K.1.b Grouping Activities, II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional.

[Below are references to Examples in Prop. Reg. § 1.199A-4(d). Each Example is bookmarked so that users of the full set of materials can click on it and go to the Example.]

As to the Prop. Reg. § 1.199A-4(b)(1)(i) ownership requirement:

- It allows partnerships and S corporations to be aggregated (which is often important for real estate, which often is held by a partnership that leases it to an S corporation).[696] Prop. Reg. § 1.199A-4(d), Example (3) provides, "W owns more than 50% of the stock of S1 and more than 50% of the capital and profits of PRS thereby satisfying paragraph (b)(1)(i) of this section." Example (8) concludes, "G owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section."

- Example (5), allowing a 10% owner to aggregate when another person owned more than 50%, implements the statement from the preamble above, "Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate." So does Example (10), allowing 5% and 10% owners to aggregate.

- Example (9) shows that family attribution under Reg. § 1.199A-4(b)(3) can allow an owner to satisfy Prop. Reg. § 1.199A-4(b)(1)(i).[697]

Only passthrough activity can be aggregated. Prop. Reg. § 1.199A-4(d), Example (11).

Regarding the Prop. Reg. § 1.199A-4(b)(1)(v)(B) requirement that "the trades or businesses share facilities or share significant centralized business elements, such as personnel,

---

[696] In part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business, fn 810 refers back to these Examples. That part demonstrates that real estate might not qualify as a trade or business and mentions that leasing it to a business under common control under Prop. Reg. § 1.199A-4(b)(1)(i) can allow the rental to be eligible for the Code § 199A deduction.
[697] Reg. § 1.199A-4(b)(3) is reproduced in the text accompanying fn 700.

accounting, legal, manufacturing, purchasing, human resources, or information technology resources":

- Prop. Reg. § 1.199A-4(d), Example (1) states that subparagraph (B) was satisfied when two businesses, a catering business and a restaurant, "share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting."[698]

- In Example (3), the 75% owner of two businesses manages the businesses, but the Example states that does not satisfy subparagraph (B).

- In Example (4), "A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses." The analysis concludes that subparagraph (B) is satisfied "because the businesses share accounting and human resource functions." The analysis implicitly seems to suggest that having a team of executives overseeing operations and controlling policy decisions adds little or no weight to analyzing how subparagraph (B) operates but rather places great weight on common accounting and human resource functions.

- In Example (6), two businesses share "centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business." The Example analysis concludes that subparagraph (B) is satisfied "because of their centralized purchasing and accounting offices."

- Example (7) has the same facts as Example (6), but the businesses "do not have centralized purchasing or accounting functions." Its analysis concludes that taking away these centralized functions prevents subparagraph (B) from being satisfied.

- In Example (8), sharing "common advertising and management" appears to satisfy subparagraph (B) because they are viewed as sharing "significant centralized business elements."

- In Example (10), a 5% owner of various restaurants, G, "is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies." The Example's analysis concludes, "paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies."

- Example (14) states that subparagraph (B) is satisfied when the businesses "have a centralized human resources department, payroll, and accounting department."

---

[698] Facts included the following, with A being the common sole owner:

> The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

For what is an SSTB violating the Prop. Reg. § 1.199A-4(b)(1)(iv) prohibition against aggregating SSTBs,[699] see part II.E.1.c.iv Specified Service Trade or Business.

Reg. § 1.199A-4(b)(3), "Family attribution," provides that, for purposes of determining ownership under Reg. § 1.199A-4(b)(1)(i),[700] an individual is considered as owning the interest in each trade or business owned, directly or indirectly, by or for-

> (i) The individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
>
> (ii) The individual's children, grandchildren, and parents.

If an individual aggregates multiple trades or businesses under Prop. Reg. § 1.199A-4(b)(1), the individual must combine the QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 wage and unadjusted basis immediately after acquisition (UBIA) of qualified property limitations described in Prop. Reg. § 1.199A-1(d)(2)(iv).[701] Otherwise, however, an individual may aggregate trades or businesses operated directly and the individual's share of QBI, W-2 wages, and UBIA of qualified property from trades or businesses operated through RPEs.[702] Multiple owners of an RPE need not aggregate in the same manner.[703] For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the Prop. Reg. § 1.199A-4 aggregation rules.[704]

Prop. Reg. § 1.199A-4(c)(1) provides consistency rules:

> Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. However, an individual may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a change in facts and circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the individual must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any).

For each taxable year, individuals (including trusts)[705] must attach a statement to their returns identifying each trade or business aggregated under Reg. § 1.199A-4(b)(1).[706] If an individual

---

699 Prop. Reg. § 1.199A-4(d), Example (10) implicitly assumes that restaurants owned in part and run to a large degree by an executive chef are not SSTBs.
700 For an example of this interaction see the text accompanying fn 697, referring to Prop. Reg. § 1.199A-4(d), Example (9).
701 Reg. § 1.199A-4(b)(2).
702 Reg. § 1.199A-4(b)(2).
703 Reg. § 1.199A-4(b)(2).
704 Reg. § 1.199A-4(b)(2).
705 Reg. § 1.199A-1(a)(2), "Usage of term individual," provides:

fails to attach the required statement, the IRS may disaggregate the individual's trades or businesses.[707]

Prop. Reg. § 1.199A-4(d) provides the examples listed in the rest of this part II.E.1.c.iii.(b), all of which include particular assumptions.[708]

Prop. Reg. § 1.199A-4(d), Example (1) provides:

(i) *Facts*. A wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

(ii) *Analysis*. Because the restaurant and catering business are held in disregarded entities, A will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, A satisfies the following factors: (1) paragraph (b)(1)(v)(A) is met as both businesses offer prepared food to customers; and (2) paragraph (b)(1)(v)(B) of this section is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Having satisfied paragraph (b)(1)(i)-(v) of this section, A may treat the catering business and the restaurant as a single trade or business for purposes of applying § 199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (2) provides:

(i) *Facts*. Assume the same facts as in Example 1, but the catering and restaurant businesses are owned in separate partnerships and A, B, C, and D each own a 25%

For purposes of applying the rules of §§ 1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A deduction is determined by the trust or estate under the rules of § 1.199A-6.

[706] Prop. Reg. § 1.199A-4(c)(2)(i), "Required annual disclosure," requires the statement to contain:

(A) A description of each trade or business;
(B) The name and EIN of each entity in which a trade or business is operated;
(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
(D) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

[707] Prop. Reg. § 1.199A-4(c)(2)(ii).

[708] Prop. Reg. § 1.199A-4(d) provides:

The following examples illustrate the principles of this section. For purposes of these examples, assume the taxpayer is a United States citizen, all individuals and RPEs use a calendar taxable year, there are no ownership changes during the taxable year, all trades or businesses satisfy the requirements under section 162, all tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c), and none of the trades or businesses is an SSTB within the meaning of § 1.199A-5. Except as otherwise specified, a single letter denotes an individual taxpayer.

interest in the capital and profits of each of the two partnerships. A, B, C, and D are unrelated.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section A, B, C, and D together own more than 50% of the capital and profits in each of the two partnerships, they may each treat the catering business and the restaurant as a single trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (3) provides:

(i) *Facts*. W owns a 75% interest in S1, an S corporation, and a 75% interest in the capital and profits of PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. W manages S1 and PRS.

(ii) *Analysis*. W owns more than 50% of the stock of S1 and more than 50% of the capital and profits of PRS thereby satisfying paragraph (b)(1)(i) of this section. Although W manages both S1 and PRS, W is not able to satisfy the requirements of paragraph (b)(1)(v) of this section as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. W must treat S1 and PRS as separate trades or businesses for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (4) provides:

(i) *Facts*. E owns a 60% interest in the capital and profits of each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses. E reports PRS1, PRS3, and PRS4 as an aggregated trade or business under paragraph (b)(1) of this section and reports PRS2 as a separate trade or business. Only PRS2 generates a net taxable loss.

(ii) *Analysis*. E owns more than 50% of the capital and profits of each partnership thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the following factors are satisfied: (1) paragraph (b)(1)(v)(A) of this section because each partnership operates a hardware store; and (2) paragraph (b)(1)(v)(B) of this section because the businesses share accounting and human resource functions. E's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business for purposes of applying § 1.199A-1(d) is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3 and PRS4 pursuant to § 1.199A-1(d)(2)(iii).

Prop. Reg. § 1.199A-4(d), Example (5) provides:

(i) *Facts*. Assume the same facts as Example 4, and that F owns a 10% interest in the capital and profits of PRS1, PRS2, PRS3, and PRS4.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section E owns more than 50% of the capital and profits in the four partnerships, F may aggregate PRS 1, PRS2, PRS3, and PRS4 as a single trade or business for purposes of applying § 1.199A-1(d), provided that F can demonstrate that the ownership test is met by E.

Prop. Reg. § 1.199A-4(d), Example (6) provides:

(i) *Facts*. D owns 75% of the stock of S1, S2, and S3, each of which is an S corporation. Each S corporation operates a grocery store in a separate state. S1 and S2 share centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. S3 is operated independently from the other businesses.

(ii) *Analysis*. D owns more than 50% of the stock of each S corporation thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the grocery stores satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only S1 and S2 satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. D is only able to show that the requirements of paragraph (b)(1)(v)(B) of this section are satisfied for S1 and S2; therefore, D only may aggregate S1 and S2 into a single trade or business for purposes of § 1.199A-1(d). D must report S3 as a separate trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (7) provides:

(i) *Facts*. Assume the same facts as Example 6 except each store is independently operated and S1 and S2 do not have centralized purchasing or accounting functions.

(ii) *Analysis*. Although the stores provide the same products and services within the meaning of paragraph (b)(1)(v)(A) of this section, D cannot show that another factor under paragraph (b)(1)(v) of this section is present. Therefore, D must report S1, S2, and S3 as separate trades or businesses for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (8) provides:

(i) *Facts*. G owns 80% of the stock in S1, an S corporation and 80% of the capital and profits in LLC1 and LLC2, each of which is a partnership for Federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. The entities share common advertising and management.

(ii) *Analysis*. G owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section. LLC1, LLC2, and S1 share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group. G can treat the business operations of LLC1 and LLC2 as a single trade or business for purposes of applying § 1.199A-1(d). S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(13) and meets the requirements of paragraph (b)(1) of this section.

Example (8) above and Example (9) below refer to Prop. Reg. § 1.199A-1(b)(13), which provides in part:[709]

> … rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

Prop. Reg. § 1.199A-4(d), Example (9) provides:

> (i) *Facts*. Same facts as Example 8, except G owns 80% of the stock in S1 and 20% of the capital and profits in each of LLC1 and LLC2. B, G's son, owns a majority interest in LLC2, and M, G's mother, owns a majority interest in LLC1. B does not own an interest in S1 or LLC1, and M does not own an interest in S1 or LLC2.
>
> (ii) *Analysis*. Under the rules in paragraph (b)(3) of this section, B and M's interest in LLC2 and LLC1, respectively, are attributable to G and G is treated as owning a majority interest in LLC2 and LLC; G thus satisfies paragraph (b)(1)(i) of this section. G may aggregate his interests in LLC1, LLC2, and S1 as a single trade or business for purposes of applying § 1.199A-1(d). Under paragraph (b)(3) of this section, S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(13) and meets the requirements of paragraph (b)(1) of this section.

Prop. Reg. § 1.199A-4(d), Example (10) provides:

> (i) *Facts*. F owns a 75% interest and G owns a 5% interest in the capital and profits of five partnerships (PRS1-PRS5). H owns a 10% interest in the capital and profits of PRS1 and PRS2. Each partnership operates a restaurant and each restaurant separately constitutes a trade or business for purposes of section 162. G is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.
>
> (ii) *Analysis*. F owns more than 50% of capital and profits in the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business, and paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies. F can show the requirements under paragraph (b)(1) of this section are satisfied as to all of the restaurants. Because F owns a majority interest in each of the partnerships, G can demonstrate that paragraph (b)(1)(i) of this section is satisfied G can also aggregate all five restaurants into a single trade or business for purposes of applying § 1.199A-1(d). H, however, only owns an interest in PRS1 and PRS2. Like G, H satisfies Paragraph (b)(1)(i) of this section because F owns a majority interest. H can,

[709] Reg. § 1.199A-1(b)(13) is reproduced in full in fn 691 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

therefore, aggregate PRS1 and PRS2 into a single trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (11) provides:

(i) *Facts*. H, J, K, and L own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S corporation. H, J, K and L also own interests in C, an entity taxable as a C corporation. H owns 30%, J owns 20%, K owns 5%, L owns 45% of each of the five entities. All of the entities satisfy 2 of the 3 factors under paragraph (b)(1)(v) of this section. For purposes of Section 199A the taxpayers report the following aggregated trades or businesses: H aggregates PRS1 and S1 together and aggregates PRS2 and S2 together; J aggregates PRS1, S1 and S2 together and reports PRS2 separately; K aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and L aggregates S1, S2, and PRS2 together and reports PRS1 separately. C cannot be aggregated.

(ii) *Analysis*. Under paragraph (b)(1)(i) of this section, because H, J, and K together own a majority interest in PRS1, PRS2, S1, and S2, H, J, K, and L are permitted to aggregate under paragraph (b)(1). Further, the aggregations reported by the taxpayers are permitted, but not required for each of H, J, K, and L. C's income is not eligible for the Section 199A deduction and it cannot be aggregated for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (12) provides:

(i) *Facts*. L owns 60% of the profits and capital interests in PRS1, a partnership, a business that sells non-food items to grocery stores. L also owns 55% of the profits and capital interests in PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1.

(ii) *Analysis*. L is able to meet (b)(1)(i) as the majority owner of PRS1 and PRS2. Under paragraph (b)(1)(v) of this section, L is only able to show the operations of PRS1 and PRS2 are operated in reliance of one another under paragraph (b)(1)(v)(C) of this section. For purposes of applying § 1.199A-1(d), L must treat PRS1 and PRS2 as separate trades or businesses.

Example (12)'s point is that satisfying only one of the three factors in Prop. Reg. § 1.199A-4(b)(1)(v) is not enough.

Prop. Reg. § 1.199A-4(d), Example (13) provides:

(i) *Facts*. C owns a majority interest in a sailboat racing team and also owns an interest in PRS1 which operates a marina. PRS1 is a trade or business under section 162, but the sailboat racing team is not a trade or business within the meaning of section 162.

(ii) *Analysis*. C has only one trade or business for purposes of Section 199A and, therefore, cannot aggregate the interest in the racing team with PRS1 under paragraph (b)(1) of this section.

Contrast Example (13) with Examples (8) and (9) above, which referred to Reg. § 1.199A-1(b)(13), which allows rental activity that does not rise to the level of trade or business to be treated as a trade or business.[710] The sailboat racing team is not a trade or business in the facts of Example (13), and Example (13) implicitly assume it is not tangible or intangible property rented or licensed to the marina.

Prop. Reg. § 1.199A-4(d), Example (14) provides:

> (i) *Facts*. Trust wholly owns LLC1, LLC2, and LLC3. LLC1 operates a trucking company that delivers lumber and other supplies sold by LLC2. LLC2 operates a lumber yard and supplies LLC3 with building materials. LLC3 operates a construction business. LLC1, LLC2, and LLC3 have a centralized human resources department, payroll, and accounting department.
>
> (ii) *Analysis*. Because Trust owns 100% of the interests in LLC1, LLC2, and LLC3, Trust satisfies paragraph (b)(1)(i) of this section. Trust can also show that it satisfies paragraph (b)(1)(v)(B) of this section as the trades or businesses have a centralized human resources department, payroll, and accounting department. Trust also can show is meets paragraph (b)(1)(v)(C) of this section as the trades or businesses are operated in coordination, or reliance upon, one or more in the aggregated group. Trust can aggregate LLC1, LLC2, and LLC3 for purposes of applying § 1.199A-1(d).

II.E.1.c.iii.(c). "Trade or Business" in Other Areas of Tax Law

Neither the statute nor the legislative history explain what is a "trade or business." Here are some resources that may help, to the extent that regulations do not provide guidance:

- Part II.G.4.i.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit would be the most important source.

- What is a "trade or business" is important regarding particular issues for the Code § 1411 3.8% tax on net investment income ("NII"), which is tied to the Code § 469 passive activity loss ("PAL") rules. When reviewing the resources below, keep in mind that (a) being passive tends to be bad for taxpayers in the context of the NII and PAL rules but is irrelevant for Code § 199A, and (b) real estate has special rules regarding its character as passive, which again is irrelevant for Code § 199A:

    - The government received and responded to comments on what is a "trade or business" when working on regulations for the net investment income. See:

        - Part II.I.8.a General Application of 3.8% Tax to Business Income, fns 1939-1948, and

        - Part II.I.8.c.iii Rental as a Trade or Business, fns 2002-2012.

    - In the PAL rules:

[710] See text accompanying fn 709.

- What is a trade or business has received some attention in the real estate professional exception, but most of that tends to be whether the trade or business qualifies as a real estate trade or business. Although I don't view those as particularly instructive as to what is a trade or business, here is the discussion so you can see for yourself: Part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.

- Part II.K.1.f Royalty as a Trade or Business may have some application.

- Because what is a "trade or business" is so driven by facts and circumstances and one needs to delineate among separate trades or businesses in applying Code § 199A, one wonders whether the government might provide some guidance. The PAL rules provide guidance that one might speculate the government might consider adopting, rather than creating a whole new set of rules. The PAL rules allow taxpayers to group activities, with a general grouping rule and a rule specific to real estate professionals. See parts II.K.1.b Grouping Activities and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional. The net investment income tax rules were required to refer to the PAL rules, so they also adopted those grouping rules, but allowed taxpayers to regroup when first subject to the NII tax. See part II.I.8.a.ii Passive Activity Grouping Rules.

- Self-employment tax is imposed only on activity that is a trade or business. See:

  - Part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, fns 2818-2821.

  - Part II.L.2.a.ii Rental Exception to SE Tax and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, keeping in mind that the rental exception excludes certain trades or businesses for self-employment tax purposes. Part II.L.2.a.ii also discusses that generally equipment rental is a trade or business, in contrast to real estate, which needs more activity to rise to the level of a trade or business.

- A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.[711]

The last bullet point, focusing of accounting methods, might be a paradigm if the government does not base the separation of businesses on passive loss rules. Reg. § 1.446-1(d), "Taxpayer engaged in more than one business," provides:

> (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection

[711] Code § 446(d). Thus, a single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business; see CCA 201430013 (see fn 306 in part II.B Limited Liability Company (LLC)).

with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

II.E.1.c.iv. Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds

II.E.1.c.iv.(a). Introduction to Specified Service Trade or Business (SSTB)

Prop. Reg. § 1.199A-5(a)(2), "Effect of being an SSTB," provides:

> If a trade or business is an SSTB, no QBI, W-2 wages, or UBIA of qualified property from the SSTB may be taken into account by any individual whose taxable income exceeds the phase-in range as defined in § 1.199A-1(b)(3), even if the item is derived from an activity that is not itself a specified service activity. If a trade or business conducted by a relevant passthrough entity (RPE) is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity. However, the SSTB limitation does not apply to individuals with taxable income below the threshold amount as defined in § 1.199A-1(b)(11). A phase-in rule, provided in § 1.199A-1(d)(2), applies to individuals with taxable income within the phase-in range, allowing them to take into account a certain "applicable percentage" of QBI, W-2 wages, and UBIA of qualified property from an SSTB. A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of section 199A and this section, regardless of whether the owner is passive or participated in the specified service activity.

A "specified service trade or business" is any trade or business other than (A) certain businesses listed in Code § 1202(e)(3)(A) that do not qualify for the Code § 1202 exclusion from capital gain on the sale of C corporation stock, or (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).[712]

Code § 1202(e)(3)(A), which is discussed in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, fns. 4358-4359, lists as a "specified service trade or business" (SSTB) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts,

---

[712] Code § 199A(d)(2).

consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. However, Code § 199A(d)(2)(A) specifically excludes engineering and architecture from this blacklist, so that those professions do qualify for QBI treatment. Also, Code § 199A(d)(2)(A) specifically looks to the work of not only employees but also owners.

This blacklisting of a specified service trade or business is relaxed or does not apply if taxable income is below certain thresholds.[713] See part II.E.1.c.v.(a) Taxable Income "Threshold.

Getting into details:

Prop. Reg. § 1.199A-5(e) provides the effective date of the Prop. Reg. § 1.199A-5 (described below), regarding SSTBs and the trade or business of being an employee:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraphs (c)(2), (c)(3), and (d)(3) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The preamble, REG-107892-18 (8/16/2018), provides:

V. Proposed § 1.199A-5: Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the Section 199A deduction for QBI. Section 199A(d)(1) provides that a "qualified trade or business" means any trade or business other than (A) an SSTB, or (B) the trade or business of performing services as an employee.

A. SSTB

This part V.A. explains the provisions under proposed § 1.199A-5 relating to SSTBs. First, the effect of classification as an SSTB is discussed. Second, the exceptions for

[713] Code § 199A(d)(3).

taxpayers below the threshold amount and a de minimis exception are described. Third, guidance is provided on the meaning of the activities listed in the definition of SSTB. Fourth, the rules for determining whether a trade or business is treated as part of an SSTB are described. Finally, rules regarding classification as an employee for purposes of Section 199A are discussed.

1. Effect of being an SSTB

a. General Rule

Consistent with Section 199A, proposed § 1.199A-5(a)(2) provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI. In the case of an SSTB conducted by an entity, such as a partnership or an S corporation, if it is determined that the trade or business is an SSTB, none of the income from that trade or business flowing to an owner of the entity is QBI, regardless of whether the owner participates in the specified service activity. Therefore, a direct or indirect owner of a trade or business engaged in an SSTB is treated as engaged in the SSTB for purposes of Section 199A regardless of whether the owner is passive or participated in the SSTB. Similarly, none of the W-2 wages or UBIA of qualified property will be taken into account for purposes of Section 199A. For example, because the field of athletics is an SSTB, if a partnership owns a professional sports team, the partners' distributive shares of income from the partnership's athletics trade or business is not QBI, regardless of whether the partners participate in the partnership's trade or business. Proposed § 1.199A-5 contains further examples illustrating the operation of this rule.

b. Exceptions to the General Rule

Under Section 199A(d)(3), individuals with taxable income below the threshold amount are not subject to a restriction with respect to SSTBs. Therefore, if an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under Section 199A notwithstanding that a trade or business is an SSTB. As described in part I.C of this Explanation of Provisions, the exclusion of QBI, W-2 wages, and UBIA of qualified property from the computation of the Section 199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust, or estate level, which may not be where the trade or business is operated. Therefore, if a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation's taxable income but rather, the taxable income of the individual partner or shareholder claiming the Section 199A deduction. For example, if the partnership's taxable income is less than the threshold amount, but each of the partnership's individual partners have income that exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return) then none of the partners may claim a Section 199A deduction with respect to any income from the partnership's SSTB.

An RPE conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount. However, the RPE is best positioned to make the determination as to whether its trade or business is an SSTB. Therefore, reporting rules under proposed § 1.199A-6(b)(3)(B) requires each RPE to determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners. With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business. In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity, or grantor trust, the determination of whether the business is an SSTB is made by the individual.

Section 199A defines an SSTB to include any trade or business that "involves the performance of services in" a specified service activity. Although the statute, read literally, does not suggest that a certain quantum of specified service activity is necessary to find an SSTB, the Treasury Department and the IRS believe that requiring all taxpayers to evaluate and quantify any amount of specified service activity would create administrative complexity and undue burdens for both taxpayers and the IRS. Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Accordingly, proposed § 1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in proposed § 1.199A-4) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) and less than 10 percent of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

2. Definition of Specified Service Trade or Business

The definition of an SSTB set forth in Section 199A incorporates, with modifications, the text of section 1202(e)(3)(A). The text of section 1202(e)(3)(A) substantially tracks the definition of 'qualified personal service corporation' under section 448. Therefore, consistent with ordinary rules of statutory construction, the guidance in proposed § 1.199A-5(b) is informed by existing interpretations and guidance under both sections 1202 and 448 when relevant. However, existing guidance under those sections is sparse and the scope and purpose of those sections and Section 199A are different. The Treasury Department and the IRS also note that, unlike sections 1202(e)(3)(A) and 448, the purpose of Section 199A is to provide a deduction based on the character of the taxpayer's trade or business. Distinct guidance for Section 199A is warranted. Therefore, the guidance in proposed § 1.199A-5(b) applies only to Section 199A, not sections 1202 and 448.

a. Guidance on the Meaning of the Listed Activities

Section 199A(d)(2)(A) provides that an SSTB is any trade or business described in section 1202(e)(3)(A) (applied without regard to the words "engineering [and] architecture") or that would be so described if the term "employees or owners" were substituted for "employees" therein. Section 199A(d)(2)(B) provides that an SSTB is any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Section 1202 provides an exclusion from gross income for some or all of the gain on the sale of certain qualified small business stock. Section 1202 generally requires that, for stock to be qualified small business stock, the corporation must be engaged in a qualified trade or business. Section 1202(e)(3) provides that, for purposes of section 1201(e), the term 'qualified trade or business' means any trade or business other than any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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; any banking, insurance, financing, leasing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and; any business of operating a hotel, motel, restaurant, or similar business.

Thus, after application of the modifications described in Section 199A(d)(2)(A), the definition of an SSTB for purposes of Section 199A is (1) 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 one or more of its employees or owners, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

The Treasury Department and the IRS have received comments requesting guidance on the meaning and scope of the various trades or businesses described in the preceding paragraph. The Treasury Department and the IRS agree with commenters that guidance with respect to these trades or businesses is necessary for several reasons. Most importantly, Section 199A is a new Code provision intended to benefit a wide range of businesses, and taxpayers need certainty in determining whether their trade or business generates income that is eligible for the Section 199A deduction. As previously discussed, given the differing scope, objectives, and, in some respects, language of sections 199A, 448, and 1202, the guidance under sections 1202(e)(3)(A) and 448(d)(2) is not an appropriate substitute for clear and distinct guidance governing what constitutes an SSTB under Section 199A. In particular, some SSTBs are listed in section 1202(e)(3)(A), but not listed in section 448(d)(2), such as athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. In addition, some activities are mentioned only in 199A, such as investment management, trading, and dealing. As described in the remainder of this part V.A.2., proposed § 1.199A-5(b) provides guidance on the definition of an SSTB based on the plain meaning of the statute, past interpretations of substantially similar language in other Code provisions, and other indicia of legislative intent.

The preamble then provides an overview of parts II.E.1.c.iv.(b) Health, II.E.1.c.iv.(c) Law, II.E.1.c.iv.(d) Accounting, II.E.1.c.iv.(e) Actuarial Science, II.E.1.c.iv.(f) Performing Arts, II.E.1.c.iv.(g) Consulting, II.E.1.c.iv.(h) Athletics, II.E.1.c.iv.(i) Financial Services, II.E.1.c.iv.(j) Brokerage Services, and II.E.1.c.iv.(n) Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners:

i. SSTBs Listed in Section 199A(d)(2)(A)

The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in section 448(d)(2)(A) and § 1.448-1T(e)(4)(i), as the legislative history notes. See Joint Explanatory Statement of the Committee of Conference, footnotes 44-46. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Under section 448, qualified personal service corporations generally are not subject to the prohibition from using the cash method. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The regulations under section 448(d)(2), found in § 1.448-1T(e)(4)(i), provide additional guidance on several of the terms, including health, performing arts, and consulting. In addition, there have been several court opinions, technical advice memoranda, and private letter rulings interpreting the various fields listed in section 448(d)(2) and § 1.448-1T(e)(4)(i).

In general, the guidance under section 448(d)(2) emphasizes the direct provision of services by the employees of a trade or business, rather than the application of capital. Commenters have suggested that the regulations under section 448 serve as a reasonable starting point for defining an SSTB for purposes of Section 199A. However, commenters also noted that the objectives and included categories of trades or businesses within section 448 and Section 199A are different. Consistent with ordinary rules of statutory construction and the legislative history of Section 199A, proposed § 1.199A-5(b) draws upon the existing guidance under section 448(d)(2) when appropriate for purposes of Section 199A. Proposed § 1.199A-5(b) generally follows the guidance issued under section 448(d)(2) with some modifications. In certain instances, the principles of section 448(d)(2) provide useful analogies in defining the particular fields listed in section 1202(e)(3)(A) (as modified by Section 199A(d)(2)(A)) for purposes of Section 199A.

In addition, section 1202(e)(3)(A) also includes 'any trade or business where the principal asset of such trade or business is the reputation of skill of 1 or more of its employees.' Section 199A(d)(2)(A) modifies this clause by adding the words 'or owners' to the end, to read as follows: '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 or owners.' The meaning of this clause is best determined by examining the language of section 1202(e)(3) (A) in light of the purpose of Section 199A.

Case law under section 448 provides that whether a service is performed in a qualifying field under section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws. *See Rainbow Tax Serv., Inc. v. Commissioner*, 128 T.C. 42 (2007); *Kraatz & Craig Surveying Inc., v. Commissioner*, 134 T.C. 167 (2010). This approach also is appropriate for Section 199A purposes.

Additionally, states can widely vary in what they require in terms of licensure or certification. The Treasury Department and the IRS believe that the Federal tax law should not treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification. Thus, proposed § 1.199A-5(b) does not adopt a bright-line licensing rule for purposes of determining whether a trade or business is within a certain field for purposes of Section 199A.

The preamble then provides an overview of parts II.E.1.c.iv.(k) Investing and Investment Management, II.E.1.c.iv.(l) Trading, and II.E.1.c.iv.(m) Dealing in Securities, Partnership Interests, or Commodities:

ii. SSTBs Described in 199A(d)(2)(B)

As mentioned previously, Section 199A(d)(2)(B) provides that an SSTB also includes any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)). This rule does not appear in section 1202(e)(3)(A) or section 448(d)(2).

Section 475(c)(2) provides a detailed list of interests treated as securities, including stock in a corporation; ownership interests in widely held or publicly traded partnerships or trusts; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in any of the foregoing securities or any currency, including any option, forward contract, short position, or any similar financial instruments; and certain hedges with respect to any such securities. Section 475(e)(2) provides a similarly detailed list of property treated as a commodity, including any commodity which is actively traded (within the meaning of section 1092(d)(1)) or any notional principal contract with respect to any such commodity, evidences of an interest in, or derivative financial instruments in any of the foregoing commodities, and certain hedges with respect to any such commodities.

The preamble then provides some anti-abuse rules, which are in part II.E.1.c.iv.(o).

Implementing the above, Prop. Reg. § 1.199A-5(b), "Definition of specified service trade or business," provides:

Except as provided in paragraph (c)(1) of this section, the term specified service trade or business (SSTB) means any of the following:

(1) *Listed SSTBs*. Any trade or business involving the performance of services in one or more of the following fields:

(i) Health as described in paragraph (b)(2)(ii) of this section;

(ii) Law as described in paragraph (b)(2)(iii) of this section;

(iii) Accounting as described in paragraph (b)(2)(iv) of this section;

(iv) Actuarial science as described in paragraph (b)(2)(v) of this section;

(v) Performing arts as described in paragraph (b)(2)(vi) of this section;

(vi) Consulting as described in paragraph (b)(2)(vii) of this section;

(vii) Athletics as described in paragraph (b)(2)(viii) of this section;

(viii) Financial services as described in paragraph (b)(2)(ix) of this section;

(ix) Brokerage services as described in paragraph (b)(2)(x) of this section;

(x) Investing and investment management as described in paragraph (b)(2)(xi) of this section;

(xi) Trading as described in paragraph (b)(2)(xii) of this section;

(xii) Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) as described in paragraph (b)(2)(xiii) of this section; or

(xiii) Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners as defined in paragraph (b)(2)(xiv) of this section.

(2) *Additional rules for applying section 199A(d)(2) and paragraph (b) of this section*.

(i) *In general*. This paragraph (b)(2) provides additional rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) and paragraph (b) of this section only. The rules of this paragraph (b)(2) may not be taken into account for purposes of applying any provision of law or regulation other than section 199A and the regulations thereunder except to the extent such provision expressly refers to section 199A(d) or this section.

Prop. Reg. § 1.199A-5(b)(3), "Examples," provides caveats to its examples that are reproduced below in various parts of this part II.E.1.c.iv:

> The following examples illustrate the rules in paragraphs (a) and (b) of this section. The examples do not address all types of services that may or may not qualify as specified services. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

II.E.1.c.iv.(b). Health

Footnote 44 of the Senate report commented about the services in the field of health:

> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field

> of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii).

The preamble, REG-107892-18 (8/16/2018), describes "Health":

> Proposed § 1.199A-5(b)(2)(ii) is informed by the definition of 'health' under section 448 and provides that the term 'performance of services in the field of health' means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

Prop. Reg. § 1.199A-5(b)(2)(ii), "Meaning of services performed in the field of health," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient). The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

II.E.1.c.iv.(c). Law

The preamble, REG-107892-18 (8/16/2018), describes "Law":

> Proposed § 1.199A-5(b)(2)(iii) is based on the ordinary meaning of 'services in the field of law' and provides that the term 'performance of services in the field of law' means the provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

Prop. Reg. § 1.199A-5(b)(2)(iii), "Meaning of services performed in the field of law," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(ii) of this section only, the performance of services in the field of law means the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. The performance of

> services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

II.E.1.c.iv.(d). Accounting

The preamble, REG-107892-18 (8/16/2018), describes "Accounting":

> Proposed § 1.199A-5(b)(2)(iv) is based on the ordinary meaning of 'accounting' and provides that the term 'performance of services in the field of accounting' means the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The aim of proposed § 1.199A-5(b)(2)(iv) is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA. The field of accounting does not include payment processing and billing analysis.

Prop. Reg. § 1.199A-5(b)(2)(iv), "Meaning of services performed in the field of accounting," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(iii) of this section only, the performance of services in the field of accounting means the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(e). Actuarial Science

The preamble, REG-107892-18 (8/16/2018), describes "Actuarial Science":

> Proposed § 1.199A-5(b)(2)(v) is based on the ordinary meaning 'actuarial science' and provides that the term 'performance of services in the field of actuarial science' means the provision of services by actuaries and similar professionals in their capacity as such. Accordingly, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

Prop. Reg. § 1.199A-5(b)(2)(v), "Meaning of services performed in the field of actuarial science," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(iv) of this section only, the performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(f). Performing Arts

Footnote 45 of the Senate report commented about the services in the field of performing arts:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

The preamble, REG-107892-18 (8/16/2018), describes "Performing Arts":

> Proposed § 1.199A-5(b)(2)(vi) is informed by the definition of 'performing arts' under section 448 and provides that the term 'performance of services in the field of the performing arts' means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Prop. Reg. § 1.199A-5(b)(2)(vi), "Meaning of services performed in the field of performing arts," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(v) of this section only, the performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (1) provides:

> A, a singer, records a song. A is paid a mechanical royalty when the song is licensed or streamed. A is also paid a performance royalty when the recorded song is played publicly. A is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of paragraphs (b)(1)(v) and (b)(2)(vi) of this section.

> The royalties that A receives for the song are not eligible for a deduction under section 199A.

II.E.1.c.iv.(g). Consulting

Footnote 46 of the Senate report commented about the services in the field of consulting:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).

The preamble, REG-107892-18 (8/16/2018), describes "Consulting":

> Proposed § 1.199A-5(b)(2)(vii) is informed by the definition of 'consulting' under section 448 and provides that the term 'performance of services in the field of consulting' means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel. This determination is made based on all the facts and circumstances of a person's business.
>
> Additionally, the Treasury Department and the IRS are aware of the concern noted by commenters that in certain kinds of sales transactions it is common for businesses to provide consulting services in connection with the purchase of goods by customers. For example, a company that sells computers may provide customers with consulting services relating to the setup, operation, and repair of the computers, or a contractor who remodels homes may provide consulting prior to remodeling a kitchen. As described previously in this Explanation of Provisions, proposed § 1.199A-5(c) provides a de minimis rule, under which a trade or business is not an SSTB if less than 10 percent of the gross receipts (5 percent if the gross receipts are greater than $25 million) of the trade or business are attributable to the performance of services in a specified service activity. However, this de minimis rule may not provide sufficient relief for certain trades or business that provide ancillary consulting services. The Treasury Department and the IRS believe that if a trade or business involves the selling or manufacturing of goods, and such trade or business provides ancillary consulting services that are not separately purchased or billed, then such trades or businesses are not in a trade or business in the field of consulting. Accordingly, proposed § 1.199A-5(b)(2)(vii) provides that the field of consulting does not include consulting that is

> embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

Prop. Reg. § 1.199A-5(b)(2)(vii), "Meaning of services performed in the field of consulting," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (3) provides:

> C is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. C studies its client's organization and structure and compares it to peers in its industry. C then makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure, including the use of temporary workers. C is engaged in the performance of services in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (4) provides:

> D is in the business of licensing software to customers. D discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. D is paid a flat price for the software license. After the customer licenses the software, D helps to implement the software. D is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

II.E.1.c.iv.(h). Athletics

The preamble, REG-107892-18 (8/16/2018), describes "Athletics":

> The field of athletics is not listed in section 448(d)(2), and there is little guidance on its meaning as used in section 1202(e)(3)(A). However, commenters noted, and the

Treasury Department and the IRS agree, that among the services specified in Section 199A(d)(2)(A) the field of athletics is most similar to the field of performing arts. Accordingly, proposed § 1.199A-5(b)(2) (viii) provides that the term 'performance of services in the field of athletics' means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Prop. Reg. § 1.199A-5(b)(2)(viii), "Meaning of services performed in the field of athletics," provides:

For purposes of section 199A(d)(2) and paragraph (b)(1)(vii) of this section only, the performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (2) provides:

B is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets to the public to attend games in which the sports team competes. Therefore, Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. B is a passive owner in Partnership and B does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, B's distributive share of the income, gain, loss, and deduction with respect to Partnership is not eligible for a deduction under section 199A.

II.E.1.c.iv.(i). Financial Services

The preamble, REG-107892-18 (8/16/2018), describes "Financial Services":

Commenters requested guidance as to whether financial services includes banking. These commenters noted that section 1202(e)(3)(A) includes the term financial services, but that banking in separately listed in section 1202(e)(3)(B) which suggests that banking is not included as part of financial services in section 1202(e)(3)(A). The Treasury Department and the IRS agree with such commenters that this suggests that financial services should be more narrowly interpreted here. Therefore, proposed § 1.199A-5(b)(2)(ix) limits the definition of financial services to services typically

> performed by financial advisors and investment bankers and provides that the field of financial services includes the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans.

Prop. Reg. § 1.199A-5(b)(2)(ix), "Meaning of services performed in the field of financial services," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(viii) of this section only, the performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals performing services in their capacity as such.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (5) provides:

> E is in the business of providing services to assist clients with their finances. E will study a particular client's financial situation, including, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, E will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. E is engaged in the performance of services in an SSTB in the field of financial services within the meaning of paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

II.E.1.c.iv.(j). Brokerage Services

The preamble, REG-107892-18 (8/16/2018), describes "Brokerage Services":

> Proposed § 1.199A-5(b)(2)(x) uses the ordinary meaning of 'brokerage services' and provides that the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

Prop. Reg. § 1.199A-5(b)(2)(x), "Meaning of services performed in the field of brokerage services," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (6) provides:

> F is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with F to trade securities or commodities based on the taxpayer's recommendations. F's compensation for its services typically is based on completion of the trade orders. F is engaged in an SSTB in the field of brokerage services within the meaning of paragraphs (b)(1)(ix) and (b)(2)(x) of this section.

II.E.1.c.iv.(k). Investing and Investment Management

The preamble, REG-107892-18 (8/16/2018), describes "Investing and Investment Management":

> Proposed § 1.199A-5(b)(2)(xi) uses the ordinary meaning of 'investing and investment management' and provides that any trade or business that involves the 'performance of services that consist of investing and investment management' means a trade or business that earns fees for investment, asset management services, or investment management services including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives either a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management. The performance of services of investing and investment management does not include directly managing real property.

Prop. Reg. § 1.199A-5(b)(2)(xi), "Meaning of the provision of services in investing and investment management," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

II.E.1.c.iv.(l). Trading

The preamble, REG-107892-18 (8/16/2018), describes "Trading":

> Proposed § 1.199A-5(b)(2)(xii) provides that any trade or business involving the 'performance of services that consist of trading' means a trade or business of trading in

> securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances. Factors that have been considered relevant to determining whether a person is a trader include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account. See *Endicott v. Commissioner*, T.C. Memo. 2013-199; *Nelson v. Commissioner*, T.C. Memo. 2013-259, *King v. Commissioner*, 89 T.C. 445 (1987). A person that is a trader under these principles will be treated as performing the services of trading for purposes of Section 199A(d)(2)(B).

Prop. Reg. § 1.199A-5(b)(2)(xii), "Meaning of the provision of services in trading," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(xi) of this section only, the performance of services that consist of trading means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof. A taxpayer, such as a manufacturer or a farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming is not considered to be engaged in the trade or business of trading commodities.

II.E.1.c.iv.(m). Dealing in Securities, Partnership Interests, or Commodities

The preamble, REG-107892-18 (8/16/2018), describes "Dealing in Securities, Partnership Interests, and Commodities":

> For purposes of proposed § 1.199A-5(b)(2)(xiii), the 'performance of services that consist of dealing in securities (as defined in section 475(c)(2))' means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For purposes of the preceding sentence, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of Section 199A(d)(2). See § 1.475(c)-1(c)(2) and (4) for the definition of negligible sales.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in partnership interests' means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))' means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign,

or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business.

Prop. Reg. § 1.199A-5(b)(2)(xiii), "Meaning of the provision of services in dealing," provides:

(A) *Dealing in securities*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in securities (as defined in section 475(c)(2)) means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For purposes of the preceding sentence, however, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of section 199A(d)(2) and this section. See § 1.475(c)-1(c)(2) and (4) for the definition of negligible sales.

(B) *Dealing in commodities*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in commodities (as defined in section 475(e)(2)) means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business.

(C) *Dealing in partnership interests*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

II.E.1.c.iv.(n). Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners

The preamble, REG-107892-18 (8/16/2018), describes "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 or Owners":

> Guidance on the meaning of the 'reputation or skill' clause in section 1202(e)(3)(A) is limited to dicta in one case. In *John P. Owen v. Commissioner*, T.C. Memo. 2012-21, the Tax Court examined whether Mr. Owen, whose business was insurance, was entitled to benefits under section 1202 with respect to the sale of his interest in a corporation conducting such business. Under the facts described in the case, the corporation had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. Although the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure of the business rather than Mr. Owen's services.

The Treasury Department and the IRS received several comments regarding the meaning of the ‘reputation or skill’ clause. Commenters described potential methods to give maximum effect to the literal language of the reputation or skill clause by describing ways to (1) determine the extent to which the reputation or skill of employees or owners constitutes an asset of the business under Federal tax accounting principles, and (2) measure whether such an asset is in fact the principal asset of the business.

One commenter suggested using an activity-based standard under which no service-based businesses would qualify for the Section 199A deduction. An SSTB definition this broad would not comport with the statute and would deny a Section 199A deduction to businesses that the statute does not appear to exclude. If the ‘reputation or skill’ clause was intended to exclude all service businesses from Section 199A, there would have been no reason to enumerate specific types of businesses in Section 199A(d)(2); that language would be pure surplusage. A broad service-based test would also fail to provide a clear classification of businesses that combine services with sales of products, such as plumbing and HVAC services, if those businesses sell goods or equipment in the course of providing services. Therefore, the Treasury Department and the IRS do not believe it is consistent with the text, structure, or purpose of Section 199A to exclude all service businesses above the threshold amount from qualifying for the Section 199A deduction.

Another commenter described a balance sheet test that would compare the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. The commenter acknowledged that such a test could also be broader than Congress intended. In addition, the commenter noted that such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements and would both be ripe for abuse, and could potentially result in many legal disputes between taxpayers and the IRS.

Finally, one commenter described a standard based on whether the trade or business involves the provision of highly-skilled services. The commenter argued that the primary benefit of a standard like this is that it would harmonize the meaning of the reputation or skill phrase with the trades or businesses listed in section 1202(e)(3)(A), each of which involve the provision of services by professionals who either received a substantial amount of training (for example, doctors, nurses, lawyers, and accountants), or who have otherwise achieved a high degree of skill in a given field (for example, professional athletes or performing artists).

Congress enacted Section 199A to provide a deduction from taxable income to trades or businesses conducted by sole proprietorships and passthrough entities that do not benefit from the income tax rate reduction afforded to C corporations under the TCJA. The Treasury Department and the IRS are concerned that a broad definition of the ‘reputation or skill’ phrase that relied on a balance sheet test or numerical ratios would have several consequences inconsistent with the intent of Section 199A. Testing businesses based on metrics, some of them subjective, that change over time could result in inappropriate year-over-year tax consequences and lead to distorted decision-making. As the commenters noted, such mechanical tests pose administrative difficulties and fail to provide taxpayers with needed certainty regarding the tax law necessary for conducting their business affairs. Most significantly, such mechanical rules might prevent trades or businesses that Congress intended to be eligible for the Section 199A deduction from claiming the Section 199A deduction.

> In sum, the Treasury Department and the IRS believe that the 'reputation or skill' clause as used in Section 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners. Additionally, the Treasury Department and the IRS believe that 'reputation or skill' must be interpreted in a manner that is both objective and administrable. Thus, proposed § 1.199A-5(b)(2)(xiv) limits the meaning of the 'reputation or skill' clause to fact patterns in which the individual or RPE is engaged in the trade or business of: (1) receiving income for endorsing products or services, including an individual's distributive share of income or distributions from an RPE for which the individual provides endorsement services; (2) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, including an individual's distributive share of income or distributions from an RPE to which an individual contributes the rights to use the individual's image; or (3) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players). Proposed § 1.199A-5(b)(4) contains two examples illustrating the application of this definition. The Treasury Department and the IRS request comments on this rule, the clarity of definitions for the statutorily enumerated trades or businesses that are SSTBs under Section 199A(d)(2)(A), and the accompanying examples.

Prop. Reg. § 1.199A-5(b)(2)(xiv), "Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(xiii) of this section only, the term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following (or any combination thereof):
>
> (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
>
> (B) A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity,
>
> (C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.
>
> (D) For purposes of paragraph (b)(2)(xiv)(A) through (C) of this section, the term fees, compensation, or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain or loss from the S corporation stock.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (7) provides:

> G owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including G. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair services performed by G and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. G is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (8) provides:

> H is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of $500,000 for the use of H's name on a line of cooking utensils and cookware. H is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, H is also in the trade or business of receiving endorsement income. H's trade or business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (9) provides:

> J is a well-known actor. J entered into a partnership with Shoe Company, in which J contributed her likeness and the use of her name to the partnership in exchange for a 50% interest in the capital and profits of the partnership and a guaranteed payment. J's trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for J's likeness and the use of her name is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

II.E.1.c.iv.(o). SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules

The preamble, REG-107892-18 (8/16/2018), “Defining What is Included in an SSTB,” provides:

> The Treasury Department and the IRS are aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the Section 199A deduction. Such a strategy is inconsistent with the purpose of Section 199A. Therefore, in accordance with Section 199A(f)(4), in order to carry out the purposes of Section 199A, proposed § 1.199A-5(c)(2) provides that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB. Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB). For example, A, a

dentist, owns a dental practice and also owns an office building. A rents half the building to the dental practice and half the building to unrelated persons. Under proposed § 1.199A-5(c)(2), the renting of half of the building to the dental practice will be treated as an SSTB.

Additionally, proposed § 1.199A-5 provides a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, therefore, as an SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business.

Prop. Reg. § 1.199A-5(c), “Special rules,” provides:

(1) *De minimis rule*.

(i) *Gross receipts of $25 million or less*. For a trade or business with gross receipts of $25 million dollars or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.

(ii) *Gross receipts of greater than $25 million*. For a trade or business with gross receipts of greater than $25 million for the taxable year, the rules of paragraph (c)(1)(i) of this section are applied by substituting “5 percent” for “10 percent” each place it appears.

(2) *Services or property provided to an SSTB*.

(i) *In general*. An SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB if there is 50 percent or more common ownership of the trades or businesses.

(ii) *Less than substantially all of property or services provided*. If a trade or business provides less than 80 percent of its property or services to an SSTB within the meaning of this section and there is 50 percent or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50 percent or more commonly-owned SSTB is treated as a part of the SSTB.

(iii) *50 percent or more common ownership*. For purposes of paragraphs (c)(2)(i) and (ii) of this section, 50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b).

(iv) *Example*. Law Firm is a partnership that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees. All three of the partnerships are owned by the same people (the original owners of Law Firm). Because there is 50% or more common ownership of each of the three partnerships, Partnership 2 provides substantially all of its property to Partnership 1, and Partnership 3 provides substantially all of its services to Partnership 1, Partnerships 1, 2, and 3 will be treated as one SSTB under paragraph (a)(6) of this section.

(3) *Incidental to specified service trade or business*.

(i) *In general*. If a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB, including related parties (within the meaning of sections 267(b) or 707(b)), and has shared expenses with the SSTB, including shared wage or overhead expenses, then such trade or business is treated as incidental to and, therefore, part of the SSTB within the meaning of this section if the gross receipts of the trade or business represents no more than 5 percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year.

(ii) *Example*. A, a dermatologist, provides medical services to patients on a regular basis through Dermatology LLC, a disregarded entity owned by A. In addition to providing medical services, Dermatology LLC also sells skin care products to A's patients. The same employees and office space are used for the medical services and sale of skin care products. The gross receipts with respect to the skin care product sales do not exceed 5% of the gross receipts of Dermatology LLC. Accordingly, the sale of the skin care products is treated as incidental to A's SSTB of performing services in the field of health (within the meaning of paragraph (b)(1)(i) and (b)(2)(ii) of this section) and is treated under paragraph (c)(3) of this section as part of such SSTB.

Code § 267(b) is reproduced in part II.G.4.i.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

The "De minimis rule" title of Prop. Reg. § 1.199A-5(c)(1) is really a snake-in the grass. If gross income from an SSTB is at least 5% or 10%, that rule taints the entire business! This puts a premium on classifying SSTB gross receipts as belonging to a separate tarde or business than non-SSTB gross receipts. See part II.E.1.c.iii "Trade or Business" for Code § 199A, especially part II.E.1.c.iii.(c) "Trade or Business" in Other Areas of Tax Law"Trade or Business" in Other Areas of Tax Law.

II.E.1.c.v. Calculation of Deduction Generally

Taxpayers other than C corporations may deduct a portion of qualified business income ("QBI") and qualified cooperative dividends ("QCDs"). Code § 199A(a) provides:

In general. In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—

(1) the lesser of -

(A) the combined qualified business income amount of the taxpayer, or

(B) an amount equal to 20 percent of the excess (if any) of-

(i) the taxable income of the taxpayer for the taxable year, over

(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(2) the lesser of -

(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The deduction for QCDs[714] is not a focus of this document,[715] nor do Prop. Reg. §§ 1.199A-1 through 1.199A-6 address it.[716] Note the limitation related to net capital gain.[717] This limitation

[714] Code § 199A(e)(4) provides:

Qualified Cooperative Dividend. The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—

(A) is includible in gross income, and

(B) is received from—

(i) an organization or corporation described in section 501(c)(12) or 1381(a), or

(ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

[715] The Senate report explained (footnotes omitted) (remember that the Conference Committee reduced the deduction from 23% to 20%):

A deduction is allowed under the provision for 23 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the seems designed to keep the capital gain rate as the floor for a taxpayer's rate and not let the QBI/QCD deduction reduce that rate. Capital gains cannot be QBI.[718] In understanding how this limitation works, note that the QBI/QCD deduction is not a deduction in arriving at gross income, is not a deduction in arriving at adjusted gross income, and is not an itemized deduction.[719] When one calculates income tax, one calculates it on taxable income with and without net capital gain.[720] Thus, this limit on the QBI deduction is applied after all business and nonbusiness income and deductions are calculated to determine taxable income. Therefore, if capital gain can be QBI, the related deduction can be applied against any business or nonbusiness income that is not net capital gain.

The QBI-based deduction is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate QCDs.[721]

The combined QBI amount is (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus (B) "20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year."[722] By "qualified" I mean not a specified service trade or business (SSTB)[723] unless taxable income is below certain thresholds.[724]

All of the analysis in this part II.E.1.c.v Calculation of Deduction Generally needs to be viewed in light of part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Parts II.E.1.c.v.(b) and II.E.1.c.v.(c) below provide details on this part II.E.1.c.v and refer to the threshold amount, which is described in part II.E.1.c.v.(a) Taxable Income "Threshold

---

> extent provided in regulations) section 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of section 751).

716 Reg. § 1.199A-1(a)(1) concludes with:

> This section and §§1.199A-2 through 1.199A-6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.

717 Although Code § 199A(a)(1)(B)(ii) refers to Code § 1(h) to define "net capital gain," Code § 1(h) does not define the term. "Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. Code § 1222(11), which applies for purposes of subtitle A (Code §§ 1-1563).

718 See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

719 See fns 661-662 in part II.E.1.c.i.(a) Summary of Impact of Deduction.

720 Code § 1(h).

721 Code § 199A(a)(1).

722 Code § 199A(b)(1). Fn 676 defines "qualified REIT dividend" and "qualified publicly traded partnership income."

723 See part II.E.1.c.iv Specified Service Trade or Business (SSTB).

724 For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

II.E.1.c.v.(a). Taxable Income "Threshold Amount"

The wage limitation[725] and the disqualification of SSTBs[726] are eased up or do not apply if the taxpayer's taxable income, computed without regard to the Code § 199A deduction,[727] is below the "threshold amount." The "threshold amount" is $315,000 for a joint return and $157,500 for any other return.[728] The "threshold amount" will be indexed for inflation in a manner similar to indexing the income tax brackets.[729] For taxable years beginning in 2019, the threshold amount is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for single and head of household returns.[730]

Prop. Reg. § 1.199A-1(b)(11) provides:

> Threshold amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **B. Computation of the Section 199A Deduction for Individuals With Taxable Income Below the Threshold Amount**
>
> **1. Basic Computational Rules**
>
> An individual with income attributable to one or more domestic trades or businesses, other than as a result of owning stock of a C corporation or engaging in the trade or business of being an employee, and with taxable income (before computing the Section 199A deduction) at or below the threshold amount, is entitled to a Section 199A deduction equal to the lesser of (i) 20 percent of the QBI (generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer) from the individual's trades or businesses plus

---

[725] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[726] See text accompanying fns. 712-713 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

[727] Code § 199A(e)(1).

[728] Code § 199A(e)(2)(A).

[729] Code § 199A(e)(2)(B) provides:

> INFLATION ADJUSTMENT.—In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—
> (i) such dollar amount, multiplied by
> (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.
>
> The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

[730] Rev. Proc. 2018-57, § 3.27.

20 percent of the individual's combined qualified REIT dividends and qualified PTP income or (ii) 20 percent of the excess (if any) of the individual's taxable income over the individual's net capital gain. Proposed § 1.199A-1(c) contains guidance on calculating the amount of the deduction in these circumstances. If an individual's combined QBI is negative or combined qualified REIT dividends and PTP income is less than zero, proposed § 1.199A-1(c)(2) provides rules for the carryover of the losses.

2. Carryover Loss Rules for Negative Total QBI Amounts

If an individual has multiple trades or businesses, the individual must calculate the QBI from each trade or business and then net the amounts. Section 199A(c)(2) provides that, for purposes of Section 199A, if the net QBI with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. Proposed § 1.199A-1(c)(2)(i) repeats this rule and provides that the Section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

3. Carryover Loss Rules if Combined Qualified REIT Dividends and Qualified PTP Income is Less Than Zero

One commenter stated it was not clear whether, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified PTP income (because a loss from a PTP exceeds REIT dividends and PTP income), the negative amount should be netted against any net positive QBI (regardless of source), or whether the negative amount should be segregated and subject to its own loss carryforward rule distinct from but analogous to the QBI loss carryforward rule. Section 199A contemplates that qualified REIT dividends and qualified PTP income are computed and taken into account separately from QBI and should not affect QBI. If overall losses attributable to qualified REIT dividends and qualified PTP income were netted against QBI, these losses would affect QBI. Therefore, a separate loss carryforward rule is needed to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. Additionally, commenters have expressed concern that losses in excess of income could create a negative Section 199A deduction, a result incompatible with the statute. Accordingly, proposed § 1.199A-1(c)(2)(ii) provides that if an individual has an overall loss after qualified REIT dividends and qualified PTP income are combined, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. In addition, the overall loss does not affect the amount of the taxpayer's QBI. Instead, such overall loss is carried forward and must be used to offset combined qualified REIT dividends and qualified PTP income in the succeeding taxable year or years for purposes of Section 199A.

Prop. Reg. § 1.199A-1(c), "Computation of the § 199A deduction for individuals with taxable income not exceeding threshold amount," provides:

(1) *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends, and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount

by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

(2) *Carryover rules*.

(i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable year of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Prop. Reg. § 1.199A-1(c)(3), "Examples," provides:

The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(1) of this section and all of tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Prop. Reg. § 1.199A-1(c)(3), Example (1), provides:

A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generated $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).

Prop. Reg. § 1.199A-1(c)(3), Example (2), provides:

Assume the same facts as in Example 1 of this paragraph (c)(3), except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000 - $7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000 x 20% = $13,400).

Prop. Reg. § 1.199A-1(c)(3), Example (3), provides:

> B and C are married and file a joint individual income tax return. B earned $500,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generated $100,000 in net income from operations in 2018. X paid C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 x 20% = $54,000).

Prop. Reg. § 1.199A-1(c)(3), Example (4), provides:

> Assume the same facts as in Example 3 of this paragraph (c)(3) except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Section 199A deduction is equal to $20,300, the lesser of (i) 20% of C's QBI from the business ($100,000 x 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 x 20% = $300) and (ii) 20% of B and C's total taxable for the taxable year ($271,500 x 20% = $54,300).

II.E.1.c.v.(b). Calculation When Taxable Income Does Not Exceed the Threshold Amount

Prop. Reg. § 1.199A-1(c)(1) combines the above, as well as the benefits of taxable income not exceeding the threshold amount:[731]

> *In general*. The section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends, and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

Prop. Reg. § 1.199A-1(b)(12) provides:

> Total QBI amount means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

Prop. Reg. § 1.199A-1(c)(3), "Examples," provides:

---

[731] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

> The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(1) of this section and all of tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the section 199A deduction.

Prop. Reg. § 1.199A-1(c)(3), Example (1) provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generated $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).

Prop. Reg. § 1.199A-1(c)(3), Example (2) provides:

> Assume the same facts as in Example 1 of this paragraph (c)(3), except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000 - $7,000). A's section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000 x 20% = $13,400).

The difference between the facts in the two examples is that A's total taxable income minus net capital gain in Example (2) was only $67,000, which is $14,000 less than $81,000 in Example (1). Because in each example the total QBI amount exceeded total taxable income minus net capital gain, the change in total taxable income minus net capital gain is the sole difference accounting for the difference in the deduction. Multiplying this $14,000 difference by 20% equals $2,800, which equals the difference between the $16,200 deduction in Example (1) and the $13,400 deduction in Example (2).

Prop. Reg. § 1.199A-1(c)(3), Example (3) provides:

> B and C are married and file a joint individual income tax return. B earned $500,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generated $100,000 in net income from operations in 2018. X paid C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's section 199A deduction is equal to $20,000, the lesser of 20% of C's

> QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 x 20% = $54,000).

Example (3) points out that, even though B and C have income that is significantly higher than the $315,000 (subject to future indexing) threshold amount, their $270,000 taxable income is below that. For B's and C's wages not being QBI, see part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

Prop. Reg. § 1.199A-1(c)(3), Example (4) provides:

> Assume the same facts as in Example 3 of this paragraph (c)(3) except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's section 199A deduction is equal to $20,300, the lesser of (i) 20% of C's QBI from the business ($100,000 x 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 x 20% = $300) and (ii) 20% of B and C's total taxable for the taxable year ($271,500 x 20% = $54,300).

II.E.1.c.v.(c). Calculation When Taxable Income Exceeds the Threshold Amount

Parts II.E.1.c.iv Specified Service Trade or Business (SSTB) and II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds apply when not fully protected by part II.E.1.c.v.(a) Taxable Income “Threshold Amount”.

If the wage limitation reduces the QBI-related amount (20% of QBI income)[732] with respect to any qualified trade or business, and the taxpayer’s taxable income does not exceed the threshold amount by $100,000 for a joint return or $50,000 for other returns, then the reduction is pro-rated.[733] The reduction is multiplied by the excess over the threshold divided by $100,000 or $50,000, as applicable.[734] Thus, the phase-out of the benefit of modest taxable income

---

[732] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[733] Code § 199A(b)(3)(B)(i), “Phase-in of limit for certain taxpayers,” provides:

> *In general*. If-
> - (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and
> - (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,
>
> then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

[734] Code § 199A(b)(3)(B)(ii) and (iii) provide:

> - (ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as-
>   - (I) the amount by which the taxpayer’s taxable income for the taxable year exceeds the threshold amount, bears to
>   - (II) $50,000 ($100,000 in the case of a joint return).
> - (iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of-
>   - (I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

occurs initially from $315,000-$415,000 for married filing jointly and $157,500-$207,500 for all others (all subject to future indexing).

If an SSTB is excluded from being QBI, the taxpayer having taxable income below the threshold removes the exclusion, so that the trade or business qualifies for the deduction.[735] If the taxpayer's taxable exceeds the threshold, the deduction is phased out using a $100,000 or $50,000 calculation similar to that described above:[736]

> only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

The "applicable percentage" is 100% minus the ratio of the excess taxable income to the $100,000 or $50,000 threshold.[737]

Applying these concepts, Prop. Reg. § 1.199A-1(b) includes the following definitions:

> (2) Applicable percentage means, with respect to any taxable year,100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).
>
> (3) Phase-in range means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return).
>
> (8) Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(8), the excess amount is 20 percent of QBI over the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

Prop. Reg. § 1.199A-1(d)(1) explains:

> (II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

[735] Code § 199(d)(3)(A)(i) provides, "any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," so one needs to go to Code § 199(d)(1)(A).

[736] Code § 199A(d)(3)(A)(ii).

[737] Code § 199A(d)(3)(B) provides:

> *Applicable percentage*. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-
>
> (i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to
>
> (ii) $50,000 ($100,000 in the case of a joint return).

> *In general*. The section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

Note the reference to "the QBI component" for individuals with taxable income <u>above</u> the threshold amount, contrasted with Prop. Reg. § 1.199A-1(c)(1) referring to "20 percent of the total QBI amount" for individuals with taxable income <u>below</u> the threshold amount. Prop. Reg. § 1.199A-1(d)(2), "QBI component," provides:

> An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the following computational rules, which are to be applied in the order they appear.
>
> (i) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of QBI, W-2 wages, and UBIA of qualified property for each SSTB is taken into account for purposes of determining the individual's section 199A deduction. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of QBI, W-2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.
>
> (ii) *Aggregated trade or business*. If an individual chooses to aggregate trades or businesses under the rules of § 1.199A-4, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the W-2 wages and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

Prop. Reg. § 1.199A-1(d)(2)(iv), "QBI component calculation," provides:

> (A) *General rule*. Except as provided in paragraph (d)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business. For each trade or business (including trades or businesses operated through RPEs) the individual must determine the lesser of—
>
> (1) 20 percent of the QBI for that trade or business; or
>
> (2) The greater of—
>
> (i) 50 percent of W-2 wages with respect to that trade or business, or
>
> (ii) the sum of 25 percent of W-2 wages with respect to that trade or business plus 2.5 percent of the UBIA of qualified property with respect to that trade or business.
>
> (B) *Taxpayers with taxable income within phase-in range*. If the individual's taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(2) of this section for a trade or business is less than the

> amount determined under paragraph (d)(2)(iv)(A)(1) of this section for that trade or business, the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(2) of this section, the QBI component for the trade or business is the amount determined under paragraph (d)(2)(iv)(A)(1) of this section reduced by the reduction amount as defined in paragraph (b)(8) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(2) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section (in which circumstance the QBI component for the trade or business will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(1) of this section).

Prop. Reg. § 1.199A-1(d)(3), "Negative combined qualified REIT dividends/qualified PTP income," is discussed in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Prop. Reg. § 1.199A-1(d)(4), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (d). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(13) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(10) of this section and §1.199A-5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c). Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the section 199A deduction.

Prop. Reg. § 1.199A-1(d)(4), Example (1) provides:

> D, an unmarried individual, owns several parcels of land that D manages and which are leased to several suburban airports for parking lots. The business generated $1,000,000 of QBI in 2018. The business paid no wages and the property was not qualified property because it was not depreciable. After allowable deductions unrelated to the business, D's total taxable income for 2018 is $980,000. Because D's taxable income exceeds the applicable threshold amount, D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. D's section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

This example illustrates part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds. Note the assumption, however, that leasing several parcels of land to several suburban airports for parking lots constitutes QBI, which is helpful given uncertainty as to whether real estate rental qualifies as a trade or business.[738]

Prop. Reg. § 1.199A-1(d)(4), Example (2) provides:

> Assume the same facts as in Example 1 of this paragraph (d)(4), except that D developed the land parcels in 2019, expending a total of $10,000,000 to build parking

[738] See part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

structures on each of the parcels, all of which is depreciable. During 2020, D leased the parking structures and the land to the suburban airports. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is $3,980,000. Because D's taxable income is above the threshold amount, the QBI component of D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the business has no W-2 wages, the QBI component of D's section 199A deduction will be limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D's section 199A deduction is thus limited to $250,000. D's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($250,000) or (ii) 20% of D's taxable income ($3,980,000 x 20% = $796,000). Therefore, D's section 199A deduction for 2020 is $250,000.

See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Prop. Reg. § 1.199A-1(d)(4), Example (3) provides:

E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reported QBI of $3,000,000. The LLC paid total W-2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E's taxable income is $880,000. Because E's taxable income is above the threshold amount, the QBI component of E's section 199A deduction will be limited to the lesser of (i) 20% of E's share of LLC's QBI or (ii) the greater of the W-2 wage or UBIA of qualified property limitations. Twenty percent of E's share of QBI of $900,000 is $180,000. The W-2 wage limitation equals 50% of E's share of the LLC's wages ($300,000) or $150,000. The UBIA of qualified property limitation equals $75,750, the sum of (i) 25% of E's share of LLC's wages ($300,000) or $75,000 plus (ii) 2.5% of E's share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of E's section 199A deduction is thus limited to $150,000, the lesser of (i) 20% of QBI ($180,000) and (ii) the greater of the limitations amounts ($150,000). E's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($150,000) or (ii) 20% of E's taxable income ($880,000 x 20% = $176,000). Therefore, E's section 199A deduction is $150,000 for 2018.

Prop. Reg. § 1.199A-1(d)(4), Example (4) provides:

F, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. In 2018, Z reported QBI of $6,000,000. Z paid total W-2 wages of $2,000,000, and its total UBIA of qualified property is $200,000. For the 2018 taxable year, F reports $3,000,000 of QBI from Z. F is not an employee of Z and receives no wages or reasonable compensation from Z. After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), F's taxable income is $1,880,000. Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction will be limited to the lesser of (i) 20% of F's share of Z's QBI or (ii) the greater of the W-2 wage and UBIA of qualified property limitations. Twenty percent of F's share of QBI of $3,000,000 is $600,000. The W-2 wage limitation equals 50% of F's share of Z's W-2 wages ($1,000,000) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of (i) 25% of F's share of Z's W-2 wages ($1,000,000) or $250,000 plus (ii) 2.5% of E's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of F's section 199A deduction is thus limited to $500,000, the lesser of (i) 20% of QBI ($600,000) and (ii) the greater of the limitations amounts ($500,000). F reported a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss against QBI. Instead, the portion of F's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($500,000) or (ii) 20% of F's taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F's section 199A deduction is $376,000 for 2018. F must also carry forward the $(10,000) qualified loss from a PTP to be netted against F's qualified REIT dividends and qualified PTP income in the succeeding taxable year.

Prop. Reg. § 1.199A-1(d)(4), Example (5), “Phase-in range,” provides:

(i) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B's share of the M's QBI is $300,000 in 2018. B's share of the W-2 wages from M in 2018 is $40,000. C earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C's taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus $100,000, or $415,000. Consequently, the QBI component of B and C's section 199A deduction may be limited by the W-2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(ii) The UBIA of qualified property limitation amount is zero because M does not hold qualified property. B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI. Twenty percent of B's share of M's QBI of $300,000 is $60,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $40,000 is $20,000. Because 50% of B's share of M's W-2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(iii) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W-2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C's section 199A deduction is equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000. B and C's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($36,000) or (ii) 20% of B and C's taxable income ($375,000 x 20% = $75,000). Therefore, B and C's section 199A deduction is $36,000 for 2018.

Prop. Reg. § 1.199A-1(d)(4), Example (6) explains how the phase-in works when the business is am SSTB and has insufficient wages (or wages and UBIA):

(i) Assume the same facts as in Example 5 to paragraph (d)(4), except that M was engaged in an SSTB. Because B and C are within the phase-in range, B must reduce the QBI and W-2 wages allocable to B from M to the applicable percentage of those items. B and C's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000. Their applicable percentage is 40%. The applicable percentage of B's QBI is ($300,000 x 40% =) $120,000, and the applicable percentage of B's share of W-2 wages is ($40,000 x 40% =) $16,000. These reduced numbers must then be used to determine how B's section 199A deduction is limited.

(ii) B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI as limited by paragraph (i) of this example. Twenty percent of B's share of M's QBI of $120,000 is $24,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $16,000 is $8,000. Because 50% of B's share of M's W-2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(iii) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, as adjusted in paragraph (i) of this example or $24,000, over 50% of B's share of M's W-2 wages, as adjusted in paragraph (i) of this example, or $8,000. Thus, the excess amount is $16,000. The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of B and C's section 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600. B and C's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000 x 20% = $75,000). Therefore, B and C's section 199A deduction is $14,400 for 2018.

The $14,400 deduction in Example (6) is 40% of the $36,000 deduction in Example (5). That 40% result from Example (6) applying the SSTB limitation, and being 60% through the phase-in range leaves 40% of the benefit of the threshold remaining.

Prop. Reg. § 1.199A-1(d)(4), Example (7) provides:

(i) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each business. For Business X, the lesser of 20% of QBI ($1,000,000 x 20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000 x 50% = $250,000) is $200,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($1,000,000 x 20% = $200,000) and 50% of its W-2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 x 20% = $400) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $400.

(iii) Next, F must then combine the amounts determined in paragraph (ii) of this example and compare that sum to 20% of F's taxable income. The lesser of these two amounts equals F's section 199A deduction. The total of the combined amounts in paragraph (ii) is $200,400 ($200,000 + 0 + 400). Twenty percent of F's taxable income is $544,400 ($2,722,000 x 20%). Thus, F's section 199A deduction for 2018 is $200,400.

Note that $100,000 Business X's wages were wasted, in that Business X needed only $400,000 of wages to support a $200,000 deduction. Similarly, all but $800 ($4,000 deduction divided by 50%) of Business Z's $500,000 of wages were wasted. Thus, $599,200 of wages are wasted ($100,000 + $500,000 minus $800).

Prop. Reg. § 1.199A-1(d)(4), Example (8) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000 x 20%) and 50% of W-2 wages from the aggregated businesses, which is $500,000 ($1,000,000 x 50%). F's section 199A deduction is equal to the lesser of $400,400 and 20% of F's taxable income ($2,722,000 x 20% = $544,400). Thus, F's section 199A deduction for 2018 is $400,400.

Example (8) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A. Although Example (8) has more wages than necessary to support the $400,400 deduction, aggregation enabled F to use most of wages that were wasted in Example (7).

Prop. Reg. § 1.199A-1(d)(4), Examples (9) through (12) are reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.E.1.c.vi. Wage Limitation If Taxable Income Is Above Certain Thresholds

After considering part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A, [739] the wage limitation is the greater of:[740]

(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

For details on the wage limitation, see parts II.E.1.c.vi.(a) W-2 Wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A, which generally are effectuated under Prop. Reg § 1.199A-2. Prop. Reg § 1.199A-2(d), "Effective/applicability date," provides:

(1) *General rule*. Except as provided in paragraph (d)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

  (i) *Anti-abuse rules*. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.

  (ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The wage limitation is relaxed or does not apply if taxable income is below certain thresholds.[741] See part II.E.1.c.v.(a) Taxable Income "Threshold.

---

[739] Within that part, fn 694 cross-references fn 740 of this part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[740] Code § 199A(b)(2)(B). Prop. Reg. § 1.199A-1(d)(2)(iv)(A) provides:

General rule. Except as provided in subparagraph (d)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business. For each trade or business (including trades or businesses operated through RPEs) the individual must determine the lesser of—

(1) 20 percent of the QBI for that trade or business; or

(2) The greater of—

  (i) 50 percent of W-2 wages with respect to that trade or business, or

  (ii) the sum of 25 percent of W-2 wages with respect to that trade or business plus 2.5 percent of the UBIA of qualified property with respect to that trade or business.

II.E.1.c.vi.(a). W-2 Wages under Code § 199A

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **II. Proposed § 1.199A-2: Determination of W-2 Wages and the UBIA of Qualified Property**
>
> As described in part I.C. of this Explanation of Provisions, if an individual's taxable income exceeds the threshold amount, Section 199A(b)(2)(B) imposes a limit on the Section 199A deduction based on the greater of either (i) the W-2 wages paid, or (ii) the W-2 wages paid and UBIA of qualified property attributable to a trade or business. This part of this Explanation of Provisions describes the rules in proposed § 1.199A-2 regarding the determination of W-2 wages and UBIA of qualified property.
>
> **A. W-2 wages attributable to a trade or business**
>
> The W-2 wage rules of proposed § 1.199A-2 generally follow the rules under former section 199. Section 199, which was repealed by the TCJA, provided for a deduction with respect to certain domestic production activities and contained a W-2 wage limitation similar to the one in Section 199A. The legislative text of the W-2 wage limitation in Section 199A is modeled on the text of former section 199, and both taxpayers and the IRS have developed experience in applying those W-2 wage rules for over a decade. The regulations under former section 199 provided rules to determine W-2 wages, which provide a useful starting point in developing the W-2 wage rules under Section 199A, including rules on the definition of W-2 wages, wages paid by persons other than the common-law employer, and methods for calculating W-2 wages.
>
> The Treasury Department and the IRS have received comments concerning whether amounts paid to workers who receive Forms W-2 from third party payors (such as professional employer organizations, certified professional employer organizations, or agents under section 3504) that pay these wages to workers on behalf of their clients and report wages on Forms W-2, with the third party payor as the employer listed in Box c of the Forms W-2, may be included in the W-2 wages of the clients of third party payors. In order for wages reported on a Form W-2 to be included in the determination of W-2 wages of a taxpayer, the Form W-2 must be for employment by the taxpayer. The regulations under former section 199, specifically § 1.199-2(a)(2), addressed this issue, providing that, since employees of the taxpayer are defined in the regulations as including only common law employees of the taxpayer and officers of a corporate taxpayer, taxpayers may take into account wages reported on Forms W-2 issued by other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer.
>
> Proposed § 1.199A-2(b)(2)(ii) provides a rule for wages paid by a person other than the common law employer that is substantially similar to the rule in § 1.199-2(a)(2). Specifically, the proposed regulations provide that, in determining W-2 wages, a person may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or

[741] Code § 199A(b)(3).

officers of the person for employment by the person. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. Persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504. Under this rule, persons who otherwise qualify for the deduction under Section 199A are not limited in applying the deduction merely because they use a third party payor to pay and report wages to their employees. However, with respect to individuals who taxpayers assert are their common law employees for purposes of Section 199A, taxpayers are reminded of their duty to file returns and apply the tax law on a consistent basis.

Unlike former section 199, the W-2 wage limitation in Section 199A applies separately for each trade or business. Accordingly, proposed § 1.199A-2 provides that, in the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined to be in the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses. Section 199A(b)(4) also requires that to be taken into account, W-2 wages must be properly allocable to QBI. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.

Additionally, proposed § 1.199A-2(b)(4) restates the rule of Section 199A(f)(1)(A)(iii), which provides that, in the case of a trade or business conducted by an RPE, a partner's or shareholder's allocable share of wages must be determined in the same manner as the partner's allocable share or a shareholder's pro rata share of wage expenses.

Consistent with Section 199A(b)(5) and the legislative history of the TCJA, which direct the Secretary to provide rules for applying the W-2 wage limitation in cases in which the taxpayer acquires, or disposes of, a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the year, proposed § 1.199A-2 (b)(2)(iv)(B) provides rules that apply in the case of an acquisition or disposition of a trade or business. See Joint Explanatory Statement of the Committee of Conference, 38. Specifically, proposed § 1.199A-2(b)(2)(iv)(B)(1) provides that, in the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2. For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in proposed § 1.199A-2(b).

A notice of proposed revenue procedure, Notice 2018-64, 2018-35 IRB ____, which provides three methods for calculating W-2 wages is being issued concurrently with this notice of proposed rulemaking. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, for purposes of calculating "paragraph (e)(1) wages" (that is, wages described in § 1.199-2(e)(1) issued under former section 199). The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

For a taxpayer using W-2 wages in calculating the QBI deduction, see Prop. Reg. § 1.199A-2(a)(2), reproduced in the text accompanying fn 657 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Prop. Reg. § 1.199A-2(b)(1) provides an overview of the rules for W-2 wages:

> *In general*. Section 199A(b)(2)(B) provides limitations on the Section 199A deduction based on the W-2 wages paid with respect each trade or business. Section 199A(b)(4)(B) provides that W-2 wages do not include any amount which is not properly allocable to QBI for purposes of Section 199A(c)(1). This section provides a three step process for determining the W-2 wages paid with respect to a trade or business that are properly allocable to QBI. First, each individual or RPE must determine its total W-2 wages paid for the taxable year under the rules in paragraph (b)(2) of this section. Second, each individual or RPE must allocate its W-2 wages between or among one or more trades or businesses under the rules in paragraph (b)(3) of this section. Third, each individual or RPE must determine the amount of such wages with respect to each trade or business that are allocable to the QBI of the trade or business under the rules in paragraph (b)(4) of this section.

"W-2 wages" means, with respect to any person for any taxable year of such person, the W-2 wages paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year:[742]

- In the case of a partnership or S corporation, each partner or shareholder is treated "as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."[743] A partner's or shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expenses.[744] A partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property is determined in the same manner as the partner's or shareholder's allocable share of depreciation.[745] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[746]

- For trusts and estates, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply.[747] See part II.E.1.f Trusts/Estates and the

[742] Code § 199A(b)(4)(A).
[743] Code § 199A(f)(1)(A)(iii).
[744] Code § 199A(f)(1)(A) (flush language).
[745] Code § 199A(f)(1)(A) (flush language).
[746] Code § 199A(f)(1)(A) (flush language).
[747] Code § 199A(f)(1)(B) provides:

> *Application to Trusts and Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the

Code § 199A Deduction, which is summarized in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

For a clue how statutory employees are treated, Section 3.01 of the proposed Revenue Procedure in Notice 2018-64 provides:

> Section 1.199A-2(b)(2)(i) also provides that, for purposes of § 1.199A-2, employees of the person are limited to employees of the person as defined in section 3121(d)(1) and (2) (that is, officers of a corporation and employees of the person under the common law rules). Therefore, Forms W-2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W-2 in which the "Statutory Employee" box in Box 13 is checked) should not be included in calculating W-2 wages under any of the methods described in this revenue procedure.

Code § 3121(d)(3) excludes from "employee" any person, other than "any officer of a corporation" or a common law employee, "who performs services for remuneration for any person":

> (A) as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;
>
> (B) as a full-time life insurance salesman;
>
> (C) as a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or
>
> (D) as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations;
>
> if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed….

---

apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

If employers cannot treat payments to these statutory employees as wages under part II.E.1.c.vi.(a) W-2 Wages under Code § 199A, then these payments should not be treated as wages excluded from QBI. Indeed, the closing parenthetical to Prop. Reg. § 1.199A-5(d) confirms this result.[748]

W-2 wages generally are wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans.[749] The wages must be "properly allocable to" QBI.[750] The wages must be "properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return."[751]

Prop. Reg. § 1.199A-2(b)(2), "Definition of W-2 wages," elaborates on the above, starting with:

> (i) *In general*. Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section 402A). For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(2) and (b)(2)(iv)(D) of this section, the Forms W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages are those issued for the calendar year ending during the individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. For purposes of this section, employees of the individual or RPE are limited to employees of the individual or RPE as defined in section 3121(d)(1) and (2). (For purposes of Section 199A, this includes officers of an S corporation and employees of an individual or RPE under common law.)
>
> (ii) *Wages paid by a person other than a common law employer*. In determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. In such cases, the person paying the W-2 wages and reporting

[748] See Prop. Reg. § 1.199A-5(d)(1), reproduced in part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI).

[749] Code § 199A(b)(4)(A) provides:

> *In General*. The term "W-2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

If a taxpayer has qualified business income from sources within the commonwealth of Puerto Rico and all that income is taxable under Code § 1 for the taxable year, then Code § 199A(f)(1)(C)(ii) provides that:

> the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

[750] Code § 199A(b)(4)(B).

[751] Code § 199A(b)(4)(C).

the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. For purposes of this subparagraph, persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(iii) *Requirement that wages must be reported on return filed with the Social Security Administration (SSA)*.

(A) *In general*. Pursuant to Section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under § 31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, "Transmittal of Wage and Tax Statements," together constitute an information return to be filed with SSA. Similarly, each Form W-2c, "Corrected Wage and Tax Statement," and the transmittal Form W-3 or W-3c, "Transmittal of Corrected Wage and Tax Statements," together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 will be considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c will be considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in § 31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under § 31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(B) *Corrected return filed to correct a return that was filed within 60 days of the due date*. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (b)(2)(iii)(C) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(C) *Corrected return filed to correct a return that was filed later than 60 days after the due date*. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c (or corrected Form W-2) is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2 (or to correct a Form W-2c relating to an information return including a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2), then the information return including this Form W-2c (or corrected Form W-2) will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this information return including the Form W-2c (or corrected Form W-2), regardless of when the information return including the Form W-2c (or corrected Form W-2) is filed.

The IRS must explain how the QBI rules apply "in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year."[752]

Prop. Reg. § 1.199A-2(b)(2), "Methods for calculating W-2 wages," implements the above:

(A) *In general*. The Secretary may provide for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(B) *Acquisition or disposition of a trade or business*.

(1) In general. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, "Wage and Tax Statement." For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in § 1.199A-2(b).

(2) Acquisition or disposition. For purposes of this paragraph (b)(2)(iv)(B), the term acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

(C) *Application in the case of a person with a short taxable year*.

[752] Code § 199A(b)(5).

(1) In general. In the case of an individual or RPE with a short taxable year, subject to the rules of paragraph (b)(2) of this section, the W-2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the individual or RPE.

(2) Short taxable year that does not include December 31. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (b) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(D) *Remuneration paid for services performed in the Commonwealth of Puerto Rico*. In the case of an individual or RPE that conducts a trade or business in the Commonwealth of Puerto Rico, the determination of W-2 wages of such individual or RPE will be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. The individual or RPE must maintain sufficient documentation (for example, Forms 499R-2/W-2PR) to substantiate the amount of remuneration paid for services performed in the Commonwealth of Puerto Rico that is used in determining the W-2 wages of such individual or RPE with respect to any trade or business conducted in the Commonwealth of Puerto Rico.

Prop. Reg. § 1.199A-2(b)(3), “Allocation of wages to trades or businesses,” provides:

> After calculating total W-2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 wages must be allocated to the trade or business that generated those wages. In the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under § 1.199A-3(b)(5).

Prop. Reg. § 1.199A-2(b)(4), “Allocation of wages to QBI,” completes the allocation process:

> Once W-2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W-2 wages properly allocable to QBI for each trade or business. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under § 1.199A-3. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S. The RPE must also identify and report the associated W-2 wages to its partners or shareholders.

Prop. Reg. § 1.199A-2(b)(5), “Non-duplication rule,” provides:

Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year. Also, an amount cannot be treated as W-2 wages by more than one trade or business.

II.E.1.c.vi.(b). Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A

As discussed above, part of the wage limitation test is an alternative calculation relating to qualified property.[753] For a taxpayer using Unadjusted Basis Immediately after Acquisition (UBIA) of qualified property in calculating the QBI deduction, see Prop. Reg. § 1.199A-2(a)(3), reproduced in the text accompanying fn 657 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **B. The UBIA of qualified property**
>
> Section 199A(b)(2)(B)(ii) provides an alternative deduction limitation based on 25 percent of W-2 Wages with respect to the qualified trade or business and 2.5 percent of the UBIA of qualified property. Proposed § 1.199A-2 restates the statutory definitions under the qualified property rules, and provides additional guidance.
>
> **1. General definition of UBIA of qualified property**
>
> Proposed § 1.199A-2(c)(1) restates the definition of qualified property in Section 199A(b)(6)(A), which provides that "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, a trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the depreciable period has not ended before the close of the taxable year. Proposed § 1.199A-2(c)(2) also restates the definition of depreciable period in Section 199A(b)(6)(B), which provides that "depreciable" period means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of the application of section 168(g).
>
> Because the applicable recovery period under section 168(c) of the property is not changed by any additional first-year depreciation deduction allowable under section 168, proposed § 1.199A-2(c)(2)(ii) also clarifies that the additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or section 168(m)) does not affect the applicable recovery period under section 168(c).
>
> Proposed § 1.199A-2(c)(3) provides a definition of UBIA. The Treasury Department and the IRS believe that existing general principles used to define "unadjusted basis" in § 1.263(a)-3(h)(5) provide a reasonable basis for an administrable rule that is appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. In addition, the Treasury Department and the IRS believe that

[753] Code § 199A(b)(2)(B)(ii).

"immediately after acquisition" means as of the date the property is placed in service because Section 199A provides that "qualified property" must be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service. Determining UBIA as of the date the property is placed in service ensures consistency between purchased and produced qualified property, and reduces compliance costs, burden, and administrative complexity because taxpayers are already required to determine that amount. Accordingly, proposed § 1.199A-2 provides that the term "UBIA" means the basis as determined under section 1012 or other applicable sections of chapter 1, including subchapter O (relating to gain or loss on dispositions of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C). Therefore, for purchased or produced qualified property, UBIA generally will be its cost under section 1012 as of the date the property is placed in service. For qualified property contributed to a partnership in a section 721 transaction and immediately placed in service, UBIA generally will be its basis under section 723. For qualified property contributed to an S corporation in a section 351 transaction and immediately placed in service, UBIA generally will be its basis under section 362. Further, for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014. However, proposed § 1.199A-2(c)(3) provides that UBIA does reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business.

2. Partnership special basis adjustments

After the enactment of the TCJA, the Treasury Department and the IRS received comments requesting guidance as to whether partnership special basis adjustments under sections 734(b) or 743(b) constitute qualified property for purposes of Section 199A. Treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended).

Accordingly, proposed § 1.199A-2(c)(1)(iii) provides that partnership special basis adjustments are not treated as separate qualified property.

3. Property transferred with a principal purpose of increasing Section 199A deduction

Qualified property includes depreciable property used during the taxable year in the production of QBI and held by, and available for use in, the trade or business at the close of the taxable year. However, it would be inconsistent with the purposes of Section 199A to permit trades or businesses to transfer or acquire property at the end of the year merely to manipulate the UBIA of qualified property attributable to the trade or business. Therefore, pursuant to the authority granted to the Secretary under Section 199A(f)(4), proposed § 1.199A-2(c)(1)(iv) provides that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

4. Like-kind exchanges and involuntary conversions

Section 199A does not provide rules to determine UBIA for qualified property in the case of an exchange of property under section 1031 (like-kind exchange) or involuntary conversion under section 1033. However, Section 199A(h)(2) specifically instructs the Secretary to do so. The Treasury Department and the IRS believe that existing general principles used for like-kind exchanges and involuntary conversions under § 1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2 (c)(2)(iii) generally follows the rules of § 1.168(i)-6 to provide that qualified property that is acquired in a like-kind exchange, as defined in § 1.168(i)-6(b)(11), or in an involuntary conversion, as defined in § 1.168(i)-6(b)(12), is treated as replacement Modified Accelerated Cost Recovery System (MACRS) property as defined in § 1.168(i)-6(b)(1) whose depreciable period generally is determined as of the date the relinquished property was first placed in service. Accordingly, subject to one exception, proposed § 1.199A-2(c)(2)(iii) provides that, for purposes of determining the depreciable period, the date the exchanged basis in the replacement qualified property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE and the date the excess basis in the replacement qualified property is first placed in service by the individual or RPE is the date on which the replacement qualified property was first placed in service by the individual or RPE. As a result, the depreciable period under Section 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

The exception is that proposed § 1.199A-2(c)(2)(iii)(C) provides that, for purposes of determining the depreciable period, if the individual or RPE makes an election under § 1.168(i)-6(i)(1) (the election not to apply § 1.168(i)-6)), the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the individual or RPE, with UBIA determined as of that date. In this case, the depreciable periods under Section 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is actually placed in service; for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the relinquished property was first placed in service. The proposed regulations contain an example illustrating these rules.

5. Other nonrecognition transactions

The Treasury Department and the IRS have received comments requesting guidance on the application of the qualified property rules to nonrecognition transfers involving transferred basis property within the meaning of section 7701(a)(43) (transferred basis transactions). For example, taxpayers and practitioners requested guidance on how to determine the depreciable period of the property if a partnership conducts a trade or business and qualified property is contributed to that trade or business in a nonrecognition transfer under section 721(a). Also of relevance in the context of non-recognition transfers, Section 199A(h)(1) grants the Secretary anti-abuse authority to apply rules similar to the rules under section 179(d)(2) (which can restrict the expensing of certain assets in transferred basis transactions) to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

The Treasury Department and the IRS believe that existing general principles used for transferred basis transactions under § 168(i)(7) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2(c)(2)(iv) provides that, for purposes of determining the depreciable period, if an individual or RPE (the transferee) acquires qualified property in a transaction described in section 168(i)(7)(B), the transferee determines the date on which the qualified property was first placed in service using a two-step approach. First, for the portion of the transferee's UBIA of the qualified property that does not exceed the transferor's UBIA of such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service. Second, for the portion of the transferee's UBIA of the qualified property that exceeds the transferor's UBIA of such property, if any, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer. Thus, qualified property acquired in these non-recognition transactions will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is placed in service by the transferee (for instance, the date the partnership places in service property received in a section 721 transaction); for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the transferor first placed the property in service (for instance, the date the partner placed the property in service in his or her sole proprietorship). The proposed regulations contain an example illustrating these rules.

The Treasury Department and the IRS request comments concerning appropriate methods for accounting for non-recognition transactions, including rules to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

6. Redetermination of UBIA and subsequent improvements to qualified property

The Treasury Department and the IRS have received comments requesting guidance on the treatment of subsequent improvements to qualified property. Subsequent improvements to qualified property are generally treated as a separate item of property under section 168(i)(6). The Treasury Department and the IRS do not believe a different approach is necessary for purposes of Section 199A. Accordingly, proposed § 1.199A-

2(c)(1)(ii) provides that, in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that the taxpayer first placed in service on the date such addition or improvement is placed in service by the taxpayer for purposes of determining the depreciable period of the qualified property. For example, if a taxpayer acquired and placed in service a machine on March 26, 2018, and then incurs additional capital expenditures to improve the machine in May 2020, and places such improvements in service on May 27, 2020, the taxpayer has two qualified properties: the machine acquired and placed in service on March 26, 2018, and the improvements to the machine incurred in May 2020 and placed in service on May 27, 2020.

7. Allocation of UBIA of qualified property by RPEs

In the case of a trade or business conducted by an RPE, Section 199A(f) provides that a partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation. Proposed § 1.199A-2(a)(3) provides that, in the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year. In the case of qualified property of a partnership that does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property of an S corporation that does not produce tax depreciation during the year, each shareholder's share of the UBIA of the qualified property is a share of the UBIA proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

Getting into the Code and Proposed Regulations themselves:

"Qualified property" means, with respect to any QBI for a taxable year, tangible property of a character subject to the allowance for depreciation under Code § 167:[754]

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

After almost mirroring this statutory definition,[755] Prop. Reg. § 1.199A-2(c)(1) continues:

---

[754] Code § 199A(b)(6)(A).

[755] Prop. Reg. § 1.199A-2(c)(1)(i) almost mirrors the above definition, except:

- It refers to Code § 167(a) instead of Code § 167.

(ii) *Improvements to qualified property*. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of paragraph (c)(2) of this section.

(iii) *Adjustments under sections 734(b) and 743(b)*. Basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.

(iv) *Property acquired at end of year*. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

Clause (iii) does not surprise me. Although certain positive basis adjustments under Code § 743(b) on the transfer of a partnership interest or under Code § 734(b) on a partnership's distribution of property are treated as the purchase of new property for purposes of Code § 168 depreciation deductions, they apply only for the purpose of Code § 168 and do not appear to affect the unadjusted basis used in this calculation.[756] From a practical viewpoint, if the policy goal of Code § 199A is to encourage new investment in business assets, allowing a basis step-up on death would not have achieved that result. On the other hand, when a person invests by buying a partnership interest, the buyer is essentially buying a share of the partnership's assets; shouldn't that be treated as an investment?

On the other hand, the preamble above provides, "for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014." Presumably, the heir's business is considered a new business, because for tax purposes the decedent was the business, that business died with the decedent, and the heir is now the business. After discussing the "depreciable period," we will revisit this issue.[757]

Note that the test for qualified property refers to "unadjusted basis," so it does not take into account depreciation deductions or any other basis reductions, such as bonus depreciation deductions.[758] Also note that land is not "qualified property" except to the extent of depreciable land improvements.

Prop. Reg. § 1.199A-2(c)(3), "Unadjusted basis immediately after acquisition," provides:

> The term unadjusted basis immediately after acquisition (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other

- It provides that the taxable year is the individual's or RPE's taxable year.

[756] See fns 4789-4790 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest and fn 4858 in part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[757] See fn 767.

[758] See part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation. Code § 179 expense is not available to nongrantor trusts.

applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis for which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business.

Code § 1016(a)(2), (3) is the basis adjustment for accumulated depreciation.

The "depreciable period" means the period beginning on the date the taxpayer first placed the property in service and ending on the later of the tenth anniversary of being placed in service or the last day of the last full year in the applicable recovery period under Code § 168 (the current depreciation rules).[759] The IRS must:[760]

(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

Prop. Reg. § 1.199A-2(c)(2), "Depreciable period," provides:

(i) *In general*. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of—

(A) The date that is 10 years after such date, or

(B) The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g).

(ii) *Additional first-year depreciation under section 168*. The additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or (m)) does not affect the applicable recovery period under this paragraph for the qualified property.

(iii) *Qualified property acquired in transactions subject to section 1031 or section 1033*. For purposes of paragraph (c)(2)(i) of this section, qualified property that is acquired in a like-kind exchange, as defined in § 1.168(i)-6(b)(11), or in an involuntary conversion, as defined in § 1.168(i)-6(b)(12), is treated as replacement MACRS property as defined in § 1.168(i)-6(b)(1). For purposes of paragraph (c)(2)(i) of this

[759] Code § 199A(b)(6)(B), which also provides that Code § 168(g), under which an extended depreciable life is required or permitted to be elected, does not apply in determining the property's depreciable life.
[760] Code § 199A(h).

section, the date on which the replacement MACRS property was first placed in service by the individual or RPE is determined as follows—

(A) Except as provided in paragraph (c)(2)(iii)(C) of this section, the date the exchanged basis, as defined in § 1.168(i)-6(b)(7), in the replacement MACRS property was first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE; and

(B) Except as provided in paragraph (c)(2)(iii)(C) of this section, the date the excess basis, as defined in § 1.168(i)-6(b)(8), in the replacement MACRS property was first placed in service by the individual or RPE is the date on which the replacement MACRS property was first placed in service by the individual or RPE; or

(C) If the individual or RPE makes an election under § 1.168(i)-6(i)(1) (the election not to apply § 1.168(i)-6)), the date the exchanged basis and excess basis in the replacement MACRS property was first placed in service by the trade or business is the date on which the replacement MACRS property was first placed in service by the individual or RPE.

(iv) *Qualified property acquired in transactions subject to section 168(i)(7)*. If an individual or RPE acquires qualified property in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the individual or RPE must determine the date on which the qualified property was first placed in service for purposes of paragraph (c)(2)(i) of this section as follows—

(A) For the portion of the transferee's unadjusted basis in the qualified property that does not exceed the transferor's unadjusted basis in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferee's unadjusted basis in the qualified property that exceeds the transferor's unadjusted basis in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

Code § 168(i)(7)(B) refers to Code §§ 332 (parent corporation not recognizing gain on liquidation of a subsidiary), 351 (no gain or loss on contribution of property to a controlled corporation in exchange for stock in that corporation),[761] 721 (no gain or loss on contribution of property to a partnership in exchange for a partnership interest),[762] and 731 (no gain or loss on distribution of property from a partnership).[763]

Prop. Reg. § 1.199A-2(c)(4), Example (1), provides:

[761] See part § II.M.2 Buying into or Forming a Corporation.
[762] See part II.M.3 Buying into or Forming a Partnership.
[763] See part II.Q.8.b.i Distribution of Property by a Partnership.

(i) On January 5, 2012, A purchases for $1 million and places in service Real Property X in A's trade or business. A's trade or business is not an SSTB. A's basis in Real Property X under section 1012 is $1 million. Real Property X is qualified property within the meaning of Section 199A(b)(6). As of December 31, 2018, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $821,550.

(ii) For purposes of Section 199A(b)(2)(B)(ii) and this section, A's UBIA of Real Property X is its $1 million cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2).

Prop. Reg. § 1.199A-2(c)(4), Example (2), provides:

The facts are the same as in Example 1 of this paragraph (c)(4), except that on January 15, 2019, A enters into a like-kind exchange under section 1031 in which A exchanges Real Property X for Real Property Y. Real Property Y has a value of $1 million. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $820,482. A's UBIA in Real Property Y is $820,482 as determined under section 1031(d) (A's adjusted basis in Real Property X carried over to Real Property Y). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Property X was first placed in service by A.

Prop. Reg. § 1.199A-2(c)(4), Example (3), provides:

(i) C operates a trade or business that is not an SSTB as a sole proprietorship. On January 5, 2011, C purchases for $10,000 and places in service Machinery Y in C's trade or business. C's basis in Machinery Y under section 1012 is $10,000. Machinery Y is qualified property within the meaning of Section 199A(b)(6). Assume that Machinery Y's recovery period under section 168(c) is 10 years, and C depreciates Machinery Y under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, C's basis in Machinery Y, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $2,500. On January 1, 2019, C incorporates the sole proprietorship and elects to treat the newly formed entity as an S corporation for Federal income tax purposes. C contributes Machinery Y and all other assets of the trade or business to the S corporation in a non-recognition transaction under section 351. The S corporation immediately places all the assets in service.

(ii) For purposes of Section 199A(b)(2)(B)(ii) and this section, C's UBIA of Machinery Y from 2011 through 2018 is its $10,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). Pursuant to paragraph (c)(3) of this section, S corporation's UBIA of Machinery Y is determined under the applicable rules of subchapter C as of date the S corporation places it in service. Therefore, the S corporation's UBIA of Machinery Y is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(2)(iv)(A) of this section, for purposes of determining the depreciable

> period of Machinery Y, the S corporation's placed in service date will be the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

Example (3) shows a strategic mistake that a business owner can make when reorganizing. By incorporating C's business, C reduced Machinery Y's UBIA from $10,000 to only $2,500. (In addition to reducing UBIA under these rules, contributions of appreciated property may generate surprising allocations of UBIA; see fn 772.) C should have retained Machinery Y outside of the S corporation and leased it to the S corporation. C would have been able to aggregate C's rental income and deductions with the S corporation's QBI, even if the rental activity did not rise to the level of a trade or business.[764] Even if aggregation were not possible, equipment rental generally is considered to be a trade or business with even minimal activity,[765] whereas real estate requires some substantial level of activity.[766]

With all of this in mind, let's revisit the contrast between the lack of Code § 754 basis attributes for Code § 199A and the fresh start given when an individual (presumably including a disregarded entity) owns property.[767] Should each partner should consider whether he or she should have his or her own single member LLC own and lease property to the business? Consider equipment rental:

- As mentioned above,[768] equipment rental generally is considered to be a trade or business with even minimal activity, whereas real estate requires some substantial level of activity.

- Suppose equipment rental income is 20% of UBIA. That would generate a tentative QBI deduction of 4% (20% of 20%) of UBIA. That tentative deduction may be limited by the wage & UBIA limitation of 2.5% of UBIA. So the Code § 199A deduction may be less than it otherwise would be if the equipment rental cannot get aggregated with the main business and use the wage base.

- This strategy would backfire if the owner dies only a few years after the equipment purchase. Generally, used equipment is worth only a fraction of its original purchase price, so the UBIA would be significantly decreased. On the other hand, if the owner dies toward the end of the depreciable period (the greater of 10 years or the property's class life, then restarting the depreciable period would be helpful. Note, however, that restarting the depreciable period would not be helpful under current law, because Code § 199A is scheduled to last less than 10 years; on the other hand, equipment near the end of the depreciable period may benefit from a depreciable period restart.

Now let's use a similar analysis for real estate:

---

[764] See Example (8) and Example (9) in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A, referring to Reg. § 1.199A-1(b)(13) (special rule deeming rental as a trade or business when it otherwise would not be), which is reproduced in full in fn 691 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

[765] See part II.L.2.a.ii Rental Exception to SE Tax, fns 2840-2844.

[766] See part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

[767] For this contrast, see text preceding and accompanying fn 757.

[768] See fns 765-766.

- Real estate requires some substantial level of activity to constitute a trade or business,[769] unless it is under common control with a tenant that engages in a trade or business.[770]

- Gross rental income tends to be about 8% of the property's value, although in 2017 I heard of long-term leases with high quality tenants being 4% or lower. Depreciation over approximately 40 years means 2.5% per year. On the high end of the spectrum, that means profit of no more than 5.5% per year (8.0% minus 2.5%), which would generate a tentative QBI deduction of 1.1% (20% of 5.5%) of UBIA. Thus, that tentative deduction would not be limited by the wage & UBIA limitation of 2.5% of UBIA. However, if the property's value increased and the rent increased with it, the wage & UBIA limitation would kick in. At that point, consider whether to shift employees from the operating business to the landlord, if the rental is not aggregated with the operating business.

- The strategy would well if the property's value increased before the owner's death or the property needed a depreciable period restart. However, given that Code § 199A is scheduled to sunset in a period that is much shorter than real estate's class life, a restart would help only for real estate bought decades ago that is nearing the end of its class life or if Code § 199A is permanently extended.

If going for this new UBIA and new depreciation period in a disregarded entity LLC is helpful, consider distributing separate properties from the current partnership/LLC to separate disregarded entity LLCs:

- Distributions from a partnership to partners generally is tax-free, unless the distributed property was contributed by a partner other than the recipient partner. Be sure to consider all of the issues described in part II.Q.8.b Partnership Redemption or Other Distribution.

- Distributing a fractional interest to separate LLCs is unlikely to work. As described in part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership, co-owners operating a trade or business generally will be treated as partners for federal income tax purposes and under state law. The main way to avoid partnership treatment is if the property is fully leased with triple-net-leases involving almost no work by the landlord; see part II.D.4.a Investment Trusts. If real estate is not a trade or business, it can qualify as QBI only by being under common control with the tenant.[771]

As mentioned in the preamble above, Prop. Reg. § 1.199A-2(a)(3), reproduced in the text accompanying fn 657 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, determines the allocation of UBIA to various owners, which includes:

> In the case of qualified property held by an RPE, each partner's … share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner's … share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified

769 See part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

770 Prop. Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 696, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.

771 See fn 810 in part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

property held by a partnership which does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property.

In its Ocetober 12, 2018 comments regarding Prop. Reg. § 1.199A-2(a)(3), the American Bar Association's Section on Taxation stated:

> We recommend that the Final Regulations provide that a partnership allocate the UBIA of its Qualified Property to its partners in the same manner as the allocation of section 704(b) depreciation with respect to the Qualified Property. If Qualified Property does not produce section 704(b) depreciation, then the UBIA with respect to that Qualified Property should be allocated in the same manner as either (i) the allocation of section 704(b) depreciation with respect to other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss, as described in Regulation section 1.704-1(a)(1)(vii).

Its recommendation is based on the idea that book depreciation is based on economics, whereas the Proposed Regulation allocations, which the comments refer to as the "Tax Items Approach," require much more detailed calculations and take into account the effect of prior depreciation deductions, which the concept of UBIA is supposed to ignore.[772] That recommendation persuades me, but we'll see whether it persuades the government.

---

[772] The comments said (footnotes omitted):

> The Tax Items Approach would require a separate calculation for each piece of Qualified Property. Section 704(c), which affects the allocation of tax depreciation in situations where there is a difference between section 704(b) basis and tax basis, generally is applied property-by-property. Therefore, the manner in which tax depreciation is allocated can vary for each piece of Qualified Property held by a partnership. In addition, these calculations could be even more complicated if the traditional method with curative allocations or the remedial method is used. If UBIA of Qualified Property is allocated based on section 704(b) depreciation instead of tax depreciation, then section 704(c) would not be taken into account, meaning that the allocation of Qualified Property would not necessarily need to be done separately for each piece of Qualified Property. The gain on the Hypothetical Transaction would also need be allocated separately for each piece of Qualified Property to properly account for section 704(c). This burdensome property-by-property calculation could be avoided by allowing taxpayers to refer to either (i) the allocation of section 704(b) depreciation of other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss items under Regulation section 1.704-1(a)(1)(vii), when allocating the UBIA of Qualified Property that does not produce depreciation.
>
> The Tax Items Approach could also produce results that are unintended from a policy perspective. Often times, section 704(c) results in the contributing partner being allocated little or none of the tax depreciation with respect to contributed property. Therefore, little or none of the UBIA of Qualified Property that is contributed to a partnership with a built-in gain would be allocated to the contributing partner. The fact that the contributing partner receives little to no tax depreciation with respect to contributed property is especially problematic considering that the impact of section 704(c) allocations will generally result in the contributing partners receiving a disproportionately large share of the partnership's income. If the contributing partner is allocated a disproportionately large share of the partnership's QBI and is allocated a disproportionately small share of the partnership's UBIA of Qualified Property, then the section 199A deduction

II.E.1.c.vii. Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, that amount is treated as a loss from a qualified trade or business in the succeeding taxable year.[773] The Senate's report states (note that the Conference Committee reduced the deduction from 23% to 20%):

> If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss.

For individuals with taxable income for the taxable year that does not exceed the threshold amount, Prop. Reg. § 1.199A-1(c)(2), "Carryover rules," provides:

> (i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.
>
> (ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of

---

available to the contributing partner may be limited even though the non-contributing partners have abundant UBIA of Qualified Property.

We considered whether the fact that a contributing partner may have contributed property with little to no basis is a good policy reason to allocate such partner a disproportionately small share of UBIA of Qualified Property. Because the rules under section 704(c) generally operate to ensure that a contributing partner is recognizing its built-in gain or loss over the life of contributed property, we do not believe limiting a contributing partner's ability to take a section 199A deduction is appropriate. Thus, any policy concerns with allocating UBIA of Qualified Property based on section 704(b) items versus tax items seem unwarranted, especially given the administrative burden resulting from the Tax Items Approach. Accordingly, it would seem more appropriate for partners to share in the UBIA of Qualified Property in the same manner that they share in the economic depreciation of such Qualified Property. For these reasons, we recommend that a partnership's UBIA of Qualified Property be allocated based on section 704(b) items, instead of applying the Tax Items Approach adopted in the Proposed Regulations.

[773] Code § 199A(c)(2).

the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Thus, losses from QBI are computed completely separately from losses from qualified PTP income that exceed qualified REIT dividends.

For individuals with taxable income for the taxable year that exceeds the threshold amount, Prop. Reg. § 1.199A-1(d)(2)(iii), "Netting and Carryover," provides:

(A) *Netting*. If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The adjusted QBI is then used in paragraph (d)(2)(iv) of this section. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(B) *Carryover of negative total QBI amount*. If an individual's QBI from all trades or businesses combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

Let's see how some examples apply these rules. Prop. Reg. § 1.199A-1(d)(4), Example (7), part (i) provides the facts on which the examples below are based:

F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

Prop. Reg. § 1.199A-1(d)(4), Example (9) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that for taxable year 2018, Business Z generates a loss that results in ($600,000) of negative QBI and pays $500,000 of W-2 wages. After allowable deductions unrelated to the businesses, F's taxable income is $2,120,000. Because Business Z had negative

QBI, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X and Business Y produced the same amount of positive QBI, the negative QBI from Business Z is apportioned equally among Business X and Business Y. Therefore, the adjusted QBI for each of Business X and Business Y is $700,000 ($1 million plus 50% of the negative QBI of $600,000). The adjusted QBI in Business Z is $0, because its negative QBI has been fully apportioned to Business X and Business Y.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, the lesser of 20% of QBI ($700,000 x 20% = $140,000) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $140,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($700,000 x 20% = $140,000) and 50% of its W-2 wages (zero) is zero.

(iii) F must combine the amounts determined in paragraph (ii) of this example and compare the sum to 20% of taxable income. F's section 199A deduction equals the lesser of these two amounts. The combined amount from paragraph (ii) of this example is $140,000 ($140,000 + $0) and 20% of F's taxable income is $424,000 ($2,120,000 x 20%). Thus, F's section 199A deduction for 2018 is $140,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

Business Z’s wages are totally wasted from a Code § 199A view, because it has a loss and the wages cannot support a deduction. That’s not much of a different result that Example (7), where Business Z has nominal income. Note also the way that the losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI.

Prop. Reg. § 1.199A-1(d)(4), Example (10) provides:

(i) Assume the same facts as in Example 9 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of §1.199A-4.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses ($1,400,000 x 20% = $280,000) and 50% of W-2 wages from the aggregated businesses ($1,000,000 x 50% = $500,000), or $280,000. F's section 199A deduction is equal to the lesser of $280,000 and 20% of F's taxable income ($2,120,000 x 20% = $424,000). Thus, F's section 199A deduction for 2018 is $280,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

Example (10) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A. Although Example (10) has more wages than necessary to support the $280,000 deduction, aggregation enabled F to use most of wages that were wasted in Example (9).

Prop. Reg. § 1.199A-1(d)(4), Example (11) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that Business Z generates a loss that results in ($2,150,000) of negative QBI and pays $500,000 of W-2 wages with respect to the business in 2018. Thus, F has a negative combined QBI of ($150,000) when the QBI from all of the businesses are added together ($1 million plus $1 million minus the loss of ($2,150,000)). Because F has a negative combined QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. None of the W-2 wages carry forward. However, for income tax purposes, the $150,000 loss may offset F's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(ii) In taxable year 2019, Business X generates $200,000 of net QBI and pays $100,000 of W-2 wages with respect to the business. Business Y generates $150,000 of net QBI but pays no wages. Business Z generates a loss that results in ($120,000) of negative QBI and pays $500 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. Pursuant to paragraph (d)(2)(iii)(B) of this section, the ($150,000) of negative QBI from 2018 is treated as arising in 2019 from a separate trade or business. Thus, F has overall net QBI of $80,000 when all trades or businesses are taken together ($200,000 plus $150,000 minus $120,000 minus the carryover loss of $150,000). Because Business Z had negative QBI and F also has a negative QBI carryover amount, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z and the carryover amount in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X produced 57.14% of the total QBI from Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% allocated to Business Y. Therefore, the adjusted QBI in Business X is $45,722 ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710)). The adjusted QBI in Business Y is $34,278 ($150,000, minus 42.86% of the loss from Business Z ($51,432) minus one third of the carryover loss ($64,290)). The adjusted QBI in Business Z is $0, because its negative QBI has been apportioned to Business X and Business Y.

(iii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, 20% of QBI is $9,144 ($45,722 x 20%) and 50% of W-2 wages is $50,000 ($100,000 x 50%), so the lesser amount is $9,144. Business Y pays no W-2 wages. Twenty percent of Business Y's QBI is $6,856 ($34,278 x 20%) and 50% of its W-2 wages (zero) is zero, so the lesser amount is zero.

(iv) F must then compare the combined amounts determined in paragraph (iii) of this example to 20% of F's taxable income. The section 199A deduction equals the lesser of these amounts. F's combined amount from paragraph (iii) of this example is $9,144 ($9,144 plus zero) and 20% of F's taxable income is $192,000 ($960,000 x 20%) Thus, F's section 199A deduction for 2019 is $9,144. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

Note again how losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI – this time not only for the current loss but also the carryover loss. Also note that some wages from Business X and all wages from Business Z were wasted, with Business Y not receiving any benefit from them. However, at least Business Y was able to absorb some of the losses from Business Z and the carryover losses, so the Business X was not hit with all of them and was therefore able to use its wages.

Prop. Reg. § 1.199A-1(d)(4), Example (12) provides:

(i) Assume the same facts as in Example 11 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4. For 2018, F's QBI from the aggregated trade or business is ($150,000). Because F has a combined negative QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. However, for income tax purposes, the $150,000 loss may offset taxpayer's $750,000 of wage income (assuming the loss is otherwise allowable under the Code)

(ii) In taxable year 2019, F will have QBI of $230,000 and W-2 wages of $100,500 from the aggregated trade or business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. F must treat the negative QBI carryover loss ($150,000) from 2018 as a loss from a separate trade or business for purposes of section 199A. This loss will offset the positive QBI from the aggregated trade or business, resulting in an adjusted QBI of $80,000 ($230,000 - $150,000).

(iii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000 x 20% = $16,000) and 50% of W-2 wages ($100,500 x 50% = $50,250) is $16,000. F's section 199A deduction equals the lesser of these amounts ($16,000) and 20% of F's taxable income ($960,000 x 20% = $192,000). Thus, F's section 199A deduction for 2019 is $16,000. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

Once again, aggregation has increased the deduction by allowing the wages of all of the qualified businesses to be counted.

A business that is projected to lose money might consider deferring wages to the next year if the wage limitation is a significant limitation in determining its owners' Code § 199A deduction. Of course, deferring that deduction also increases the owners' current taxable income, so any such planning should consider its context in the owners' overall tax planning.

Prop. Reg. § 1.199A-3(b)(1)(iv), "Previously disallowed losses," provides:

> Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

This does not authorize the wage and UBIA attributes to be carried over as well. However, for other reasons, being passive may be beneficial; see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. On the other hand, being passive is unfavorable if it generates the 3.8% tax on net investment income; see part II.I.8.a General Application of 3.8% Tax to Business Income.

II.E.1.c.viii. Income or Gain from or Sale of Property Used in the Business or Business Interest Itself

This part II.E.1.c.viii discusses specific applications:

- Part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using
- Part II.E.1.c.viii.(b) Passthrough Sale of a Building It Is Using.
- Part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a **Trade** or **Business**.
- Part II.E.1.c.viii.(d) Sale of a Stock in an S corporation Conducting a **Trade** or **Business**.

II.E.1.c.viii.(a). Passthrough Sale of Equipment It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[774] Thus, gain from the sale of equipment can be QBI only if it is with respect to a qualified trade or business.

Long-term capital gain is not QBI; see Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

[774] Code § 199A(c)(1), first cited in fn 675 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

II.E.1.c.viii.(b). Passthrough Sale of a Building It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[775] Thus, gain from the sale of a building can be QBI only if it is with respect to a qualified trade or business.

Strangely enough, property used in a business is not a capital asset. When real estate that is depreciated using straight-line depreciation (which generally applies to real estate acquired after 1986 and some acquired before 1986), Code § 1231 taxes gain of real estate held more than one year as long-term capital gain and losses as ordinary losses. Capital gain that recaptures straight-line depreciation is subject to capital gain tax higher that regular capital gain tax rates. However, if and to the extent that the taxpayer previously deducted ordinary losses under Code § 1231, the gain is taxed as ordinary income. See part II.G.6.a Code § 1231 Property, which also covers the sale of goodwill.

If and to the extent that a cost segregation study causes components to be subject to accelerated depreciation or if accelerated depreciation was used for the building, see the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

Also, if a passthrough sells depreciable property to a related party, generally any gain is taxed as ordinary income. See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill) and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships. That, too would use the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

To the extent that the sale of a building is taxed as long-term capital gain, it is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

II.E.1.c.viii.(c). Sale of an Interest in a Partnership Conducting a Trade or Business

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[776] Thus, gain from the sale of a partnership interest can be QBI only if it is with respect to a qualified trade or business.

The sale of a partnership interest may be taxed as capital gain, as provided in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, or as gain from the sale of an asset that is not a capital asset (ordinary income), under part II.Q.8.b.i.(f) Code § 751 – Hot Assets. Capital gain from the sale of a partnership interest is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

---

[775] Code § 199A(c)(1), first cited in fn 675 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[776] Code § 199A(c)(1), first cited in fn 675 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

However, Code § 751 ordinary income qualifies. See Prop. Reg. § 1.199A-3(b)(1)(i), reproduced in part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

II.E.1.c.viii.(d). Sale of a Stock in an S corporation Conducting a Trade or Business

Because the sale of S corporation stock is taxed as capital gain, it is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

However, the sale of S corporation stock is often treated as a sale of the underlying assets, with the gain increasing the stock's basis, followed by a deemed liquidation of the corporation, shifting the gain on sale of stock to a gain on sale of assets. See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. Such a sale tends to trigger ordinary income on the deemed sale of the assets, to the extent of depreciation recapture on personal property and any other property not depreciable as real estate. For additional ordinary income concerns if the buyer is a related party, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property. Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI. Thus, the Code § 199A deduction would ameliorate tax on actual or deemed asset sales.

II.E.1.c.ix. QBI and Effectively Connected Income

Items of QBI are "of income, gain, deduction, and loss" included or allowed in determining taxable income for the taxable year to the extent such items are:[777]

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears)….

The preamble, REG-107892-18 (8/16/2018), provides:

> **vi. Requirement that an item be effectively connected with a U.S. trade or business**
>
> Section 199A applies to all noncorporate taxpayers, whether such taxpayers are domestic or foreign. Accordingly, Section 199A applies to both U.S. citizens and resident aliens as well as nonresident aliens that have QBI. As noted previously in this Explanation of Provisions, QBI includes items of income, gain, deduction, and loss to the extent such items are (i) included or allowed in determining taxable income for the taxable year and (ii) effectively connected with the conduct of a trade or business within

---

[777] Code § 199A(c)(3)(A)(i), cited in fn 679 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction. Literally plugging Code § 199A(c)(3)(A)(i) into Code § 864(c) would make Code § 864(c)(1) read as follows:

> In the case of a qualified trade or business (within the meaning of section 199A) engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

the United States (within the meaning of section 864(c), determined by substituting “qualified trade or business (within the meaning of Section 199A)” for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place it appears).

a. Summary of rules for generally determining whether income is effectively connected with a United States trade or business

Section 864(c) provides rules that nonresident alien individuals and foreign corporations use to determine which items of income, gain, or loss are effectively connected with a United States trade or business. Section 873(a) permits nonresident aliens to deduct expenses only if and to the extent that they are connected with, or properly allocable and apportioned to, income effectively connected with a United States trade or business.

Thus, for example, a U.S. partner of a partnership that operates a trade or business in both the United States and in a foreign country would only include the items of income, gain, deductions, and loss that would be effectively connected with a United States trade or business. Similarly, a shareholder of an S corporation that is engaged in a trade or business in both the United States and in a foreign country would only take into account the items of income, gain, deduction, and loss that would be effectively connected to the portion of the business conducted by the S corporation in the United States, determined by applying the principles of section 864(c).

In general, whether a nonresident alien is engaged in a trade or business within the United States, as opposed to a trade or business conducted solely outside the United States, is based upon the all the facts and circumstances, as developed through case law and other published guidance. Pursuant to section 875(1), a nonresident alien is considered engaged in a trade or business within the United States if the partnership of which such individual is a member is so engaged.

Section 864(b) provides that the term “trade or business within the United States” includes (but is not limited to) the performance of personal services within the United States at any time during the taxable year, but excludes the performance of services described in section 864(b)(1) and (2). Section 864(b)(1) covers a limited set of nonresident aliens who perform services in the United States on behalf of foreign persons not otherwise engaged in a U.S. trade or business, or on behalf of U.S. persons through a foreign office, if the nonresident aliens are present in the United States less than 90 days during the taxable year and their compensation does not exceed $3,000. Section 864(b)(2) generally treats foreign persons, including partnerships, who are trading in stocks, securities, and in commodities for their own account or through a broker or other independent agent as not engaged in a United States trade or business.

b. Application to Section 199A

Although the cross reference in Section 199A(c)(3)(A)(i) to section 864 is limited to paragraph (c) of that section, no income derived from excluded services under section 864(b)(1) or (2) could ever be effectively connected income in the hands of a nonresident alien. Accordingly, Section 199A incorporates the specific rules regarding the scope of the term “trade or business in the United States” in determining QBI. As such, if a trade or business is not engaged in a U.S. trade or business by reason of section 864(b), items of income, gain, deduction, or loss from that trade or business will not be included in QBI because such items would not be effectively connected with the conduct of a U.S. trade or business.

If a trade or business is determined to be conducted in the United States, section 864(c)(3) generally treats all income of a nonresident alien from sources within the United States as effectively connected with the conduct of a U.S. trade or business. However, any income from sources within the United States described in section 871(a)(1) or (h) and any gain or loss from the sale of capital assets are only effectively connected if the income meets requirements of section 864(c)(2) and the regulations thereunder. Under section 864(c)(4), income from sources without the United States is generally not treated as effectively connected with the conduct of a U.S. trade or business unless an exception under section 864(c)(4)(B) applies. Thus, a trade or business's foreign source income, gain, or loss, (and any deductions effectively connected with such foreign source income, gain, or loss) would generally not be included in QBI, unless the income meets an exception in section 864(c)(4)(B). Whether income is U.S. or foreign sourced is determined under sections 861, 862, 863, and 865, and the regulations thereunder.

This rule does not mean that any item that is effectively connected with the conduct of a trade or business with the United States is therefore QBI. As discussed previously, the item must also be "with respect to" a trade or business. Certain provisions of the Code allow items to be treated as effectively connected, even though they are not with respect to a trade or business. For example, section 871(d) allows a nonresident alien individual to elect to treat income from real property in the United States that would not otherwise be treated as effectively connected with the conduct of a trade or business within the United Sates as effectively connected. However, for purposes of Section 199A, if items are not attributable to a trade or business under 162, such items do not constitute QBI.

Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of Section 199A. For example, for purposes of computing effectively connected taxable income, section 873(b) allows certain deductions, including for theft losses of property located within the United States and charitable contributions allowed under section 170, to be taken into account regardless of whether they are connected with income that is effectively connected with the conduct of a trade or business within the United States. However, for purposes of Section 199A, these items would not be taken into account because Section 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.

Prop. Reg. § 1.199A-3(b)(2)(i) provides:

In general. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are—

(A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

(B) Included or allowed in determining taxable income for the taxable year.

Code § 864(c) taxes nonresident alien individuals on income and sets forth rules that "apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States."[778]

Note re: various citations below to regulations under Code § 864(c): various tax research services warn that the Treasury has not yet amended them to reflect changes made by laws since 1984, and they include this warning even for regulations promulgated many years after 1984. I have not taken the time to look how accurate these warnings are; however, it has been suggested to me that the regulations are good law. Furthermore, ruling or determination letters will not ordinarily be issued:[779]

> Section 864. - Definitions and Special Rules. - Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in § 1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under § 1.864-2(c)(2); whether an instrument or item is a commodity as defined in § 1.864-2(d)(3); and for purposes of § 1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.

Code § 864(c)(2) provides that, in determining whether certain "fixed or determinable income" - or:[780]

> whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether-
>
> (A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or
>
> (B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

---

[778] Code § 864(c)(1)(A).

[779] Rev. Proc. 2018-7, Section 4.01(4).

[780] Reg. § 1.864-4(a), "In general," provides:

> This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person form sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

> In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

The fixed or determinable income to which Code § 864(c)(2) refers is "income from sources within the United States of the types described in section 871(a)(1), section 871(h), section 881(a), or section 881(c)." Code § 871(a)(1), "Income other than capital gains," provides that, except as provided in Code § 871(h) (relating to "portfolio interest"), a 30% tax is imposed on

> the amount received from sources within the United States by a nonresident alien individual as—
>
> (A) interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,
>
> (B) gains described in subsection (b) or (c) of section 631,
>
> (C) in the case of—
>
> (i) a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and
>
> (ii) a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (except that such original issue discount shall be taken into account under this clause only to the extent such discount was not theretofore taken into account under this clause and only to the extent that the tax thereon does not exceed the payment less the tax imposed by subparagraph (A) thereon), and
>
> (D) gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged,
>
> but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Code § 881, which applies to foreign corporations, is similar to Code § 871, which applies to nonresident aliens, regarding the above items.

Code § 871(a)(1)(A) is further described in part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.[781]

In determining whether fixed or determinable income and capital gains for the taxable year from sources within the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States:[782]

> the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

The asset-use test ordinarily applies in:[783]

> making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.

Ordinarily, an asset is treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is:[784]

> (a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

---

[781] Absent any guidance under the ECI rules, see part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

[782] Reg. § 1.864-4(c)(1)(i). Reg. § 1.864-4(c)(1)(ii) provides:

> *Special rule relating to interest on certain deposits*. For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before Jan. 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and § 1.864-5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of § 1.864-5.

[783] Reg. § 1.864-4(c)(2)(i), which concludes:

> See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

[784] Reg. § 1.864-4(c)(2)(ii).

(b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

Generally, "stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States."[785] However, the preceding sentence "shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation."[786]

Reg. § 1.864-4(c)(2)(iv), "Direct relationship between holding of asset and trade or business," provides:

(a) *In general*. In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (1) future diversification into a new trade or business, (2) expansion of trade or business activities conducted outside of the United States, (3) future plant replacement, or (4) future business contingencies.

(b) *Presumption of direct relationship*. Generally, an asset will be treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

The following examples illustrate Reg. § 1.864-4(c)(2)(iv):[787]

Example (1). M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities, M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required

---

785 Reg. § 1.864-4(c)(2)(iii)(a).

786 Reg. § 1.864-4(c)(2)(iii)(b), which further provides:

For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

787 Reg. § 1.864-4(c)(2)(v).

varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

> *Example (2)*. Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

The business-activities test ordinarily applies:[788]

> in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business.

The following examples illustrate the business-activities test:[789]

---

[788] Reg. § 1.864-4(c)(3)(i), which concludes:

> See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

[789] Reg. § 1.864-4(c)(3)(ii).

> *Example (1)*. Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864-2, and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, or losses.
>
> *Example (2)*. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

In applying the asset-use test or the business-activities test described above:[790]

> due regard shall be given to whether or not the asset, or the income, gain, or loss is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted condition or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

Regarding income related to an individual's personal services:[791]

[790] Reg. § 1.864-4(c)(4).
[791] Reg. § 1.864-4(c)(6).

(i) *Income, gain, or loss from assets*. Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale of exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business or performing the personal services.

(ii) *Wages, salaries, and pensions*. Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

Other than fixed or determinable income and capital gains, all income, gain, or loss "from sources within the United States" is "treated as effectively connected with the conduct of a trade or business within the United States."[792] For example:[793]

> *Example (1)*. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through it branch office in the United States. The income or loss from sources within the United States for 1968 from

[792] Code § 864(c)(3). Reg. § 1.864-4(b), "Income other than fixed or determinable income and capital gains," provides:

> All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year.

[793] Reg. § 1.864-4(b).

these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example (2). The facts are the same as in example (1) except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufacturers.

Example (3). Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

Special rules apply to whether income, gain or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual. Code § 864(c)(4), "Income from sources without United States," provides:

(A) Except as provided in subparagraphs (B) and (C), no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States.

(B) Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss-[794]

(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) derived in the active conduct of such trade or business;

(ii) consists of dividends, interest, or amounts received for the provision of guarantees of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account; or

(iii) is derived from the sale or exchange (outside the United States) through such office or other fixed place of business of personal property described in section 1221(a)(1) , except that this clause shall not apply if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.

Any income or gain which is equivalent to any item of income or gain described in clause (i), (ii) , or (iii) shall be treated in the same manner as such item for purposes of this subparagraph.

(C) In the case of a foreign corporation taxable under part I or part II of subchapter L, any income from sources without the United States which is attributable to its United States business shall be treated as effectively connected with the conduct of a trade or business within the United States.

---

[794] [my footnote – not in statute]: Code § 864(c)(5), which is discussed in case at fns 797 (together with Code § 864(c)(4)(B)) and 799 of this part II.E.1.c.ix QBI and Effectively Connected Income, provides the following rules in applying Code § 864(c)(4)(B):

(A) in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, an office or other fixed place of business of an agent shall be disregarded unless such agent (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such individual or foreign corporation, and (ii) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business,

(B) income, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived, and

(C) the income, gain, or loss which shall be attributable to an office or other fixed place of business within the United States shall be the income, gain, or loss property allocable thereto, but, in the case of a sale or exchange described in clause (iii) of such subparagraph , the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States.

(D) No income from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either -

(i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

(ii) is subpart F income within the meaning of section 952(a).

Reg. § 1.864-5(a), "In general," provides:

> This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in § 1.864-7, to which such income, gain, or loss is attributable in accordance with § 1.864-6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under § 1.864-4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

Reg. § 1.864-5(b)(1) provides that rents, royalties, or gains on sales of intangible property related to the use of the intangible property outside the United States are taken into account under Reg. § 1.864-5(a) only if "derived in the active conduct of the trade or business in the United States."

Reg. § 1.864-5(b)(2) provides that dividends or interest, or gains or loss from sales of stocks or securities are taken into account under Reg. § 1.864-5(a) if "realized by (a) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (b) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account," with "engaged in the active conduct of a banking, financing, or similar business in the United States" being determined under Reg. § 1.864-4(c)(5)(i).

Reg. § 1.864-5(b)(3)(i) provides that, to the extent not covered above:

> Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

However, Reg. § 1.864-6(a) provides that Reg. § 1.864-5(b) does not make income effectively connected for the taxable year with the conduct of a trade or business in the United States unless:

> the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864-7, which the taxpayer has in the United States at some time during the taxable year.

However, Reg. § 1.864-6(b)(1) provides:[795]

> For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

Reg. § 1.864-6(b)(2) provides special rules for rents, royalties, or gains or losses, from intangible personal property, and dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities:[796]

> (i) *Rents, royalties, or gains on sales of intangible property*. Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license,

---

[795] A case discusses Reg. § 1.864-6(b)(1) at fns 797, 798 and 800 in this part II.E.1.c.ix QBI and Effectively Connected Income.

[796] A case discusses Reg. § 1.864-6(b)(2)(i) at fn 799 in this part II.E.1.c.ix QBI and Effectively Connected Income.

sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (a) develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, (b) collects or accounts for the rents, royalties, gains, or losses, (c) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (d) performs merely clerical functions incident to the lease, license, sale, or exchange or (e) exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:

Example (1). F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licenses are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

Example (2). N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities*.

(a) *In general*. Dividends, or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of § 1.864-5, if the office or other fixed place of business either activity participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (1) collects or accounts for the dividends, interest, gains, or losses, (2) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (3) performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or (4) exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(b) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business*. Notwithstanding (a) of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of § 1.864-4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(c) *Security defined*. For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(d) *Limitations on application of rules on banking, financing, or similar business*.

(1) *Trading for taxpayer's own account*. The provisions of (b) of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of (b) of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under (a) of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(2) *Other income*. For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in (b) of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see (a) of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office*. Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864-5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the

United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out of potential customers as the place to which such sales should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: (a) the sale is made subject to the final approval of such office or other fixed place of business, (b) the property sold is held in, and distributed from, such office or other fixed place of business, (c) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or (d) such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

For purposes of that provision, Reg. § 1.864-6(c) defines a security as "any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items."

Reg. § 1.864-7 defines "an office or other fixed place of business in the United States."

Reg. § 1.864-5(c) relates to income attributable to certain foreign corporations' U.S. life insurance business.

The above analysis is informed by *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (7/13/2017), which is described in in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4722-4724. That case dealt with the sale of a partnership interest by a nonresident alien that was a passive investor in a U.S. business. The IRS argued that one must look through the partnership to determine whether gain on sale was ECI, and the taxpayer argued that the taxpayer did not participate in the business and that a partnership interest should be treated as ownership of an entity – not of the underlying assets. As described further below, 2017 tax reform added the rules relating to the sale of a partnership interest, but it did not overturn any other aspect of that ruling.

The court provided an overview of whether the redemption of the taxpayer's partnership interest was ECI:[797]

> Section 865(e)(3) provides that, in order to determine whether income from a sale is attributable to a U.S. office or fixed place of business, we must look to "[t]he principles of section 864(c)(5)", which provides rules for applying section 864(c)(4)(B) to determine what tax items are "attributable to" a U.S. office.[20] Under section 864(c)(5)(B), income, gain, or loss is attributable to a U.S. office only if: (a) the U.S. office is "a *material factor* in the production of such income", and (b) the U.S. office "*regularly carries* on activities of the type from which such income, gain, or loss is derived."[21] (Emphasis added.) 26 C.F.R. section 1.864-6, Income Tax Regs., refers to these two elements together as the "material factor" test, explaining "regularly carries on activities of the type", see sec. 864(c)(5)(B), as "realized in the ordinary course". Because the regulation employs the phrase "in the ordinary course" in its application of the statute, we also use "ordinary course" here as a synonym for "regularly carries on activities of the type".
>
> [20] By its terms, section 864(c)(4)(B) and (c)(5) does not apply to gains from dispositions of partnership interests, because such gains are not one of the three types of income denoted in section 864(c)(4)(B)(i)-(iii). Thus, section 865(e)(3) does not incorporate section 864(c)(5) per se but rather invokes only "*[t]he principles* of section 864(c)(5)". (Emphasis added.)
>
> [21] The parties have not directed us to any caselaw applying these "material factor" and "ordinary course" standards, and we find none.

The court discussed Reg. § 1.864-6(b)(1):[798]

> … the Commissioner argues in the alternative that because Premier increased the value of its underlying assets and increased its overall value as a going concern during the period that GMM was a partner, thereby increasing the value of GMM's interest, Premier's U.S. offices were an essential economic element in GMM's realization of gain in the redemption. In so arguing, the Commissioner conflates the ongoing value of a business operation with gain from the sale of an interest in that business. As we have explained previously, GMM's gain in the redemption was not realized from Premier's trade or business of mining magnesite, that is, from activities at the partnership level; rather, GMM realized gain at the partner level from the distinct sale of its partnership interest.

The court discussed Reg. § 1.864-6(b)(2)(i), to which the taxpayer pointed as requiring a higher level of activity than the taxpayer's:[799]

[797] Reg. § 1.864-6(b)(1) is quoted at fn 795 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 794 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.
[798] Reg. § 1.864-6(b)(1) is quoted at fn 795 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 794 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.
[799] Reg. § 1.864-6(b)(2)(i) is quoted at fn 796 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

> The Commissioner dismisses this argument with the observation, correct as far as it goes, that the regulation concerns "[r]ents, royalties, or gains on sales of intangible property", whereas here the income at issue is different - *i.e.*, proceeds from the redemption of a partnership interest. The Commissioner is correct in the sense that this regulation is not directly on point; however, in determining whether a sale is attributable to an office, we are directed by section 865(e)(3) to consult not "section 864(c)(5)" (which by its terms does not apply here, see supra note 19) but rather "*the principles of* section 864(c)(5)". (Emphasis added.) It therefore seems we must take guidance as appropriate from section 864(c)(5) and the regulations promulgated thereunder *without* dismissing, as the Commissioner would, provisions that are not directly on point, since the set of provisions that are directly on point is an empty set. We acknowledge it is fair to observe that a provision applicable to one kind of income might not be suited to a "material factor" analysis for another kind of income. But we see no reason to disregard this "[r]ents, royalties", etc., provision insofar as it provides an instance in which a U.S. office that "[d]evelops" and "adds substantial value to" an income-generating asset is nonetheless not a "material factor" in the realization of income from that asset. GMM reasonably derives from this regulation the principle that the creation of underlying value is simply a distinct function from being a material factor in the realization of income in a specific transaction.
>
> The material factor test is not satisfied here because Premier's actions to increase its overall value were not "an essential economic element in the realization of the income", 26 C.F.R. sec. 1.864-6(b)(1), that GMM received upon the sale of its interest. Increasing the value of Premier's business as a going concern, without a subsequent sale, would not have resulted in the realization of gain by GMM.
>
> To be sure, GMM's investment in Premier increased in value, presumably from Premier's business activities; but GMM did not realize gain from holding its interest in Premier until that amount became liquid, that is, until its partnership interest was redeemed. The regulations call for this focus in two ways—by providing that adding value alone is not a material factor, see *id.* subpara. (2)(i)(a), and by providing that performing merely clerical functions incident to the sale or exchange (*i.e.*, a reasonable description of Premier's role in effecting the liquidation)[23] is not a material factor, see *id.* subdiv. (i)(d). Thus, Premier's efforts to develop, create, or add substantial value to the property sold are not considered to be a material factor in the realization of the disputed gain pursuant to 26 C.F.R. section 1.864-6(b)(1), and the Commissioner therefore fails to show that the first test for attributing the disputed gain to a U.S. office - "material factor" - is met.
>
> [23] The Commissioner would dispute the reasonableness of that description, but in part IV.B.3.b below we discuss the nature and modest quantum of Premier's activity in the redemption

Finally, the court concluded that the taxpayer's gain on redemption of its partnership interest was not in the ordinary course of the partnership's business:[800]

> The second part of the U.S.-source attribution inquiry—"ordinary course"— is found in 26 C.F.R. section 1.864-6(b)(1), which provides:

[800] Reg. § 1.864-6(b)(1) is quoted at fn 795 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, this provision no longer apply to partnership interests, but they would apply to stock.

> [I]ncome, gain, or loss is attributable to an office or other fixed place of business which *** a foreign corporation has in the United States only *** *if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business.* *** [Emphasis added.]

Even if we were to decide that Premier's office was a "material factor" in the production of the disputed gain (which we do not), we would also need to find that the disputed gain was realized in the ordinary course of Premier's business conducted through its U.S. office in order for the gain to be attributable to that office, and thereby to be U.S.-source income.[24]

As required by its bylaws, Premier extended to GMM an offer to redeem its interest according to the terms of Premier's prior transaction with IMin. GMM accepted Premier's offer without any negotiation of the terms of the deal.

According to GMM, the redemption of its interest in Premier was a one-time, extraordinary event and therefore was not undertaken in the ordinary course of Premier's business. GMM argues that Premier's U.S. office is in the business of selling and producing magnesite, not buying and selling partnership interests. Because the disputed gain was realized in the redemption of GMM's partnership interest in Premier, not from Premier's ordinary business - magnesite production and sale - it does not satisfy the ordinary course requirement and is not U.S. source.

The Commissioner disagrees with GMM's characterization of Premier, and points to Premier's other actions - admitting a new partner and redeeming IMin's interest - to show that Premier's redemption of GMM's interest was not an isolated event. The Commissioner takes the position that the wording of section 865(e)(2)(A) ("any sale of personal property") is broad enough to cover all sales of personal property, including occasional sales. The Commissioner explains:

> The language of section 864(c)(5)(B) does not require that the sale of personal property occur regularly; it requires that the type of activities giving rise to the income occur regularly. In this regard, the language is amply broad to support attribution to an office of income from an occasional sale of personal property, *if the gain on the sale is derived from the business activities regularly conducted* through the office or other fixed place of business. [Emphasis added.]

The Commissioner again conflates the ongoing income-producing activities of Premier (magnesite production and sale), which certainly occurred in the ordinary course, and the redemption of GMM's partnership interest in Premier, which was an extraordinary event; and he thereby would effectively eliminate the "ordinary course" test and would allow the "material factor" test to stand for both tests. Premier's business did regularly produce income (and GMM paid tax on its distributive share of that income each year). However, contrary to the Commissioner's assertion, Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of its business. Premier engaged in only two such transactions (other than the redemption of GMM's interest) over the course of seven years, and this quantum of activity is not sufficient to show that Premier was in the business of redeeming and selling partnership interests. Rather, Premier is of course in the business of producing and selling magnesite products, and therefore GMM's gain realized on the redemption of its

> partnership interest in Premier was not realized in the ordinary course of the trade or business carried on through Premier's U.S. offices.
>
> Since we have held that GMM's disputed gain on its redemption was not attributable to a U.S. office or other fixed place of business, it is therefore not U.S.-source income under section 865(e)(2)(A). As noted above, the Commissioner concedes that the disputed gain is not one of the types of foreign-source income treated as effectively connected by section 864(c)(4)(B). Consequently, the disputed gain is not effectively connected income.
>
> [24] Rev. Rul. 91-32 *supra*, makes no mention of the "ordinary course" prong of the "attributable to" analysis, and this detracts from the persuasiveness of its conclusion that gain such as the disputed gain is attributable to U.S. offices.

Also, certain dividends, interest, or royalties paid by a related foreign corporation and certain Subpart F income from a controlled foreign corporation, which are from sources without the United States, are excluded from treatment as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation.[801]

Additional rules apply to deferred payment[802] and to property disposed of within 10 years after it to be used or held for use in connection with the conduct of a trade or business within the United States.[803]

In response to *Grecian Magnesite*, [804] 2017 tax reform added Code § 864(c)(8), which provides:[805]

---

[801] Reg. § 1.864-5(d). Reg. § 1.864-5(d)(3) also coordinates with Reg. § 1.864-4:

> Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of § 1.864-4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

[802] Code § 864(c)(6).

[803] Code § 864(c)(7).

[804] *Grecian Magnesite Mining v. Commissioner*, which is described above and further described in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4722-4724. The Conference report provided:

> Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.[1107] Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.[1108]
>
> [1107] Rev. Rul. 91-32, 1991-1 C.B. 107.

Gain or loss of foreign persons from sale or exchange of certain partnership interests.

(A) *In general*. Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).

(B) *Amount treated as effectively connected*. The amount determined under this subparagraph with respect to any partnership interest sold or exchanged-

(i) in the case of any gain on the sale or exchange of the partnership interest, is-

(I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or

(II) zero if no gain on such deemed sale would have been so effectively connected, and

(ii) in the case of any loss on the sale or exchange of the partnership interest, is-

(I) the portion of the partner's distributive share of the amount of loss on the deemed sale described in clause (i)(I) which would have been so effectively connected, or

(II) zero if no loss on such deemed sale would be have been so effectively connected.

For purposes of this subparagraph, a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.

(C) *Coordination with United States real property interests*. If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

(D) *Sale or exchange*. For purposes of this paragraph, the term "sale or exchange" means any sale, exchange, or other disposition.

[1108] *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).
[805] For further discussion, see part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business.

(E) *Secretarial authority*. The Secretary shall prescribe such regulations or other guidance as the Secretary determines appropriate for the application of this paragraph, including with respect to exchanges described in section 332, 351, 354, 355 , 356, or 361.

Code § 897(a)(1) provides:

Treatment as effectively connected with United States trade or business. For purposes of this title, gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest shall be taken into account-

(A) in the case of a nonresident alien individual, under section 871(b)(1), or

(B) in the case of a foreign corporation, under section 882(a)(1),

as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

Code § 897(c), "United States Real Property Interest," provides:

For purposes of this section-

(1) *United States real property interest*.

(A) *In general*. Except as provided in subparagraph (B) or subsection(k), the term "United States real property interest" means-

(i) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands, and

(ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the shorter of-

(I) the period after June 18, 1980, during which the taxpayer held such interest, or

(II) the 5-year period ending on the date of the disposition of such interest.

(B) *Exclusion for interest in certain corporations*. The term "United States real property interest" does not include any interest in a corporation if-

(i) as of the date of the disposition of such interest, such corporation did not hold any United States real property interests,

(ii) all of the United States real property interests held by such corporation at any time during the shorter of the periods described in subparagraph (A)(ii)-

(I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or

(II) ceased to be United States real property interests by reason of the application of this subparagraph to 1 or more other corporations, and

(iii) such corporation nor any predecessor of such corporation was a regulated investment company or a real estate investment trust at any time during the shorter of the periods described in subparagraph (A)(ii).

(2) *United States real property holding corporation*. The term "United States real property holding corporation" means any corporation if-

(A) the fair market value of its United States real property interests equals or exceeds 50 percent of

(B) the fair market value of-

(i) its United States real property interests,

(ii) its interests in real property located outside the United States, plus

(iii) any other of its assets which are used or held for use in a trade or business.

(3) *Exception for stock regularly traded on established securities markets*. If any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a United States real property interest only in the case of a person who, at some time during the shorter of the periods described in paragraph (1)(A)(ii), held more than 5 percent of such class of stock.

(4) *Interests held by foreign corporations and by partnerships, trusts, and estates*. For purpose of determining whether any corporation is a United States real property holding corporation-

(A) *Foreign corporations*. Paragraph (1)(A)(ii) shall be applied by substituting "any corporation (whether foreign or domestic)" for "any domestic corporation".

(B) *Assets held by partnerships, etc.* Under regulations prescribed by the Secretary, assets held by a partnership, trust, or estate shall be treated as held proportionately by its partners or beneficiaries. Any asset treated as held by a partner or beneficiary by reason of this subparagraph which is used or held for use by the partnership, trust, or estate in a trade or business shall be treated as so used or held by the partner or beneficiary Any asset treated as held by a partner or beneficiary by reason of this subparagraph shall be so treated for purposes of applying this subparagraph successively to partnerships, trusts, or estates which are above the first partnership, trust, or estate in a chain thereof.

(5) *Treatment of controlling interests*.

(A) *In general*. Under regulations, for purposes of determining whether any corporation is a United States real property holding corporation, if any corporation (hereinafter in this paragraph referred to as the "first corporation") holds a controlling interest in a second corporation-

(i) the stock which the first corporation holds in the second corporation shall not be taken into account,

(ii) the first corporation shall be treated as holding a portion of each asset of the second corporation equal to the percentage of the fair market value of the stock of the second corporation represented by the stock held by the first corporation, and

(iii) any asset treated as held by the first corporation by reason of clause (ii) which is used or held for use by the second corporation in a trade or business shall be treated as so used or held by the first corporation.

Any asset treated as held by the first corporation by reason of the preceding sentence shall be so treated for purposes of applying the preceding sentence successively to corporations which are above the first corporation in a chain of corporations.

(B) *Controlling interest*. For purposes of subparagraph (A), the term "controlling interest" means 50 percent or more of the fair market value of all classes of stock of a corporation.

(6) *Other special rules*.

(A) *Interest in real property*. The term "interest in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(B) *Real property includes associated personal property*. The term "real property" includes movable walls, furnishings, and other personal property associated with the use of the real property.

(C) *Constructive ownership rules*. For purposes of determining under paragraph (3) whether any person holds more than 5 percent of any class of stock and of determining under paragraph (5) whether a person holds a controlling interest in any corporation, section 318(a) shall apply (except that paragraphs (2)(C) and (3)(C) of section 318(a) shall be applied by substituting "5 percent" for "50 percent").

II.E.1.c.x. Bonus Depreciation and the Code § 199A Deduction

By reducing qualified business income, bonus depreciation reduces the 20% deduction.

The 20% deduction will eventually go away, whereas the lack of future depreciation deductions will come back to haunt taxpayers when rates increase and the 20% deduction is not available.

In 2018, taking bonus depreciation is an easy decision for most property, in that most property eligible for bonus depreciation has a depreciable life of 7 years or less, and the 20% deduction lasts for 7 years.

If the law does not change, then taking bonus depreciation in 2025 may be inadvisable, because it reduces the 20% deduction and eliminates depreciation deductions in more highly taxed future years.

Between 2018 and 2025 (or any change in the tax law affecting these issues), the trade-off between bonus depreciation and the 20% deduction moves over time from being not worthy of consideration to being very worthy of consideration.

See part II.G.5.b Bonus Depreciation.

II.E.1.d. Partnerships Compared to S corporations for Code § 199A

Suppose, before considering the owner's compensation, a business has $300,000 of qualified business income ("QBI"), reasonable compensation would be $200,000, distributions to the owner are at least $200,000, and the owner's taxable income is below the $315,000 threshold for married filing jointly (all subject ot future indexing).

The wage limitation would not apply. See part II.E.1.c.v.(a) Taxable Income "Threshold.

If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the taxpayer argues that the payments to the owner-employee were distributions and not wages, the IRS will have the upper hand in the dispute, because in 2017 the IRS figured out (and instructed its examiners) how to effectively keep taxpayers out of Tax Court on this issue[806] – meaning that taxpayers would have to pay the tax and sue for a refund.

However, if the wage limitation reduces the QBI deduction,[807] the S corporation may wish to increase compensation payments to get a better deduction. Given that FICA is 15.3% combined employer and employee up to the taxable wage base, this strategy would tend to be beneficial only when compensation is above the taxable wage base ($128,400 for 2018 and $132,900 in 2019)[808] and is ultimately in a range that is neither too high not too low.

In addition to an S corporation tending to generate less QBI, the sale of a partnership interest may be easier to constitute QBI than the sale of stock in an S corporation. Compare part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a **Trade** or **Business** with part II.E.1.c.viii.(d) Sale of a Stock in an S corporation Conducting a **Trade** or **Business**.

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business

Part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business describes the definitions of a trade or business generally applied to real estate.

---

[806] See part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns 93-94.
[807] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[808] See text accompanying fn 2806 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

For nonresident aliens, Part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules explains when real estate may be eligible for a Code § 199A deduction.

II.E.1.e.i. General Rules Regarding Real Estate As a Trade or Business

To constitute qualified business income, the income must be from a trade or business.[809] However:

- Rental activity that is not a trade or business can qualify as if it were a trade or business if it is rented or licensed to a trade or business which is commonly controlled under Prop. Reg. § 1.199A-4(b)(1)(i), meaning that the same person or group of persons, directly or indirectly, owns 50% percent or more of the renting trade or business, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.[810] This is described in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A[811] and illustrated in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A,[812] but it applies whether or not the real estate is aggregated (see fn 811).

- On the other hand, if rental is tied too closely to a specified service trade or business (SSTB), part or all of the rental income could be disqualified, even the rental on its own qualifies as a trade or business. See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

Each RPE separately determines whether its real estate qualifies as a trade or business. Real estate owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[813]

The rest of the discussion in this part II.E.1.e.i discusses whether the real estate activity constitutes a trade or business under Code § 162.

Before getting into general principles, consider a real estate activity Prop. Reg. § 1.199A-1 views as a trade or business. Prop. Reg. § 1.199A-1(d)(4), Examples (1) and (2) assume that leasing several parcels of land to several suburban airports for parking lots constitutes QBI.[814] The Examples assumed that the activity qualified as a trade or business but did not state that this activity would always qualify.

[809] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially fn. 684.
[810] Prop. Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 696, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.
[811] See Reg. § 1.199A-1(b)(13), which is reproduced in full in fn 691 in that part.
[812] Within that part, see text accompanying fn 709, analyzing Prop. Reg. § 1.199A-4(d), Example (8) and Example (9).
[813] See text accompanying fn 660.
[814] The Examples are reproduced in the text accompanying fn 738 in part II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 2002-2012. Another discussion on what is a trade or business is in part II.G.4.i.i.(a) "Trade or Business" Under Code § 162. These and other items are summarized near the beginning of part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

If all the taxpayer does is lease one property to one tenant on a triple net lease and merely collect rent, consider changing the responsibilities. Instead of the tenant arranging for and paying for maintenance, have the landlord take care of that and obtain reimbursement from the tenant. Consider having the landlord hire the janitors and maintenance staff and the tenant reimburse the landlord for those expenses, which helps not only move the real estate toward being a trade or business but also may improve the landlord's Code § 199A deduction:

- The tenant may have plenty of wages for purposes of the wage limitation for the Code § 199A deduction, whereas paying those wages may provide the landlord with a higher Code § 199A deduction (because the wage limitation will not reduce the deduction as much).[815] However, if the real estate activity is aggregated with a business under common control,[816] that business' wages and property count toward the Code § 199A deduction relating to the real estate's income.

- If the landlord and tenant have similar ownership, then moving duties from one entity to another may be an easy decision. On the other hand, if they have different owners and the landlord does not want an increased role, these changes may be impractical.

- Consider asset protection issues. If the landlord hires janitors and maintenance staff, the landlord would be liable if they fail to remedy any hazardous conditions. Furthermore, if an owner of the landlord is personally involved in hiring decisions, that owner may be personally liable for negligent hiring. Liability insurance may ameliorate these concerns, and every landlord should have such insurance anyway to try to avoid corporate veil piercing. This is very much a judgment call. For more on asset protection, see part II.F Asset Protection Planning.

Even the long-term rental of one property to one tenant can constitute a trade or business.[817] For further thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.b.iii Excess Passive Investment Income. A triple net lease would not work for that test, but incurring expenses and having them reimbursed by the tenant would work.[818] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

[815] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[816] See fns 811-810.
[817] See part II.I.8.c.iii Rental as a Trade or Business, fn 2009.
[818] See fns 3330-3333.

Ultimately, one needs to decide whether the effort of and exposure from rearranging lease arrangements are worth the potential tax benefits, and it is impossible to provide a one-size-fits-all solution.

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules

A nonresident alien may be eligible for the Code § 199A deduction only for income qualifying under Part II.E.1.c.ix QBI and Effectively Connected Income. Within that part, the text accompanying and immediately preceding fn 781 cross-references Code § 871(a)(1)(A), which taxes rents (among other income) and therefore is the subject of this part II.E.1.e.ii. Below is guidance on when rent constitutes QBI.

Rev. Rul. 73-522 discussed the following situation involving triple net leases:

> The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Rev. Rul. 73-522 held:

> Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular. *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); *Elizabeth Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962).
>
> In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.

> Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business.[819] Compare *Adolph Schwarcz*, 24 T.C. 733, *acq.* 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.
>
> With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.
>
> Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, *i.e.*, amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

Note that the taxpayer held more than one property with triple-net-leases, and the taxpayer's triple-net-lease was not part of a trade or business notwithstanding the taxpayer owning multiple properties.

Also note that expense reimbursements constituted rent.

As to rental that is not a triple-net-lease, *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), cited with approval in Rev. Rul. 73-522, stated, "We take it to be well settled that the operation of even a single parcel of rental realty may constitute the regular operation of a business."[820]

---

[819] [My footnote, not from the ruling:] *Neill v. Commissioner*, 46 B.T.A. 197 (1942), found that a net lease held by a NRA did not constitute carrying on a business. The facts were:

> … It is held under a long term lease by a tenant who, under the terms of that lease, erected a building thereon and is obligated under the lease to pay taxes and insurance and maintain the property.
>
> The property referred to is encumbered by a mortgage …, the ground lease on the property having been assigned at that time to the mortgagee as collateral security for the mortgage. For many years petitioner has employed a firm of attorneys with offices in Philadelphia, to whom the tenant pays the rentals due petitioner under her direction. These attorneys then pay for her the interest due upon the mortgage and such incidental expenses for which petitioner may be obligated.

The Board of Tax Appeals held:

> The ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent. *Cf. Higgins v. Commissioner*, 312 U.S. 212. We think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section. *McCoach v. Minehill & Schuylkill Haven Railroad Co.*, 228 U.S. 295; *Stafford Owners, Inc. v. United States*, 39 Fed.(2d) 743.

For a discussion of *Higgins*, see part II.G.4.i.i.(a) "Trade or Business" Under Code § 162, fn 1103.

[820] The court continued:

> In *Anders I. Lagreide*, 23 T.C. 508, 511 , we said:
>
> > The first issue to be considered is whether or not the renting out in 1949, by Alice Lagreide, of a single piece of residential real estate, amounted to the operation by her of a trade or business regularly carried on. She inherited the property from her mother in 1948 and never

Furthermore, the "fact that the taxpayer operates the rental property through an agent does not prevent him from being regularly engaged in the business,[821] and "the rule applies even though the property and the agent are in a foreign country (Austria)."[822] The court concluded:

> The record shows that petitioner actively managed the properties prior to his departure for the United States and that he was in frequent contact with his partner who managed the properties after petitioner left. We are of the opinion, accordingly, that petitioner was regularly engaged in the business of operating the … properties ….

The NRA handling repairs – even through an agent – seemed to be a tipping point in *Amodio v. Commissioner*, 34 T.C. 894 (1960) (trade or business found),[823] *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*. 221 F.2d 227 (9th Cir. 1955) (trade or business found),[824] and *Herbert*

> occupied or maintained it as her own residence. Since the time of the mother's death, the property was either rented or available for renting, and was actually rented during part of 1948 and almost all of 1949.
>
> It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. *Leland Hazard*, 7 T.C. 372 (1946). See also *Quincy A. Shaw McKean*, 6 T.C. 757 (1946); *N. Stuart Campbell*, 5 T.C. 272 (1945); *John D. Fackler*, 45 B.T.A. 708, 714 (1941), *affd.* (C.A. 6, 1943) 133 F.2d 509. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (see *Industrial Commission v. Hammond*, 77 Colo. 414, 236 Pac. 1006, 1008). It is clear, also, that the business was "regularly" carried on, there having been no deviation, at any time, from the obviously planned use.

[821] Citing "*Gilford v. Commissioner*, 201 F.2d 735, affirming a Memorandum Opinion of this Court."

[822] Citing *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955).

[823] The court held:

> The properties were managed by local real estate agents who negotiated or renewed leases, arranged for repairs, collected rents, paid taxes and assessments, and remitted net proceeds to Fidelity after deducting commissions. From the proceeds Fidelity or the local agent paid principal and interest on the mortgages, insurance premiums, and taxes. Fidelity retained its commissions and amounts to be applied on Amodio's income taxes and the remainder was sent to him. The acts of the agents are attributable to Amodio. These activities were beyond the scope of mere ownership of property and the receipt of income. They were considerable, continuous, and regular, as in the *Lewenhaupt* case. Such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States. Amodio is taxable as a nonresident alien engaged in trade or business in the United States.

[824] The Tax Court described the agent's activities:

> LaMontagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties, executing an option to purchase the El Camino Real property, and executing the sale of the Modesto property. In addition, the agent conducted a regular correspondence with the petitioner's father in England who held a power of attorney from petitioner identical with that given to LaMontagne; he submitted monthly reports to the petitioner's father; and he advised him of prospective and advantageous sales or purchases of property.
>
> The aforementioned activities, carried on in the petitioner's behalf by his agent, are beyond the scope of mere ownership of real property, or the receipt of income from real property. The activities were considerable, continuous, and regular and, in our opinion, constituted engaging in a business within the meaning of section 211(b) of the Code. See *Pinchot v. Commissioner*, 113 F.2d 718.

v. Commissioner, 30 T.C. 26, 33 (1958) (isolated minor repairs not a trade or business).[825] Letter Ruling 7904019 asserted that paying mortgages and reimbursing tenant expenses was insufficient to move the taxpayer out of the holding of Rev. Rul. 73-522.[826] However, *Pinchot v. Commissioner*, 113 F.2d 718 (2nd Cir. 1940), held that maintaining a portfolio of 11 rental properties, which probably were not triple-net leases, constituted a business;[827] *Lewenhaupt* cited *Pinchot* with approval.[828]

---

825 The Tax Court held:

> In the instant case the real property consisted of one building rented in its entirety to one tenant who has occupied it since 1940, has complete charge of its operation, and is responsible for all repairs except as to outer walls and foundation. This property (the only real property owned by petitioner in the United States) was acquired by petitioner 50 years ago, not as the result of a business transaction entered into for profit (*cf. Fackler v. Commissioner*, 133 F.2d 509) but by gift from petitioner's father when she was a very young girl (see *Grier v. United States*, 120 F.Supp. 395). During the taxable years her only activities, in addition to the receipt of rentals, were the payment of taxes, mortgage principal and interest, and insurance premiums. See *Evelyn M. L. Neill*, *supra*. The record also shows that petitioner executed a lease of the property in 1940 and a modified renewal thereof in 1946, and made minor repairs to the walls and roof in 1954 and 1955.
>
> We are of the opinion that petitioner's activities with regard to the real property here involved, which might be considered as "beyond the scope of mere ownership of real property, or the receipt of income from real property," were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable." We therefore conclude that petitioner was "not engaged in trade or business in the United States" during the taxable years within the meaning of article IX (1) of the United States-United Kingdom tax convention.

826 The IRS pointed out:

> The Lease between Corp M and Corp P, although not identical to the net leases described in Rev. Rul. 73-522, differs only in three respects. One, the lessor rather than the lessee pays real estate taxes imposed on the leased property; two, the lessor rather than the lessee pays installments on existing encumbrances; and three, the lessor, Corp M, pays a yearly fee to the lessee as reimbursement for grass, pest, and weed control and fertilization.

The IRS reasoned:

> With respect to the payment of a yearly fee by Corp M to Corp P as reimbursement for grass, pest, and weed control and fertilization, we note that Corp M does not supervise or participate in any way in the activities for which it pays the fee. Further, the fee is paid once each year and does not involve Corp M in the farming of the land. Consequently, the payment of the fee is sporadic, irregular, and minimal and does not, in and of itself, cause Corp M to be engaged in a trade or business within the United States.

827 The court summarized the facts and reasoned:

> The essential facts were stipulated and, so far as now important, are that the decedent, Antoinette Eno Johnstone, died July 1, 1934, a British subject and a non-resident. Much of her property in this country consisted of improved real estate in the City of New York owned in common by her and her two brothers of whom one is her executor and the petitioner herein. This real estate was made up of eleven parcels of which the decedent's share had a gross value of about one million dollars. The petitioner, Amos R.E. Pinchot, managed the properties for her and the third owner under broad powers of attorney which included also the management of certain personal property owned by the three. He bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions. This management "consisted of the leasing and renting of the properties when they became idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of eighteen years five parcels of real estate had been sold and five had been purchased. There were no sales or purchases during the last three years before the decedent's death.

A small interest in oil & gas that did not influence annual operations did not contribute a trade or business.[829]

> Though the stipulation does not show the number or the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney in fact. *Richards v. Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of federal tax statutes is a federal question which cannot be controlled by state decisions. *Lyeth v. Hoey*, 305 U.S. 188, 59 S.Ct. 155, 83 L.Ed. 119, 119 A.L.R. 410. It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389, Ann.Cas.1912B, 1312, and within the commonly accepted meaning of that word. We think the Board was right in deciding that this decedent was engaged in business in this country at the time of her death. The bank deposits in the United States were, therefore, properly treated as property in this country. Our decision in *Higgins v. Commissioner*, 2 Cir., 111 F.2d 795, did not touch the question of real estate management as a business.

[828] See text at end of fn 824.

[829] After citing *Pinchot*, which was discussed in fn 827, *Di Portanova v. U.S.*, 690 F.2d 169 (Ct. Cl. 1982), held:

> In this respect, an oil lease is similar to real estate. "Whether coownership in a mineral lease constitutes the carrying on of a 'trade or business' is dependent upon all the facts and circumstances in the particular case." Rev. Rul. 58-166, 1958-1 C.B. 324, 325.
>
> The oil and gas business is complex. "The proper development of an oil and gas lease requires a high degree of skill and discretion." Rev. Rul. 58-166, 1958-1 C.B. at 326. To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business. *Cataphote Corp. v. United States*, 210 Ct.Cl. 125, 143-46, 535 F.2d 1225, 1235-37 (1976); *Wier v. Enochs*, 64-1 U.S.T.C. ¶ 9387 at 92,009, 92,011 (S.D. Miss. 1963); *aff'd* per curiam, 353 F.2d 211 (5th Cir. 1965); *Nemours Corp. v. Commissioner*, 38 T.C. 585, 601 & n.3 (1962) *aff'd* per curiam, 325 F.2d 559 (3d Cir. 1963); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963).
>
> (3.) The government properly has conceded that the activities of the trusts regarding the properties subject to the 1953 and 1965 agreements do not constitute a trade or business and we so hold. The activities are functionally indistinguishable from the mere receipt of income from investments and the payment of expenses incidental to that receipt. The trusts do not manage or control the field operations or participate actively in them. Indeed, the agreements give Quintana exclusive control over "all operations of every kind." The trusts have little power under the agreements. Moreover, in view of their meager percentage of the total interest and the plaintiff's estrangement from the Cullen family, they also have virtually no informal influence over the operations.
>
> Although the trusts have the right to receive their actual share of the oil and gas produced and Quintana negotiates the sale of the minerals as an agent of the trusts, the Service by its concession recognizes that this is not enough to constitute a trade or business. Considering all the circumstances, we hold that the trusts' activities under the 1953 operating agreement and its amendments did not constitute trade or business.

II.E.1.f. Trusts/Estates and the Code § 199A Deduction

Estates and nongrantor trusts may present special opportunities in working with the taxable income thresholds described in part II.E.1.c.v.(a) Taxable Income "Threshold Amount". Estates and nongrantor trusts would have the same taxable income threshold as a single individual. Recognizing these opportunities, the proposed regulations issued August 2018 express significant antipathy towards trusts:

- Their Code § 199A anti-abuse rule provides a very low threshold for having an evil intent, resulting in zero deduction, to the point of taking away the entire Code § 199A deduction for a later year in which the QBI is not from an SSTB and each business has sufficient W-2 wages to support a full Code § 199A deduction without considering any benefits from being below the taxable income threshold.[830]

- Contrary to Code § 199A(e)(1), Prop. Reg. § 1.199A-6(d)(3)(iii) would prevent a trust from taking a distribution deduction in applying the taxable income thresholds. As is explained further below in this part II.E.1.f, in applying the taxable income thresholds that rule would double-count any income distributed to beneficiaries.

- Despite Code § 641(c)(1)(A) and the regulations thereunder treating the S portion of an electing small business trust (ESBT) as a different taxpayer than the non-S portion of an ESBT, my understanding is that the government intends to add together the taxable income of both portions in determining the taxable income thresholds.[831]

- Proposed regulations described in part II.J.9.c Multiple Trusts Created for Tax Avoidance would undermine the use of multiple trusts. Aspects of the proposed regulations are too tilted in the government's favor, but other aspects are poorly written simply because they track the poorly written legislative history of Code § 643(f).

The details provided in part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A show that, until proposed regulations apply to Code § 199A:

- Grantor trusts are disregarded, and their items attributed to their deemed owners.

- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income ("DNI"), determined after applying the separate share rules, if relevant.[832]

- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.

- Taxable income thresholds are applied separately at the trust and beneficiary levels.[833] However, the last sentence of Prop. Reg. § 1.199A-6(d)(3)(iii) would require trusts to apply

[830] See text accompanying and preceding fn 835 in this part II.E.1.f.
[831] See part II.E.1.f.iii Electing Small Business Trusts (ESBTs), text accompanying and following fn 852.
[832] See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items, II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It, and II.J.9.a Separate Share Rule.

the taxable income before the income distribution deduction, thereby counting twice (at the trust level and at the beneficiary level) any taxable income on the beneficiaries' K-1s.

The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

B. Application to Trusts, Estates, and Beneficiaries

Proposed § 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), including qualified subchapter S trusts (QSSTs) with respect to which the beneficiary has made an election under section 1361(d), the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.

In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, proposed § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

In addition, proposed § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.

Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, proposed § 1.199A-6(d)(3)(v) provides that trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.

[833] See Reg. § 1.199-5(e)(4), Example, part (ii), "Section 199 deduction," subpart (C), reproduced in the text accompanying fns 836-837 in part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

> The Treasury Department and the IRS request comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Such comments should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

For nongrantor trusts or estates, Prop. Reg. § 1.199A-6(d)(1) provides:

> *In general*. A trust or estate computes its Section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's Section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

This last sentence is important not just as a matter of calculation but also because it allows estates with fiscal years straddling 2017-2018 to pass to their beneficiaries 2017 business income that gets treated as QBI.[834]

Consistent with the Code § 199 rules regarding grantor trusts, Prop. Reg. § 1.199A-6(d)(2) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person.

Prop. Reg. § 1.199A-6(d)(3)(i), "Calculation at entity level," provides:

> A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in Section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)-3(a), and deductions not directly attributable within the meaning of § 1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)-3(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

---

[834] See part II.E.1.c.i What Kind of Deduction; Maximum Impact of Deduction, especially the paragraph accompanying fn 650.

See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items and II.J.8.f.i.(a) Allocating Deductions to Various Income Items. See also part II.J.11.a Depreciation Advantages and Disadvantages.

Prop. Reg. § 1.199A-6(d)(3)(ii), "Allocation among trust or estate and beneficiaries," provides:

> The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to Section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

Prop. Reg. § 1.199A-6(d)(3)(iii), "Threshold amount," provides:

> The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in § 1.199A-1(b)(11). For purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of a trust or estate is determined before taking into account any distribution deduction under sections 651 or 661.

The last sentence above is consistent with the preamble quoted above, which says, "Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions." However, I have been unable to find support for that statement in the statute or legislative history; Code § 199A(e)(1) says that taxable income is computed without reference to the Code § 199A deduction and provides no other exceptions. In my view, the approach of the preamble and Prop. Reg. § 1.199A-6(d)(3)(iii) creates double-counting – the beneficiary's K-1 income is counted toward the beneficiary's and the trust's taxable income threshold. For example, if a trust and beneficiary have no income or deductions other than $300,000 of QBI and the trust distributes half to the beneficiary, then (ignoring the trust's exemption and the beneficiary's standard deduction, Prop. Reg. § 1.199A-6(d)(3)(iii) would say that the trust has $300,000 taxable income towards its threshold and the beneficiary has $150,000 towards the beneficiary's taxable income threshold, thereby counting a total of $450,000 towards the trust's and beneficiary's thresholds when combined they had only $300,000 of taxable income. Furthermore, Code § 199A(f)(1)(B) directs that rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W 2 wages shall apply to the apportionment of W 2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section, and the regulations under that provision looked to the trust's and beneficiaries' taxable incomes independently of each other; see part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

Prop. Reg. § 1.199A-6(d)(3)(iv), "Electing small business trusts," is quoted and discussed in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

Prop. Reg. § 1.199A-6(d)(3)(v), "Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount," provides:

> 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.

Informal remarks made by government representatives at a September 13, 2018 webinar of the American Bar Association's Section of Real Property, Trust & Estate Law in which I also spoke indicate that the government's intent is to deny any Code § 199A deduction whatsoever if a trust triggers that regulation. I view that as a punitive approach – the regulation should provide that any abusive trust merely be denied the benefits of taxable income under the threshold.[835] For example, consider a trust with intent to benefit from having taxable income below the threshold in 2018. In 2019, its QBI is supported by wages such that it does not need to turn to the exception to the wage limitation to get a full Code § 199A deduction. Why should the deduction be denied in that case?

Prop. Reg. § 1.643(f)-1 is discussed in part II.J.9.c Multiple Trusts Created for Tax Avoidance.

Prop. Reg. § 1.199A-6(d)(3)(vi), Example (1) (the only example), begins with (i), "Computation of DNI and inclusion and deduction amounts":

> (A) *Trust's distributive share of partnership items*. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $50,000 (including W-2 wages of $25,000, miscellaneous expenses of $20,000, and depreciation deductions of $5,000) to Trust. These items are properly included in Trust's DNI. Trust's share of PRS' unadjusted basis of qualified depreciable property is $125,000. PRS distributes $5,000 of cash to Trust in 2018.
>
> (B) *Trust's activities*. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produced $100,000 of gross income and $150,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, and miscellaneous expenses of $25,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of Section 199A.) Trust also has zero unadjusted basis of qualified depreciable property in the bakery. For purposes of computing its Section 199A deduction, Trust has properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under § 1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust's DNI:

[835] See parts II.E.1.c.v.(a) Taxable Income "Threshold Amount" and II.E.1.c.v.(b) Calculation When Taxable Income Does Not Exceed the Threshold Amount, which are a subset of the general rules introduced in part II.E.1.c.v Calculation of Deduction Generally.

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

(C) *Allocation of deductions under § 1.652(b)-3*.

(1) *Directly attributable expenses*. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 (55,000 from PRS and 100,000 from the bakery) and direct business expenses of $200,000 ($50,000 from PRS and $150,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)-3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(2) *Non-directly attributable expenses*. The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(D) *Amounts included in taxable income*. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

I believe that the calculations above and below are flawed, because they do not reflect part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses). Although I believe that depreciation is deducted in calculating QBI, it is separately allocated to the beneficiaries in determining the trust's and their taxable income.

Prop. Reg. § 1.199A-6(d)(3)(vi), Example (1) (the only example), ends with (ii), "Section 199A deduction":

(A) *Trust's W-2 wages and QBI*. For the 2018 taxable year, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has $125,000 of unadjusted basis in qualified depreciable property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)-3(a)).

(B) *Section 199A deduction computation*.

(1) *A's computation*. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under § 1.199A-4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A has $100,000 of QBI from non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income exceeds the threshold amount for 2018 by $200,000. A's tentative deduction is $15,300 (.20 x $76,500), limited under the W-2 wage limitation to $20,000 (50% x $40,000 W-2 wages). Accordingly, A's section 199A deduction for 2018 is $15,300.

(2) *B's computation*. For 2018, B's taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

(3) *Trust's computation*. For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

Prop. Reg. § 1.199A-6(e), "Effective/applicability date," provides:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraph (d)(3)(v) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an

RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

II.E.1.f.i. Allocation under Former Code § 199 That Applies for Code § 199A

For trusts and estates, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply. Code § 199A(f)(1)(B) provides:

> *Application To Trusts And Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

Code § 199(d)(1)(B)(i) provided:

> In the case of a trust or estate…the items referred to in subparagraph (A)(ii) (as determined therein) and the W-2 wages of the trust or estate for the taxable year, shall be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under regulations prescribed by the Secretary…

Code § 199(d)(1)(A)(ii) provided:

> In the case of a partnership or S corporation … each partner or shareholder shall take into account such person's allocable share of each item described in subparagraph(A) or (B) of subsection (c)(1) (determined without regard to whether the items described in such subparagraph (A) exceed the items described in such subparagraph (B)),

Code § 199(c)(1) provided:

> *In general*. The term "qualified production activities income" for any taxable year means an amount equal to the excess (if any) of-
>
> (A) the taxpayer's domestic production gross receipts for such taxable year, over
>
> (B) the sum of-
>
> (i) the cost of goods sold that are allocable to such receipts, and
>
> (ii) other expenses, losses, or deductions (other than the deduction allowed under this section), which are properly allocable to such receipts.

Reg. § 1.199-5(d) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part (the owned portion) of a trust under sections 671 through 679, such person (owner) computes its QPAI with respect to the owned portion of the trust as if that QPAI had been generated by activities performed directly by the owner. Similarly, for purposes of the W-2 wage limitation, the owner of the trust takes into account the

> owner's share of the paragraph (e)(1) wages of the trust that are attributable to the owned portion of the trust. The provisions of paragraph (e) of this section do not apply to the owned portion of a trust.

What is QPAI, as used above and further below? Reg. § 1.199-1(c) provides:

> *Qualified production activities income*. QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) (as defined in § 1.199-3) over the sum of-
>
> (1) The cost of goods sold (CGS) that is allocable to such receipts; and
>
> (2) Other expenses, losses, or deductions (other than the deduction allowed under this section) that are properly allocable to such receipts. See §§ 1.199-3 and 1.199-4.

Reg. § 1.199-5(e), "Non-grantor trusts and estates," includes:

> (1) *Allocation of costs*. The trust or estate calculates each beneficiary's share (as well as the trust's or estate's own share, if any) of QPAI and W-2 wages from the trust or estate at the trust or estate level. The beneficiary of a trust or estate may not recompute its share of QPAI or W-2 wages from the trust or estate by using another method to reallocate the trust's or estate's qualified production costs or paragraph (e)(1) wages, or otherwise. Except as provided in paragraph (d) of this section, the QPAI of a trust or estate must be computed by allocating expenses described in section 199(d)(5) in one of two ways, depending on the classification of those expenses under § 1.652(b)-3. Specifically, directly attributable expenses within the meaning of § 1.652(b)-3 are allocated pursuant to § 1.652(b)-3, and expenses not directly attributable within the meaning of § 1.652(b)-3 (other expenses) are allocated under the simplified deduction method of § 1.199-4(e) (unless the trust or estate does not qualify to use the simplified deduction method, in which case it must use the section 861 method of § 1.199-4(d) with respect to such other expenses). For this purpose, depletion and depreciation deductions described in section 642(e) and amortization deductions described in section 642(f) are treated as other expenses described in section 199(d)(5). Also for this purpose, the trust's or estate's share of other expenses from a lower-tier pass-thru entity is not directly attributable to any class of income (whether or not those other expenses are directly attributable to the aggregate pass-thru gross income as a class for purposes other than section 199). A trust or estate may not use the small business simplified overall method for computing its QPAI. See § 1.199-4(f)(5).
>
> (2) *Allocation among trust or estate and beneficiaries*.
>
> > (i) *In general*. The QPAI of a trust or estate (which will be less than zero if the CGS and deductions allocated and apportioned to DPGR exceed the trust's or estate's DPGR) and W-2 wages of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199. To the extent that the trust or estate has no DNI for the taxable

year, any QPAI and W-2 wages are allocated entirely to the trust or estate. A trust or estate is allowed the section 199 deduction in computing its taxable income to the extent that QPAI and W-2 wages are allocated to the trust or estate. A beneficiary of a trust or estate is allowed the section 199 deduction in computing its taxable income based on its share of QPAI and W-2 wages from the trust or estate, which are aggregated with the beneficiary's QPAI and W-2 wages from other sources, if any.

(ii) *Treatment of items from a trust or estate reporting qualified production activities income*. When, pursuant to this paragraph (e), a taxpayer must combine QPAI and W-2 wages from a trust or estate with the taxpayer's total QPAI and W-2 wages from other sources, the taxpayer, when applying §§ 1.199-1 through 1.199-8 to determine the taxpayer's total QPAI and W-2 wages from such other sources, does not take into account the items from such trust or estate. Thus, for example, a beneficiary of an estate that receives QPAI from the estate does not take into account the beneficiary's distributive share of the estate's gross receipts, gross income, or deductions when the beneficiary determines whether a threshold or de minimis rule applies or when the beneficiary allocates and apportions deductions in calculating its QPAI from other sources. Similarly, in determining the portion of the beneficiary's paragraph (e)(1) wages from other sources that is attributable to DPGR (thus, the W-2 wages from other sources), the beneficiary does not take into account DPGR and non-DPGR from the trust or estate.

(3) *Transition rule for definition of W-2 wages and for W-2 wage limitation*. The definition of W-2 wages of a trust or estate and the section 199(d)(1)(A)(iii) rule for determining the respective shares of wages from that trust or estate, and thus the beneficiary's share of W-2 wages from that trust or estate, is determined under the law applicable to pass-thru entities based on the beginning date of the taxable year of the trust or estate, regardless of the beginning date of the taxable year of the beneficiary.

Reg. § 1.199-5(e)(4) provides a detailed example:

Example. The following example illustrates the application of this paragraph (e). Assume that the partnership, trust, and trust beneficiary all are calendar year taxpayers. The example reads as follows:

Example. (i) *Computation of DNI and inclusion and deduction amounts*.

(A) *Trust's distributive share of partnership items*. Trust, a complex trust, is a partner in PRS, a partnership that engages in activities that generate DPGR and non-DPGR. In 2010, PRS distributes $10,000 cash to Trust. PRS properly allocates (in the same manner as wage expense) paragraph (e)(1) wages of $3,000 to Trust. Trust's distributive share of PRS items, which are properly included in Trust's DNI, is as follows:

Gross income attributable to DPGR ($15,000 DPGR - $5,000 CGS (including wage expense of $1,000))	$10,000

Gross income attributable to non-DPGR ($5,000 other gross receipts - $0 CGS)	5,000
Selling expenses attributable to DPGR (includes wage expense of $2,000)	3,000
Other expenses (includes wage expense of $1,000)	2,000

(B) *Trust's direct activities*. In addition to its cash distribution in 2010 from PRS, Trust directly has the following items which are properly included in Trust's DNI:

Dividends	$10,000
Tax-exempt interest	10,000
Rents from commercial real property operated by Trust as a business	10,000
Real estate taxes	1,000
Trustee commissions	3,000
State income and personal property taxes	5,000
Wage expense for rental business	2,000
Other business expenses	1,000

(C) *Allocation of deductions under § 1.652(b)-3*.

(1) *Directly attributable expenses*. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, the $5,000 of CGS, $3,000 of selling expenses, and $2,000 of other expenses are subtracted from the gross receipts from PRS ($20,000), resulting in net income from PRS of $10,000. With respect to the Trust's direct expenses, $1,000 of the trustee commissions, the $1,000 of real estate taxes, and the $2,000 of wage expense are directly attributable under § 1.652(b)-3(a) to the rental income.

(2) *Non-directly attributable expenses*. Under § 1.652(b)-3(b), the trustee must allocate a portion of the sum of the balance of the trustee commissions ($2,000), state income and personal property taxes ($5,000), and the other business expenses ($1,000) to the $10,000 of tax-exempt interest. The portion to be attributed to tax-exempt interest is $2,222 ($8,000 x ($10,000 tax exempt interest / $36,000 gross receipts net of direct expenses)), resulting in $7,778 ($10,000-$2,222) of net tax-exempt interest. Pursuant to its authority recognized under § 1.652(b)-3(b), the trustee allocates the entire amount of the remaining $5,778 of trustee commissions, state income and

personal property taxes, and other business expenses to the $6,000 of net rental income, resulting in $222 ($6,000-$5,778) of net rental income.

(D) *Amounts included in taxable income*. For 2010, Trust has DNI of $28,000 (net dividend income of $10,000 + net PRS income of $10,000 + net rental income of $222 + net tax-exempt income of $7,778). Pursuant to Trust's governing instrument, Trustee distributes 50%, or $14,000, of that DNI to B, an individual who is a discretionary beneficiary of Trust. Assume that there are no separate shares under Trust, and no distributions are made to any other beneficiary that year. Consequently, with respect to the $14,000 distribution B receives from Trust, B properly includes in B's gross income $5,000 of income from PRS, $111 of rents, and $5,000 of dividends, and properly excludes from B's gross income $3,889 of tax-exempt interest. Trust includes $20,222 in its adjusted total income and deducts $10,111 under section 661(a) in computing its taxable income.

(ii) *Section 199 deduction*.

(A) *Simplified deduction method*. For purposes of computing the section 199 deduction for the taxable year, assume Trust qualifies for the simplified deduction method under § 1.199-4(e). The determination of Trust's QPAI under the simplified deduction method requires multiple steps to allocate costs. First, the Trust's expenses directly attributable to DPGR under § 1.652(b)-3(a) are subtracted from the Trust's DPGR. In this step, the directly attributable $5,000 of CGS and selling expenses of $3,000 are subtracted from the $15,000 of DPGR from PRS. Second, the Trust's expenses directly attributable under § 1.652(b)-3(a) to non-DPGR from a trade or business are subtracted from the Trust's trade or business non-DPGR. In this step, $4,000 of Trust expenses directly allocable to the real property rental activity ($1,000 of real estate taxes, $1,000 of Trustee commissions, and $2,000 of wages) are subtracted from the $10,000 of rental income. Third, Trust must identify the portion of its other expenses that is attributable to Trust's trade or business activities, if any, because expenses not attributable to trade or business activities are not taken into account in computing QPAI. In this step, in this example, the portion of the trustee commissions not directly attributable to the rental operation ($2,000) is directly attributable to non-trade or business activities. In addition, the state income and personal property taxes are not directly attributable under § 1.652(b)-3(a) to either trade or business or non-trade or business activities, so the portion of those taxes not attributable to either the PRS interests or the rental operation is not a trade or business expense and, thus, is not taken into account in computing QPAI. The portion of the state income and personal property taxes that is treated as an other trade or business expense is $3,000 ($5,000 x $30,000 total trade or business gross receipts/$50,000 total gross receipts). Fourth, Trust then allocates its other trade or business expenses (not directly attributable under § 1.652(b)-3(a)) between DPGR and non-DPGR on the basis of its total gross receipts from the conduct of a trade or business ($20,000 from PRS + $10,000 rental income). Thus, Trust combines its non-directly attributable (other) business expenses ($2,000 from PRS + $4,000 ($1,000 of other business expenses + $3,000 of income and property taxes allocated to a trade or business) from its own activities) and then apportions this total ($6,000) between DPGR and other receipts on the basis of Trust's total trade or business gross receipts ($6,000 of such expenses x $15,000 DPGR/$30,000 total trade or business gross receipts = $3,000). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is $4,000 ($7,000 ($15,000 DPGR - $5,000 CGS - $3,000 selling expenses) - $3,000). Because the distribution of Trust's DNI to B equals one-half of Trust's DNI, Trust and B each has QPAI from PRS for purposes of the section 199 deduction of $2,000. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI.

(B) *W-2 wages*. For the 2010 taxable year, Trust chooses to use the wage expense safe harbor under § 1.199-2(e)(2)(ii) to determine its W-2 wages. For its taxable year ending December 31, 2010, Trust has $5,000 ($3,000 from PRS + $2,000 of Trust) of paragraph (e)(1) wages reported on 2010 Forms W-2. Trust's W-2 wages are $2,917, as shown in the following table:

Wage expense included in CGS directly attributable to DPGR	$1,000
Wage expense included in selling expense directly attributable to DPGR	2,000
Wage expense included in non-directly attributable deductions ($1,000 in wage expense x ($15,000 DPGR/$30,000 total trade or business gross receipts))	500
Wage expense allocable to DPGR	3,500
W-2 wages (($3,500 of wage expense allocable to DPGR/$6,000 of total wage expense) x $5,000 in paragraph (e)(1) wages)	$2,917

(C) *Section 199 deduction computation*.

(1) *B's computation*. B is eligible to use the small business simplified overall method. Assume that B has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B).[836] Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, B has W-2 wages from Trust of $1,459 (50% x $2,917). B has W-2 wages of $100 from trade or business activities outside of Trust and attributable to DPGR (computed without regard to B's interest in Trust pursuant to § 1.199-2(e)) for a total of $1,559 of W-2 wages. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI. B's tentative deduction is $270 (.09 x $3,000), limited under the W-2 wage limitation to $780 (50% x $1,559 W-2 wages). Accordingly, B's section 199 deduction for 2010 is $270.

[836] [My note – not from the regulation itself:] When this regulation was finalized, Code § 199(a)(1)(B) limited the Code § 199 deduction to taxable income (computed before applying the Code § 199 deduction). That limitation was in Code § 199(a)(2) immediately before its repeal by 2017 tax reform.

(2) *Trust's computation*. Trust has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B).[837] Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, Trust has W-2 wages of $1,459 (50% x $2,917). Trust's tentative deduction is $180 (.09 x $2,000 QPAI), limited under the W-2 wage limitation to $730 (50% x $1,459 W-2 wages). Accordingly, Trust's section 199 deduction for 2010 is $180.

The Example does not seem to consider part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

II.E.1.f.ii. Nongrantor Trusts Other Than ESBTs

II.E.1.f.ii.(a). How Qualified Business Income Flows to Beneficiaries

By managing their taxable income through the income distribution deduction, trusts may be able to get below the desired threshold to qualify for a better deduction. Planning for estates and nongrantor trusts generally is discussed in part II.J Fiduciary Income Taxation.

Suppose a partnership distributes its entire $1 million K-1 income (all "QBI" - qualified business income) to a trust. Suppose the partnership then distributes enough income so that its taxable income, before the Code § 199A deduction, is $157,500. The trust's allocable portion of QBI receives the 20% deduction, without regard to the wage limitation[838] and without regard to whether the partnership conducts otherwise disqualified professional services.[839] The beneficiary's K-1 income from the trust pushes the beneficiary's taxable income way above the taxable income threshold. The beneficiary might very well have been above the taxable income threshold anyway.

Thus, we might have two taxpayers that might have been above the taxable income threshold, yet one of them gets the full benefit of being below the threshold.

Suppose each of the trust and beneficiary has zero taxable income but for a $315,000 K-1 that the trust receives. If the trust distributes to the beneficiary $157,500 plus all of its other income, each of the trust and the beneficiary may have $157,500 of taxable income. Thus, each one should be able to qualify fully for all of the benefits that taxable income below the thresholds provides, even though if the trust had retained all of the K-1 income it would have not received any of those benefits (with $315,000taxable income, which is above $207,500); however, the last sentence of Prop. Reg. § 1.199A-6(d)(3)(iii), as well as the preamble,[840] would double-count the beneficiary's K-1 income, giving the trust $315,000 taxable income and the beneficiary $157,500 taxable income. Therefore, under the proposed regulations, the trust would not benefit from being within the taxable income threshold, but the beneficiary would.

---

[837] [My note – not from the regulation itself:] When this regulation was finalized, Code § 199(a)(1)(B) limited the Code § 199 deduction to taxable income (computed before applying the Code § 199 deduction). That limitation was in Code § 199(a)(2) immediately before its repeal by 2017 tax reform.
[838] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[839] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.
[840] For complete quotes of both the preamble and the regulation, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

II.E.1.f.ii.(b). When to Shift Qualified Business Income (QBI) to Beneficiaries

Before focusing on QBI, consider planning for the trust and beneficiaries generally. See part II.J Fiduciary Income Taxation, especially part II.J.3 Strategic Fiduciary Income Tax Planning.

Generally, distributions effectively shift the trust's income to its beneficiaries.[841]

After allocating deductions to the trust's income,[842] the trustee usually needs to allocate all items of distributable net income to beneficiaries in proportion to the distributions they receive,[843] subject to the separate share rule.[844]

Be sure to consider planning opportunities described in part II.J.11.a Depreciation Advantages and Disadvantages.

A beneficiary may have business losses, deductions against gross income, or the itemized or standard deduction against which to offset income, so that shifting income to the beneficiary may provide more.

Also, if a beneficiary is a married person filing jointly, then the beneficiary's taxable income threshold is double that of a trust's, so shifting QBI to the beneficiary may allow a more favorable threshold, even if the beneficiary's losses and deductions don't make much of a difference.

II.E.1.f.ii.(c). Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs

Suppose a trust holds a partnership but would like to take advantage of the benefits provided for S corporation shareholders by part II.E.1.f.iii Electing Small Business Trusts (ESBTs) or II.E.1.f.iv Grantor Trusts. It could contribute the partnership to an S corporation and then take advantage of those benefits. See parts II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary and II.J.4.h Trapping Income in Trust Notwithstanding Distributions – ESBT. This possibility is discussed in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

Such a strategy would also have the benefit of not qualifying the partnership from electing out of the Bipartisan Budget Act partnership audit rules that became effective for years beginning after December 31, 2017; when I wrote this paragraph, the proposed regulations had not approved of trusts as eligible partners for purposes of opting out, and an S corporation's shareholders are not counted in determining the S corporation's eligibility. See part II.G.19.c Audits of Partnership Returns.

However, given that an S corporation that does not itself conduct a business cannot be divided tax-free, consider creating the same number of S corporations as there are remaindermen. That way, each remainderman will have his or her own S corporation and independently determine distributions from the S corporation or whether the S corporation should sell the

[841] See part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.
[842] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.
[843] See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.
[844] See part II.J.9.a Separate Share Rule.

partnership interest. For more thoughts on this, see part III.A.3.e.vi.(b), the title of which focuses on QSSTs, but which also applies to ESBTs.

II.E.1.f.iii. Electing Small Business Trusts (ESBTs)

As described in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview,[845] ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of Subtitle A of the Code. The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust. The grantor trust rules trump this treatment. However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. (A side benefit is that the $10,000 limit on state income tax deductions would apply separately to the S portion and the non-S portion, allowing the trust to deduct up to $20,000 in state income tax.)[846]

Code § 641(c)(2) limits the deductions that an ESBT can take. However, Code § 641(c)(2)(C)[847] and Reg. § 1.641(c)-1(d)(2)(i)[848] provide that one takes into items reported on Schedule K-1 that the S corporation issues to the trust.[849] Code § 199A(f)(1)(B) refers back to Code § 199 for the apportionment of W-2 wages and the apportionment of unadjusted basis.[850] Code § 199 items were separately stated on Schedules K-1.[851] Consistent with this framework, Prop. Reg. § 1.199A-6(d)(3)(iv), "Electing small business trusts," provides:

> An electing small business trust (ESBT) is entitled to the deduction under section 199A. The S portion of the ESBT must take into account the QBI and other items from any

---

we[845] This is part of part III.A.3.e.ii ESBTs.

[846] See text accompanying fns 5150-5153 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[847] Code § 641(c)(2)(C) provides:

> The only items of income, loss, deduction, or credit to be taken into account are the following:
> (i) The items required to be taken into account under section 1366….

[848] Reg. § 1.641(c)-1(d)(2)(i) provides:

> *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

[849] Reg. § 1.1366-1(a)(2) provides:

> Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

[850] See part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

[851] Reg. § 1.1366-1(a)(2)(x) provides that among the items a shareholder takes into account is:

> Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

2017 Instructions for Form 1120S, Schedule K-1, Box 12, page 15, includes:

> **Code P. Domestic production activities information.** The corporation will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. For details, see the Instructions for Form 8903.

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 another person (owned portion) of a trust under sections 671 through 679, and 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. See § 1.641(c)-1.

Query how the taxable income thresholds will apply. Code § 199A is found within chapter 1 of Subtitle A of the Code, so the S corporation portion should be treated as a separate trust with its own taxable income. Even the 3.8% tax on net investment income, which is in chapter 2A, respects an ESBT's separateness.[852]

If this separateness is respected as appears to be the case, then a trust with other taxable income but no more than $157,500 of S corporation taxable income would get the full benefit of being no more than the taxable income threshold.

If that idea holds up, a trust with taxable income over the threshold that holds a partnership interest might contribute enough of the partnership interest to an S corporation to trap less than $157,500 inside the ESBT. Perhaps the trust might even have two taxable income thresholds – one for the partnership owned by the corporation inside the ESBT, and another for the partnership owned directly by the trust. However, informal remarks made by government representatives at a September 13, 2018 webinar of the American Bar Association's Section of Real Property, Trust & Estate Law in which I also spoke indicate that the government's intent is to add the S portion's taxable income to the non-S portion's taxable income to see whether the taxable income threshold is exceeded. Not only would that be inconsistent with Reg. § 1.641(c)-1(a), it would violate Code § 641(c)(1)(A), which provides that, for all federal income tax purposes, "the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust."

Before considering this, carefully read part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iv. Grantor Trusts (Including QSSTs)

"Grantor trust" means that one or more person is treated for income tax purposes as owning the trust's assets. Often this person is the grantor, but it can also be a beneficiary. See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.h How to Make a Trust a Grantor Trust and III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

The most common grantor trust is the revocable trust, but that's just a probate avoidance tool that doesn't inform planning. During the settlor's life, we often look to whether the settlor of an irrevocable trust may be the deemed owner, although significant tools allow us to plan to have the primary beneficiary be the deemed owner. After the settlor's death, making the beneficiary the deemed owner is the only grantor trust planning option.

Given that all Code § 199A items are attributable to the relevant grantor(s), a grantor trust is helpful when the beneficiary has low income.

[852] See part II.J.14 Application of 3.8% NII Tax to ESBTs.

Suppose a trust has huge taxable income, as well as having a partnership K-1 with no more than $157,500 of taxable income (before applying Code § 199A). As discussed in part II.E.1.f.iii, the trust could form an S corporation, contribute the partnership interest to the S corporation, and make an ESBT election, thereby qualifying for the full Code § 199A deduction – but at the highest taxable income rates. Another alternative is to do the same, only the beneficiary elects QSST taxation.[853] All of the partnership's K-1 items are reported directly on the beneficiary's return, using the beneficiary's taxable income threshold and being taxed at the beneficiary's income tax rates. Before considering this, carefully read part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.v. Interaction with Net Investment Income Tax

The 3.8% tax on net investment income (NII) applies not only to investments but also to passive business income. See part II.I.8 Application of 3.8% Tax to Business Income.

To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business. See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

If the trust is a QSST, then consider having the trustee sufficiently participate, to avoid NII tax in case the business is sold. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.E.1.f.vi. Example Using Trusts to Split Income

Suppose Marla Alexander, a widow, owns an S corporation, which annually generates $1.5 million of taxable income each year.

Being in a state with a 5% income tax rate, Marla pays $75,000 of state income tax each year. Unfortunately, for any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits her deductions for state taxes to $10,000.[854] Given that Marla pays some real estate tax on her residence, more than $65,000 of her state income tax deduction is disallowed.

Marla has two children, Sam and Dolly. Marla needs only 60% of her stock to live quite comfortably. After converting the stock in 5 shares of voting and 95 shares of nonvoting stock,[855] Marla gifts 40 shares of nonvoting stock, 10 into each of four trusts: a discretionary trust for Sam, a QSST for Sam, a discretionary trust for Dolly, and a QSST for Dolly. See part III.A.3.e QSSTs and ESBTs.

Each ESBT will deduct its $7,500 share of state income tax. Because QSSTs are taxable as grantor trusts, each of Sam and Dolly will deduct up to $7,500 of state income tax if he or she itemizes deductions ("up to" because they may have real estate tax or other state tax

[853] See part III.A.3.e.i.(a) QSSTs Generally.
[854] It does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business). See part II.G.4.i.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.
[855] See part II.A.2.i.i Voting and Nonvoting Stock.

deductions). Although part II.J.9.c Multiple Trusts Created for Tax Avoidance is concerning, Marla's desire to distribute some income and accumulate the rest of the income, combined with the fact that a QSST must distribute all of its income, may suffice. More conservative from an income tax viewpoint would be to make gifts outright instead of using QSSTs, but that might not meet Marla's estate planning objectives.

Also consider that each trust's distributive share of income is $150,000 (10% of $1.5 million). This means that each ESBT's taxable income will be less than $157,500; thus, in computing their Code § 199A deduction, any disallowance of specific service business income[856] and any limitations placed on insufficient wages[857] would not apply. See part II.E.1.f.iii Electing Small Business Trusts (ESBTs). Whether Sam and Dolly will benefit from eliminating these potential disallowances regarding the QSST's distributive shares that are taxed to them depends on their other income and deductions; see part II.E.1.f.iv Grantor Trusts (Including QSSTs).

Also consider part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income:

- If Sam or Dolly's adjusted gross income exceeds $200,000 so that the 3.8% NII tax may apply to them, does Sam or Dolly work enough in the business to prevent the NII tax from applying to his or her distributive share of business income through his or her QSST? Working more than 100 hours per year – a mere 2 hours per week – may suffice; see part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

- Because an ESBT's threshold for the NII tax is so low, we also need to consider whether the trustee of each ESBT works enough in the business on behalf of the relevant trust to avoid NII tax. See part II.J.14 Application of 3.8% NII Tax to ESBTs. If the trustee works in the business as an individual, on audit the IRS is likely to assert that work as an individual does not count – it needs to be work expressly as a trustee. However, one can plan to avoid that argument. For all of these issues, see part II.K.2.b Participation by an Estate or Nongrantor Trust.

- The trustee of the QSSTs should also consider the planning mentioned for the ESBT. That's because the gain on sale of S corporation stock is taxed to the trust itself, rather than to the beneficiary; see parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

Suppose, instead of Marla's business being in an S corporation, it were held in an LLC taxed as a partnership. Let's first consider the state income tax issue, then consider the QBI issue.

Because there is no partnership income tax equivalent of a QSST, the mandatory income trust would apply the state income deduction at the trust level rather than at the beneficiary level. That may be more favorable, given that Sam's and Dolly's other state tax issues would not impinge on the benefits of the deduction for state income tax on the pass-through income. On the other hand, it may be more difficult to justify two separate trusts, given that a trust holding a partnership interest does not have the same type of drafting considerations that a QSST would

[856] See part II.E.1.c.iv Specified Service Trade or Business.
[857] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

have; therefore, one may be more wary of possible application of part II.J.9.c Multiple Trusts Created for Tax Avoidance. In response to this concern, one may consider the mandatory income trust placing the partnership in an S corporation, with the trust's beneficiary electing QSST treatment; query, however, whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Moving to the QBI issues, issues with the specific service business income[858] and any limitations placed on insufficient wages[859] would be divided between the trust and beneficiaries who receive distributions, as described in part II.E.1.f.ii Nongrantor Trusts Other Than ESBTs. However, if the LLC does not distribute much more than enough to pay taxes, then the beneficiaries might not receive much of a distribution, because the trust would use all or most of the distribution to pay the trust's own taxes; see parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation. To shift half of the gifted distributive shares of income to Sam or Dolly, one may need to consider having a separate mandatory income trust that places its LLC interest in an S corporation, with the trust's beneficiary electing QSST treatment; again, consider whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Also consider the same NII tax issues we did for the ESBTs.

II.E.1.f.vii. Ownership Restrictions

If an ownership interest cannot be transferred to a trust because it is a professional firm, consider which services can be split off into an entity that does not require professional ownership.

For example, CPA firms could split off their tax return and personal financial planning services.

However, if the business is inside a corporation, consider whether goodwill is personal or corporate,[860] the latter causing taxation when moving the line of business unless one can do a tax-free split-up.[861]

II.E.1.g. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation

As mentioned earlier:

- Dividends a C corporation receives from another domestic C corporation are subjected to federal income tax of no more than 10.5%.[862]

- Taxable interest and capital gains are subjected to 21% federal income tax.[863]

---

[858] See part II.E.1.c.iv Specified Service Trade or Business.
[859] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[860] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?
[861] See part II.Q.7.f Corporate Division into More Than One Corporation.
[862] See part II.E.1.a Taxes Imposed on C Corporations, especially the text accompanying fn 626, referring to fns. 10-14 in part II.A.1.a C Corporations Generally.

Contrast this to a taxpayer in the highest tax bracket, who is subjected to federal income tax of:

- 23.8% on qualified dividends[864] and net long-term capital gains, considering the 20% top capital gain rate[865] and 3.8% net investment income tax.[866]

- 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains, considering the 37% top ordinary income tax rate[867] and 3.8% net investment income tax.[868]

- For any taxable year beginning after December 31, 2017 and before January 1, 2026, individuals cannot deduct investment management fees relating to managing their own marketable securities.[869] This disallowance does not apply to C corporations, because C corporation deductions are not itemized deductions.

However, the chart in part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, which also considers moderate state income tax, illustrates that the C corporation advantage quickly dissipates if the corporation makes distributions.

The personal holding company tax or accumulated earnings tax may essentially force a corporation to declare dividends – especially if the corporation accumulates more than $125,000 in earnings.[870]

Eventually, however, income will need to be distributed so that the owner actually benefits from the investment return, imposing dividend tax at that time and undermining – to some extent (small or large) the advantage of C corporation income tax savings. Another option, which can make this strategy much more tenable, is: the investor grows the assets at smaller income tax rates, increasing future annual income, then converts to an S corporation and distributes current income while leaving prior years' income in the corporation to grow; see part II.E.2.c Converting a C Corporation to an S corporation, which also includes warnings regarding investment mix after making the S election.

Harvesting the accumulated income by simply selling the C corporation does not produce good results. See part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

---

863 Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

864 See part II.E.1.a Taxes Imposed on C Corporations, fns 627-628 and text accompanying them.

865 Code § 1(h)(1), with exceptions under Code § 1(h)(3)-(8) for depreciation recapture, collectibles and Code § 1202 gain taxed as a capital gain at 28%

866 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

867 Code § 1(j), for any taxable year beginning after December 31, 2017, and before January 1, 2026.

868 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

869 Code § 67(g).

870 See text accompanying and preceding fn 632 in part II.E.1.a Taxes Imposed on C Corporations.

Finally, if one decides to use a corporation to hold investments, consider what happens when one passes them to one's children or other various beneficiaries. A similar but perhaps more predictable termination concern applies to trusts. A corporation that invests in portfolio assets cannot divide without triggering income tax. One might consider creating a few corporations (in the case of a trust, one for each remainderman). These corporations then invest in a partnership, which can divide without triggering income tax. That way, each corporation can receive a mix of assets more along the lines of the beneficiary's preferences. For more details, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made), which describes the corporate division issue and a solution.

I cannot emphasize enough the need to consider an exit strategy. Political winds change over time, and it is very likely that at some point Congress will increase corporate taxes to bring them closer to individual rates. Beware getting into a structure that has costly exit steps and then being stuck there because of that high exit tax. Consider that the Tax Reform Act of 1986 taxed all income, including long-term capital gains, at a top rate of 28%, and the paradigm before 2017 tax reform was very different. The paradigm from 2017 tax reform will change, whether by creeping as the 1986 one did or by dramatic changes needed to reduce the exploding national debt or pay for Medicare or Social Security.

II.E.1.h. Effect of 2017 Tax Reform on Debt-Equity Structure

See part II.G.20.a Limitations on Deducting Business Interest Expense.

Business interest deduction limitations vary by industry.

Businesses with average annual gross receipts of no more than $ 25 million are exempt from this limitation.[871]

II.E.1.i. Conducting Businesses in Different Entities to Facilitate Using the Code § 199A Deduction

Each separate trade or business applies the Code § 199A separately,[872] which may at first glance seem to make shifting operations around meaningless. However, each business activity may have, within the same entity, one or more sets of functions that support that activity, which functions might themselves be viewed as a separate business if conducted in that manner.

A prime example is real estate used in a business. Suppose a law partnership owned its own real estate. If a partner's income is too high, her partnership income would not generate a Code § 199A deduction, because the income is derived from a specific service business.[873] The benefit of owning the real estate is subsumed in the disqualified income. However, if instead the real estate were owned by a separate LLC that was the landlord, the real estate could generate qualified business income (QBI) if the landlord undertook sufficient activity to qualify it as a trade or business; see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

Unlike real estate, equipment leasing almost automatically qualifies as a trade or business, according to cases and rulings in the self-employment tax and unrelated business income tax

---

[871] See text accompanying fns 1529-1530.

[872] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially text before and after fn 711.

[873] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, fns 684-713.

areas.[874] So consider forming a separate equipment leasing venture that services the equipment, with the services perhaps not needed to qualify as a business but helpful to prevent the wage limitation from reducing the Code § 199A deduction.[875] To avoid self-employment tax, be sure to make the venture be a limited partnership with an S corporation general partner or an S corporation; see parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, II.E.6 Recommended Partnership Structure – Flowchart and II.E.7 Migrating into Partnership Structure (with the latter not as important because a new leasing venture could be started for new equipment). Also, as the Code § 199A deduction approaches its termination, consider part II.E.1.c.ix QBI and Effectively Connected Income.

If a professional service firm also sells goods, consider separating the sale of goods from the provision of services. Depending on how the government approaches classifying trades or business as separate,[876] a separate entity may not be needed.

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities

II.E.2.a. Transferring the Business

Part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis shows that, when doing a seller-financed sale of a business, such as to key employees, other owners, or family members, the value of a business attributable to goodwill can be transferred much more tax-efficiently when using a partnership compared to a C corporation or an S corporation. Part or all of these dynamics can be replicated in other transactions.

A shareholder's stock's basis does not increase as a result of a C corporation's reinvested income. However, part or all of the gain on the sale of original issue stock in a qualified corporation that runs a qualified business is excluded from income. See part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, explaining Code § 1202.

However, to the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[877] or stock[878] increases. Thus, the gain on sale usually is much lower when selling a partnership interest or S corporation stock than when selling C corporation stock.

S corporations and partnerships are ideal candidates for estate planning transfers using irrevocable grantor trusts. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text preceding fn 5534. When the pass-through entity makes distributions to pay its owners' taxes, the irrevocable grantor trust that bought the stock or partnership interest uses those distributions to pay down the note owed to seller, and the seller uses this to pay taxes. Thus, tax distributions are used to build equity in the purchasing irrevocable grantor trust. Contrast this with C corporations, where the corporation pays taxes directly to the government, and any distributions are subject to double taxation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, using the scenario of a C corporation distributing all of its earnings to its shareholders.

---

[874] See part II.L.2.a.ii Rental Exception to SE Tax, fns 2840-2844.
[875] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[876] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially text before and after fn 711.
[877] Code § 705.
[878] Code § 1367.

Also, gain on the sale of C corporation stock is subject to the 3.8% tax on net investment income.[879] Gain on the sale of an S corporation or partnership that conducts a trade or business may be largely excluded from that tax when the owner sufficiently participates.[880]

Furthermore, when an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[881]

Part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons describes more reasons why I tend to prefer partnerships over S corporations and S corporations over C corporations.

II.E.2.b. Converting from S corporation to C Corporation

See parts II.A.2.k Terminating an S Election and II.P.3.d Conversion from S corporation to C Corporation for short-term planning. Ideas include:

- A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

- Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.20.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.b Conversion from C Corporation to S corporation and II.P.3.b.v Conversion from S corporation to C Corporation then Back to S corporation.

Generally, I recommend forming an S corporation parent and then converting the original corporation to a C corporation, for the reasons and using the method described in fns 3358-3366 in part II.P.3.b.v Conversion from S corporation to C Corporation then Back to S corporation, which in a nutshell include (see part II.P.3.b.v for details):

- Preserving the corporation's AAA in case it converts back to being an S corporation.

---

[879] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[880] See part II.I.8 Application of 3.8% Tax to Business Income.
[881] See part II.H.2 Basis Step-Up Issues.

- Avoiding (so it appears) having to wait 5 years before converting back to being an S corporation.[882]

- Potentially qualifying for the benefits described in part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, which does not apply to former S corporations but does apply to C corporation subsidiaries of S corporations.

However, the strategy of distributing a note before converting might trigger tax; see fns 3364-3365 in part II.P.3.b.v Conversion from S corporation to C Corporation then Back to S corporation.

II.E.2.c. Converting a C Corporation to an S corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.k Terminating an S Election.

See part II.P.3.b Conversion from C Corporation to S corporation, including II.P.3.b.v Conversion from S corporation to C Corporation then Back to S corporation. Issues discussed there include the following:

- Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before converting, so that accounts receivable do not get hit with this tax.

- Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it; investment mix may not need to be managed if the corporation is a partner in an active business that has substantial gross receipts (which is tested rather than the partnership's profits). See part II.P.3.b.iii Excess Passive Investment Income, especially fns 3334-3337.

- Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.b.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

- If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.b.i LIFO Recapture.

II.E.3. Recommended Structure for Start-Ups

The structure should start as a simple one and then, when the entity is making a lot money, would be transitioned to a more complex structure. For long-term reasons why an entity taxed

[882] See fns 197-199 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

as a sole proprietorship or partnership makes sense, see part II.E.5.a Strategic Income Tax Benefits of Recommended Structure.

Consider starting with an LLC. Start-up businesses often lose money initially, and an LLC taxed as a sole proprietorship or partnership facilitate loss deductions better than other entities[883] (although deducting start-up losses might not always generate the best result).[884] Also, often owners of closely-held businesses operate with a high degree of informality, and owners of corporations can get into trouble by taking money out without documenting compensation or documenting loans;[885] contrast that to an LLC that for income tax purposes is either disregarded entity or a partnership,[886] in which case distributions are either disregarded or generally nontaxable.[887]

A business with owners that work more than 100 but not more than 500 hours per year might want to move its real estate into the desired structure to avoid the 3.8% net investment income tax on the rental income (because the rental income and expense are disregarded for income tax purposes, being in the same umbrella as the operating business) or on the sale of the rental property. For example, a parent LLC might own an operating LLC and a real estate LLC. See parts II.I.8.c.i If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income, II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax, and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

However, deducting start-up losses may not be desirable, because the owner is in a lower tax bracket now and expects not to be in a low tax bracket in the future. In that case, consider using an entity taxed as an S corporation, with the owners guaranteeing loans by third parties but not investing or lending a lot of money themselves. If that, too, generates more losses than desirable, then try a C corporation, which will just roll forward the losses. When using a C corporation or an S corporation, consider planning to qualify for the requirements of part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under

---

[883] See part II.G.4 Limitations on Losses.

[884] If the owner is in a lower bracket in start-up years than in later years, losses might best be deferred, if possible. A variation of this idea is in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If deferring losses is expected to be particularly beneficial, consider:

- If loans are bank-financed, an S corporation can easily ensure that its owners' distributive share of losses be suspended due to basis limitations until the S corporation becomes profitable. See part II.G.4.c.i.(a) Limitations on Using Debt to Deduct S corporation Losses.
- A start-up C corporation's losses are simply carried forward and deducted against its later income. See part II.G.4.i.iii Code § 172 Net Operating Loss Deduction. In case the C corporation doesn't succeed, certain start-up documentation can generate ordinary loss (instead of capital loss) treatment when the stock becomes worthless. See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244, subject to part II.J.11.b Code § 1244 Treatment Not Available for Trusts. The timing and documentation (including initial documentation in the case of a loan) of a worthless stock or bad debt deduction can be tricky. See part II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee, especially fns. 1022-1023 (stock) and 1025-1027 (loans).

[885] Such payments are potentially taxable distributions to shareholders; see the text accompanying fns. 3999-4000 in part II.Q.7 Exiting from or Dividing a Corporation. The IRS attacks distributions from S corporations, asserting (often successfully) that they are disguised compensation (and perhaps assessing penalties as well); see part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns. 87-88.

[886] See part II.B Limited Liability Company (LLC).

[887] See part II.Q.8.b.i Distribution of Property by a Partnership.

Code § 1244 (which is not available to trusts).[888] Beware, however, that using either kind of corporation can make getting into an ideal long-term structure more difficult, because one needs to avoid triggering taxation on a deemed distribution of assets. See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure. Often a trigger for moving a corporation into the structure is the desire to avoid capital gain tax on the seller-financed sale of the business, which often makes the costs of transition worthwhile if the business has significant goodwill. See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

When the business starts making money but only enough to pay owner compensation and equipment that is expensed immediately, no additional self-employment tax is due relative to if the entity were a corporation paying compensation to its owners. Furthermore, if the business is investing profits in equipment, etc., generous write-offs are available.[889] However, note that wages paid by an S corporation may provide a higher Code § 199A deduction relative to compensation paid to a partner, so consider this corporate advantage.[890]

Then, when the client is ready for the ideal entity (for example, when self-employment tax on reinvested earnings becomes a significant number), the client can simply assign the LLC to the limited partnership described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart; see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure. However, the client might express a preference in the long-run to use part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. If so, the client might want to start with that structure instead of starting with an LLC. If one starts with an entity taxed as an S or C corporation instead of an LLC, then the presence of non-compete agreements would make migration to a partnership structure less effective, because the value of the goodwill at the time of the migration would remain inside the corporation.

Suppose that one concludes that a C corporation would be ideal. Starting with an LLC taxed as a partnership and then converting to a C corporation the earlier of five years before a sale is anticipated or shortly before its gross assets reach $50 million might be the most tax-efficient approach.[891]

Whether or not one likes the above recommendations, consider asset protection with a business' net profits. An entity's creditors' claims take priority over distributions to owners. If an entity distributes to its owners any profits not needed to keep the entity fiscally responsible, generally those assets will not be subjected to the claims of the entity's future creditors. For tax purposes, investments are best kept outside the entity, particularly for a C or an S corporation,[892] but also, to a certain but more limited extent, for a partnership.[893] The owners

---

[888] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[889] See part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.

[890] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[891] See part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (particularly the text accompanying fns. 4406-4412).

[892] Any distributions of appreciated assets trigger corporate-level income tax, whether paid by the corporation (C corporation) or shareholders (S corporation). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note also that S corporations that have accumulated earnings and profits from prior periods as an S corporation might want to avoid investments that generate

might consider loaning the distributions back to the entity, becoming creditors, rather than owners, to that extent. The owners might also consider forming an LLC taxed as a partnership to hold any distributions that they neither loan to the company nor keep for personal purposes, viewing the LLC as a source for funding future capital projects or exit strategies or perhaps for providing or securing a line of credit for the business;[894] however, S corporations might want to avoid any formal requirement in their governing documents that distributions be made to such an LLC.[895]

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure

In part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, we learned that:

- To the extent that a C corporation reinvests profits, it is more tax-efficient from the perspective of annual income from operations.
- To the extent that it distributes profits, it is not more tax-efficient.

Given that pass-through entities tend to have superior exit strategies,[896] the portion of the business that distributes profits should be in a pass-through entity.

Consider forming a limited partnership owned by a C corporation and a pass-through entity, with ownership based on the desired long-term goal for distributions:\

- This might be worked in with the general ideas of parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

---

tax-free income; see part II.P.3.b.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

893 See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Such distributions have more potential to trigger tax than do distributions of other assets, but tax can be avoided with careful planning.

894 If there is a risk that the corporation will have losses but the shareholders' basis will be insufficient to deduct those losses, then the LLC should loan the funds to its members who should then lend them to the corporation. See part II.G.4.c.i Basis Limitations for S corporation Owners Beyond Just Stock Basis. Presumably, if the loan from the LLC to the corporation is already in place, the LLC could simply distribute the loan to its members. See fn. 1042.

895 A partnership is not an eligible shareholder of an S corporation; see part II.A.2.f Shareholders Eligible to Hold S corporation Stock. Therefore, one might consider avoiding any distribution arrangements that might make a partnership appear to be a shareholder. However, distribution arrangements that are not baked into the governing documents do not count for determining whether a second class of stock exists (see part II.A.2.i.iii Disproportionate Distributions, and within that see fn. 243 for what constitutes governing documents and the effect, if any, given to certain arrangements), so presumably they would not count as creating a shareholder relationship. Although I have not seen anything directly on point, presumably an S corporation can contribute to a partnership in exchange for a partnership interest and then distribute that partnership interest to its shareholders; the parties would have substantial authority for not applying undesirable valuation discounts to that distribution – see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders for general rules, fn. 4263 for authority for no valuation discounts, and part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders for why valuation discounts are undesirable.

896 See part II.E.2.a Transferring the Business.

- If the entity is already a C corporation or an S corporation, see part II.E.7 Migrating into Partnership Structure.

The C corporation would annually receive any earnings that are to be reinvested, whereas the balance would be owned by limited partners receiving distributions. The C corporation would loan back to the partnership the earnings to be reinvested:

- The corporation's interest income would be taxed at a federal rate of 21%, whereas the interest would be deducted at the higher individual rate, causing a taxpayer-favorable tax arbitrage. However, the Code § 199A deduction of up to 20% of qualified business income[897] may reduce this benefit, and the interest might not be fully deductible.[898]

- If the interest income becomes too significant, consider whether the personal holding company tax[899] or accumulated earnings tax[900] may be triggered. If these possible taxes eventually become a factor, consider part II.E.2.c Converting a C Corporation to an S corporation.

Before doing any of this, consider that investing in a partnership might make a C corporation ineligible for part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation. However, as described in part II.Q.7.k, not all businesses are eligible for the exclusion, and the exclusion applies only to stock originally issued to the owner (or to the person who gifted or bequeathed the stock to the current owner).

An S corporation with separate business lines could also reorganize into an S corporation parent with various subsidiaries, some of which might be disregarded entity LLCs and others of which might be C corporations that reinvest their profits and may qualify for part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation. See part II.E.2.b Converting from S corporation to C Corporation.

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[901] and promote tax-efficient exit strategies,[902] the main entity should be a partnership. A partnership often is a better exit vehicle

[897] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[898] See part II.G.20.a Limitations on Deducting Business Interest Expense.
[899] See part II.A.1.e Personal Holding Company Tax. I am not too concerned about this tax, because the corporation's distributive share of the partnership's gross income – not net income – would be compared against the interest income. In part II.A.1.e, see fn 73.
[900] See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax,
[901] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations.
[902] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare part II.Q.7.f Corporate Division into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership

than a C corporation, notwithstanding part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation;[903] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[904] However, corporate structure has some advantages:

- The partnership audit rules are becoming onerous and may artificially increase tax.[905] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[906]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is available only to corporations. Forming a corporation immediately before the sale might not work;[907] I am unsure whether checking-the-box to elect corporate treatment helps any.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[908] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[909]

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[910]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[911]

---

divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S corporations Compared with Partnerships).

[903] See parts II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California).

[904] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 4406-4412).

[905] See part II.G.19.c Audits of Partnership Returns.

[906] See part II.G.19.b Audits of S corporation Returns.

[907] See part and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations, especially fn. 2936.

[908] See part II.G.21 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.

[909] See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations.

[910] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[911] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[912] However, in Tennessee, if one already has earnings that exceed the FICA/SE taxable wage base,[913] SE tax is actually good, because one is paying 2.9% or 3.8% SE tax, not worrying about the 3.8% net investment income tax,[914] and avoids paying the "Hall tax," a 6.5% excise tax on a limited liability entity's income;[915] using an LLC subject to SE tax allows one to avoid the Hall tax by paying possibly unreasonably high compensation,[916] and such compensation strategies tend to prevent an S or a C corporation form accumulating the war chest it needs for a rainy day or to buy out an owner who retires or becomes uninsurable. One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[917]

II.E.5.c. Operating the Recommended Structure

II.E.5.c.i. General Considerations

This paradigm might not work well if owner compensation is needed to get the full Code § 199A deduction. See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. This concern applies only if the ultimate taxpayer computing the deduction has taxable income in excess of certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[918] if the owner materially participates in the business.[919] Note

[912] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[913] See parts II.L.2.a.i General Rules for Income Subject to Self-Employment Tax and II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3565, the latter for rates.

[914] SE income is not subject to the net investment income tax. See fn. 1895.

[915] Tenn. Code § 67-4-2007 imposes a 6.5% excise tax on all persons, other than not-for-profit entities, doing business in Tennessee. "'Person' or 'taxpayer' means every corporation, subchapter S corporation, limited liability company, professional limited liability company, registered limited liability partnership, professional registered limited liability partnership, limited partnership, cooperative, joint-stock association, business trust, regulated investment company, REIT, state-chartered or national bank, or state-chartered or federally chartered savings and loan association," Tenn. Code § 67-4-2004(38). Just to drive home the point for LLCs, Tenn. Code § 67-4-2105 expressly includes "any limited liability company regardless of how it is treated for federal income tax purposes." The tax does not apply to self-employment income. Tenn. Code § 67-4-2006(4)(B).

[916] See fn. 32 for federal unreasonable compensation cases.

[917] See part II.G.3 State Taxation.

[918] The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax.

that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[920] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[921]

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[922] that is a 1% general partnership, and
- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[923]

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.

919 The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.

920 See part II.K.1.b.ii Grouping Activities – General Rules, particularly fn. 2565.

921 See fns. 2623-2624.

922 The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 2743 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

923 See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 2600.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical, depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[924] ***Caution***: See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. Also note that the reasonableness of the management fee (in terms of deducting the fee) depends on the reasonableness of the compensation of those whose services generated the management fee.[925] Carefully document each employee-owner's employment agreement with the corporation.[926]

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

II.E.5.c.ii. Code § 199A Deduction under Recommended Structure

The S corporation general partner ("GP") of the limited partnership ("LP") receives a K-1 with QBI, wages, and UBIA. However, because the GP is a separate RPE from the LP, any activity on the K-1 the GP receives is siloed from the GP's own activities.[927] In other words, K-1 income is QBI of the RPE that issues the K-1, not QBI of a business carried on by the K-1 recipient.

Thus, the GP needs to conduct its own trade or business for any wages it pays to count as being related to QBI.[928] Guaranteed payments for services are not QBI.[929]

When the GP receives a management fee and pays compensation to those working for the LP, those wages can be attributed back to the LP, but only if the W 2 wages were paid to the LP's common law employees or officers of the individual or RPE for employment by the LP – in other

[924] See part II.B Limited Liability Company (LLC), fns. 312-313.
[925] See fn 43 and the accompanying text in part II.A.1.b.i Compensating Individuals.
[926] See fn 1610 in part II.G.24 Taxing Entity or Individual Performing Services.
[927] See Prop. Reg. § 1.199A-6(b), reproduced shortly before fn 659 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[928] See Prop. Reg. § 1.199A-2(b)(1), reproduced in part II.E.1.c.vi.(a) W-2 Wages under Code § 199A.
[929] Prop. Reg. § 1.199A-3(b)(2)(ii)(I), (J), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

words, the GP leased the employees to the LP.[930] Thus, compensation for services rendered by the limited partners themselves would not qualify, because they cannot be common law employees of the LP.

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of pass-through entities.[931] On the other hand, if one is concerned only about avoiding the 3.8% tax on net investment income and not about disallowing passive losses or credits,[932] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[933]

II.E.5.e. Estate Planning Aspects of Recommended Structure

II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any income tax.[934] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[935]

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[936]

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[937] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[938]

---

[930] See Prop. Reg. § 1.199A-2(b)(2)(ii), reproduced in part II.E.1.c.vi.(a) W-2 Wages under Code § 199A.
[931] See part II.K.1.a.ii Material Participation.
[932] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[933] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[934] See part II.Q.8 Exiting From or Dividing a Partnership.
[935] See part II.Q.8.a Partnership as a Master Entity.
[936] See parts II.Q.7 Exiting from or Dividing a Corporation (especially part II.Q.7.f Corporate Division into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.

II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[939] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale. This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 5806-5808.

II.E.5.e.iv. Code § 2036

The IRS has attacked (and courts have agreed) a donor's retention of control when transferring a business entity, unless the grantor can prove a legitimate and significant nontax reason for forming the entity.[940]

However, retaining voting stock and transferring nonvoting stock does not cause Code § 2036 inclusion.[941] Using an S corporation general partner may help address this issue.

II.E.5.f. Recommended Structure with C Corporation

Because 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

II.E.5.g. Other Aspects of Recommended Structure

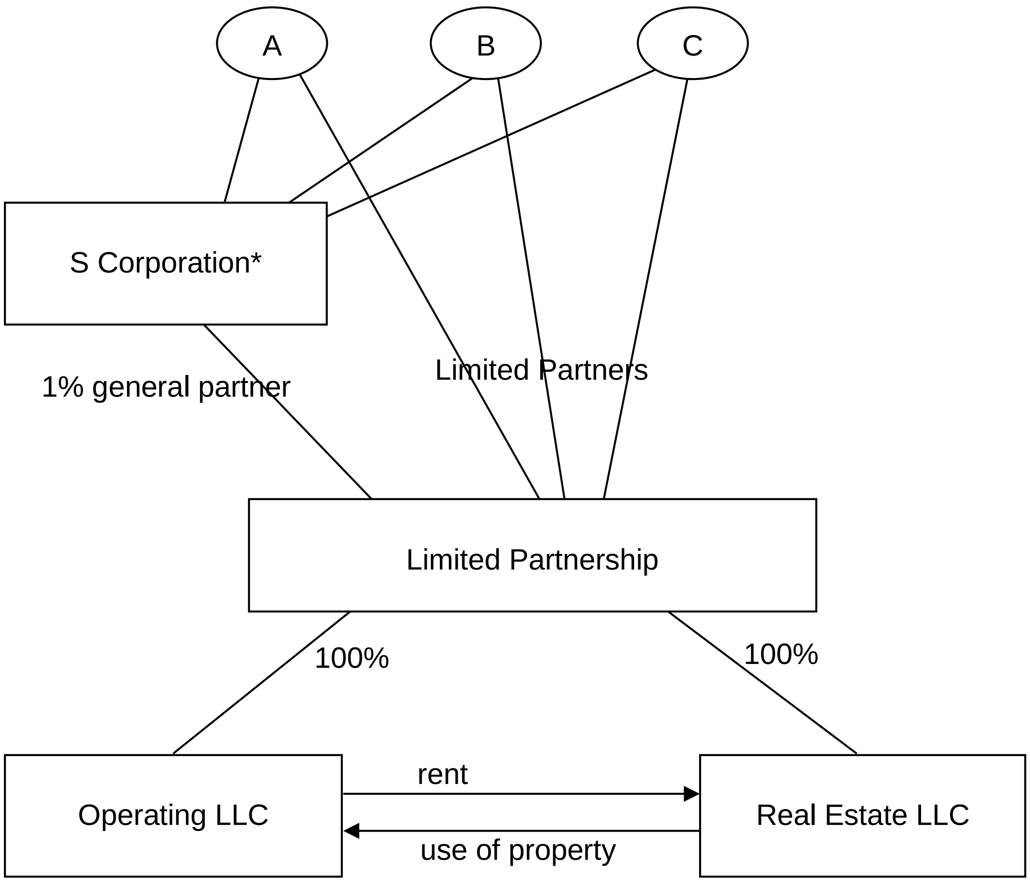
Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.a From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

---

[937] See part III.B.5.d.ii Code § 6166 Deferral.
[938] See part III.B.5.d.ii.(b) Tiered Structures.
[939] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[940] See fn 99 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.
[941] See fn 222 in part II.A.2.i.i.(b). Why Nonvoting Shares Are Needed for Estate Planning.

II.E.6. Recommended Partnership Structure – Flowchart



* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

II.E.7. Migrating into Partnership Structure

II.E.7.a. Overview of How to Migrate into Desired Structure

Moving an existing LLC, that is taxed as a partnership or as a disregarded entity, into this structure is relatively straightforward. The member or members form an S corporation. The S corporation contributes to a new limited partnership cash equal to 1/99 of the appraised value of the LLC's business, in exchange for a 1% interest as a general partner. The member or members contribute their interests in the LLC to the partnership in exchange.

Forming the S corporation and the limited partnership are not taxable events,[942] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[943] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[944] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. Thus, the 99% owners would be allocated 100% of the gain on such assets. Presumably they would own the same proportion of the S corporation as they did of the LLC, so presumably they have the same economic interest in the partnership's income as they did before, and this allocation of income is of no practical consequence, although this special allocation of income would need separate accounting on the partnership's annual return. This could be avoided by the members forming a limited partnership as general and limited partners[945] and then contributing their interests as general partners to the S corporation. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

These two transactions are illustrated in part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure, including parts II.E.7.b.i Using Cash Contribution to Fund New S corporation and II.E.7.b.ii Using LLC to Fund New S corporation.

This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[946] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[947] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account)[948] and a 10% interest in the residual profits as a general partner, and the individuals would receive 90% of the residual profits as limited partners; although receiving only a pure preferred partnership interest would not violate the disguised sale

[942] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[943] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[944] See part II.P.1.a.i Allocations of Income in Partnerships.

[945] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.

[946] See part II.P.3.a From Corporations to Partnerships and Sole Proprietorships.

[947] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.

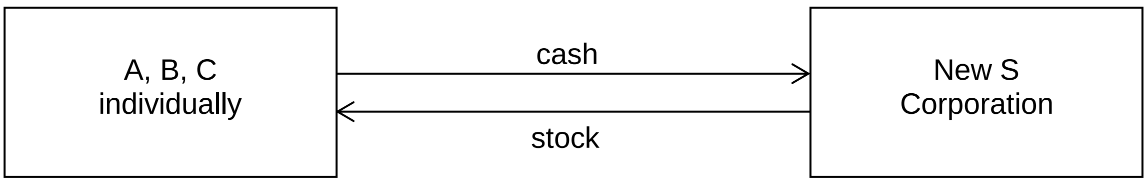
[948] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

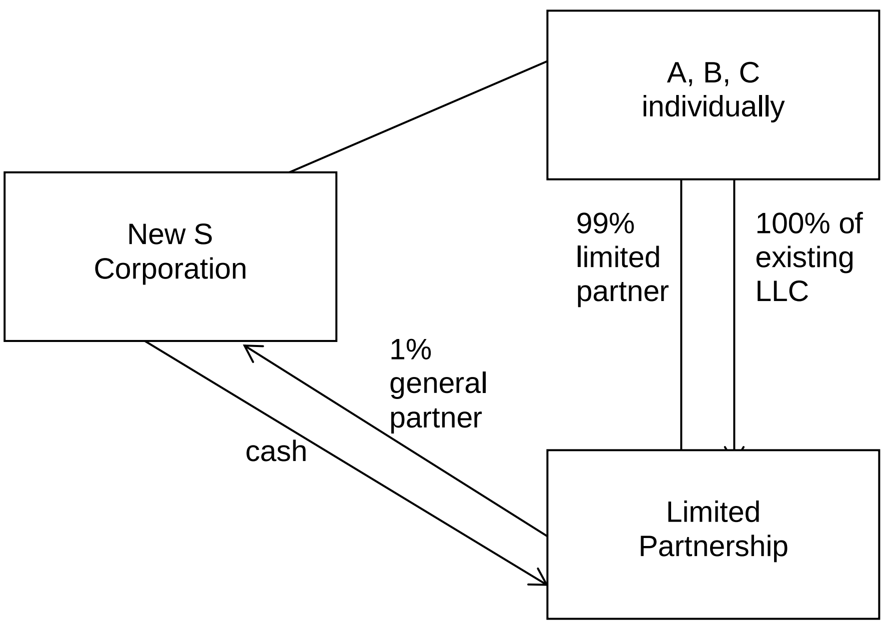
rules,[949] providing a significant interest in common helps support the corporate partner's role as a true partner, especially if the preferred payments are, for all practical purposes, extremely likely to occur. The considerations about debt reallocation described above would also apply. In some cases a C corporation might retain certain assets, collect them in due course, and then make an S election. For more information on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative, especially fn 4286 (explaining why we recommend a 10% common interest).

Note that starting as anLLC and migrating into the structure permits giving the corporate partner only a small common interest, whereas starting as a corporation and migrating requires giving the corporate partner both preferred and substantial common interests.

II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure

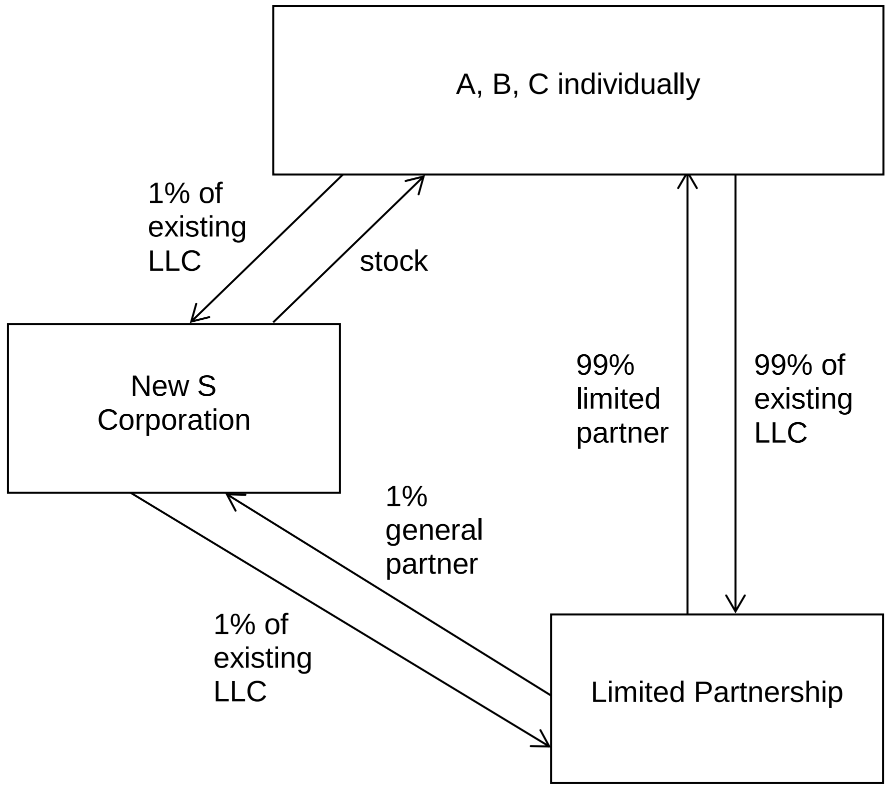
II.E.7.b.i. Using Cash Contribution to Fund New S corporation





[949] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

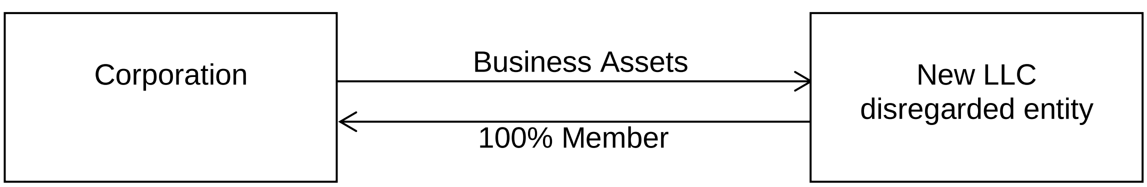
II.E.7.b.ii. Using LLC to Fund New S corporation



II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure

II.E.7.c.i. Corporation Forms New LLC

II.E.7.c.i.(a). Direct Formation of LLC



<u>Advantages</u>

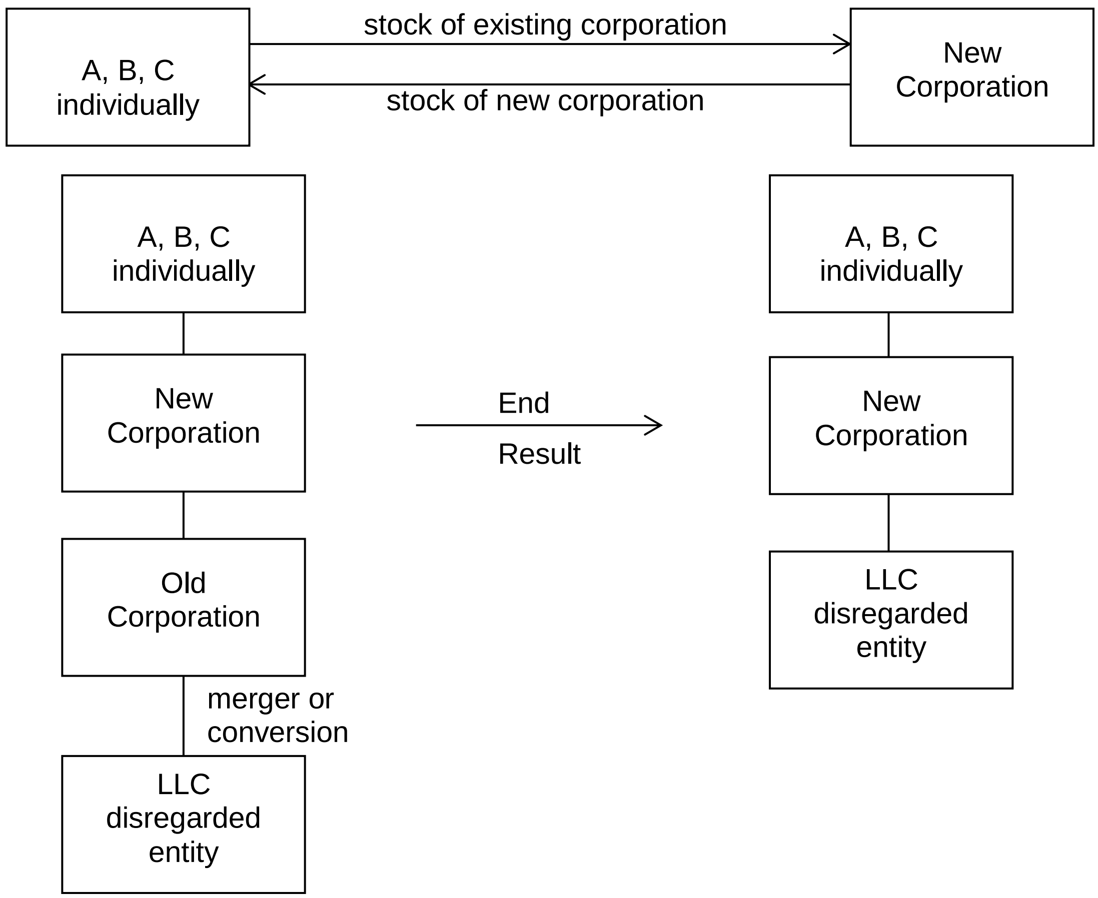
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone used to working in LLC structure

<u>Disadvantages</u>

- Piecemeal transfer of assets

- Some assets not readily transferable

II.E.7.c.i.(b). Use F Reorganization to Form LLC



<u>Advantage</u>

- Moves all assets in one fell swoop

<u>Disadvantages</u>

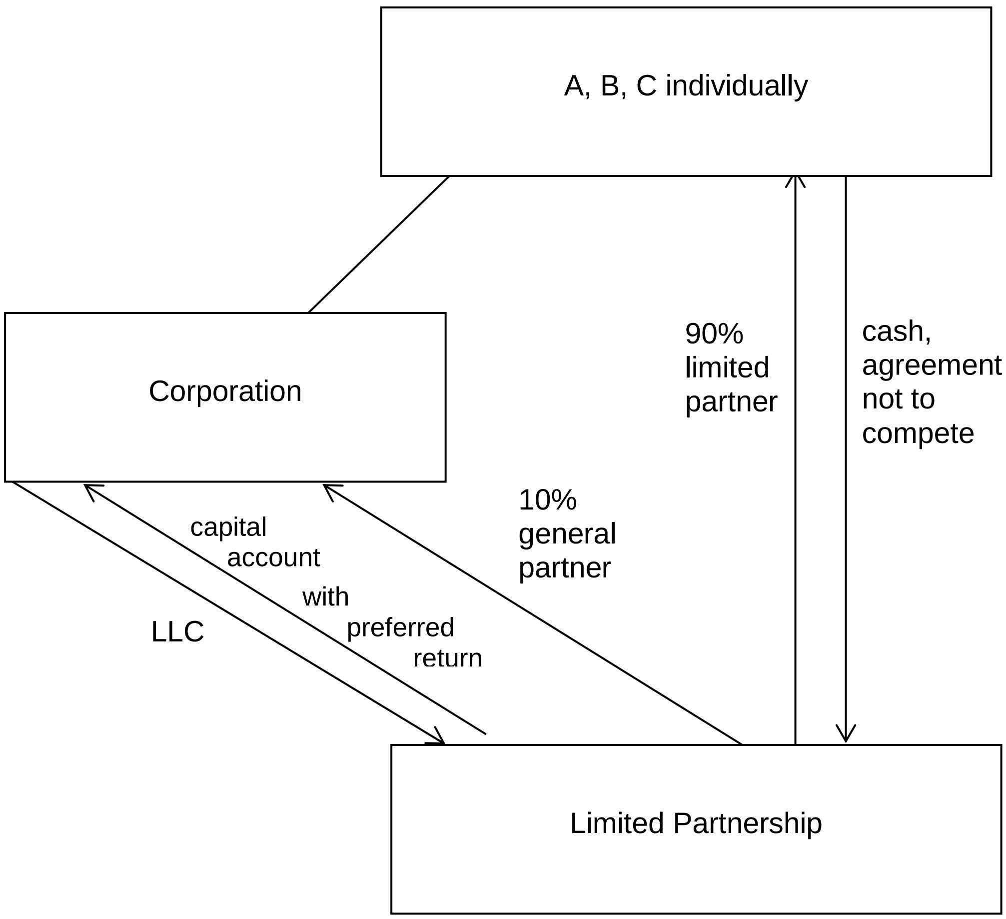
- No selectivity of retained assets

- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time

- If S corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election.

See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 193.

II.E.7.c.ii. Moving New LLC into Preferred Structure



II.E.7.c.iii. Migrating Gradually Over Time

A company might have its employees and intellectual property locked down so tightly that the migrations described in the preceding provisions of this part II.E.7 Migrating into Partnership Structure result in a large value and large preferred return that might be so large that they cause very significant estate tax issues that seem impossible to overcome. Consider:

- A corporation that needs to migrate to these structures to obtain income tax efficiencies.
- Any type of company that is subject to estate tax and difficult to move into a structure outside the estate tax system. For example, it might have too low a cash flow to make a GRAT or a sale to an irrevocable grantor trust be efficient.

In those cases, consider that, in today's economy and global environment, businesses need to reinvent themselves – sometime gradually, sometimes quickly – to keep up with or try to outperform their competitors.

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure.

The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

For examples of new activities, see part III.B.1.a Business Opportunities.

Certain IRS responses to such movement and generally successful taxpayer responses are described in parts III.B.1.a.v Sending Business and III.B.1.a.vi Asset Transfers to Children or Their Businesses.

If the business being transitioned is a corporation, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.E.8. Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary

II.E.8.a. Description of Structure; Nontax Issues

The structure would be one of the following:

- Limited Liability Limited Partnership (LLLP). An LLLP is a limited partnership (LP) (a partnership consisting of one or more general partners (GPs) and one or more limited partners) that registers for limited liability protection for its GPs.

- LP with LLC Subsidiary. The LP parents functions as a holding company and does business through one or more LLC subsidiaries, the latter which are disregarded entities for most tax purposes.[950]

See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships, the latter covering LLLPs as variations of LPs.

If one were to choose between the two structure, I would tend to favor the LP with LLC Subsidiary structure, because it facilitates opening separate branches or lines of businesses as separate LLCs without the initial business being comingled with the ownership of these new branches or lines of business. I also tend to favor it in Missouri, because in Missouri the lapse of an LLLP's registration cannot be cured, leaving the GPs exposed, whereas a Missouri LLC does not require annual registration and cannot have any lapse in liability protection. A disadvantage of the LP with LLC Subsidiary structure is that two registrations might be required in each state in which the company does business, contrasted with one registration per state for a LLLP. However, the latter might not be a disadvantage relative to the LP with LLC Subsidiary structure when separate branches or lines of businesses operate as separate LLCs.

The LP with LLC Subsidiary structure also permits the general partner's name to be kept confidential in most business dealings if the general partner is not active in the business, in that each LLC can be run by a manager who is not an owner.

II.E.8.b. Tax Issues

Let's discuss FICA/ self-employment (SE) tax issues and passive loss issues.

---

[950] See part II.B Limited Liability Company (LLC).

According to the legislative history of the SE tax, a person who is not only a GP but also a limited partner is subjected to SE tax only with respect to the GP interest.[951] However, this is based on legislative history, and I am unaware of any cases or rulings applying this principle. Any compensation paid to a partner for services is subject to SE tax to the extent that the services are rendered in carrying out a trade or business,[952] whether or not the partner is a GP.[953] Presumably the IRS would seek to reclassify distributions to a limited partner as compensation for services rendered, in a manner similar to what it does in the S corporation arena.[954]

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[955] In the passive loss area, being a general partner has a different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[956]

The idea that an interest as a limited partner has passive loss characteristics that differ from its SE tax characteristics might cause confusion in reporting and auditing. A Tax Court case includes language about the self-employment exclusion as applied to active limited partners that

---

951 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2867 and accompanying text.

952 See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, especially the text accompanying fns. 2860-2862.

953 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2863 and accompanying text.

954 See part II.L.1 FICA: Corporation, especially fn. 2793, and part II.L.5.a S corporation Blocker Generally, especially fn. 2902.

955 A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that "[a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business." ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership "reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
> > A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.
>
> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide "a full, status-based liability shield for each limited partner" even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

956 See part II.K.1.a.ii Material Participation, especially fn. 2498.

concerns a tax expert I highly respect,[957] and I would rather not tempt fate. Thus, I would generally prefer to place a client in the recommended structure with an S corporation general partner described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart. However, if the client resists that structure, the LLLP Alone and LP with LLC Subsidiary structures are alternatives to consider, after warning the client appropriately.

Also, if the business engages in domestic manufacturing, note that wages paid by a corporation would provide a small tax benefit relative to compensation paid to a partner.[958]

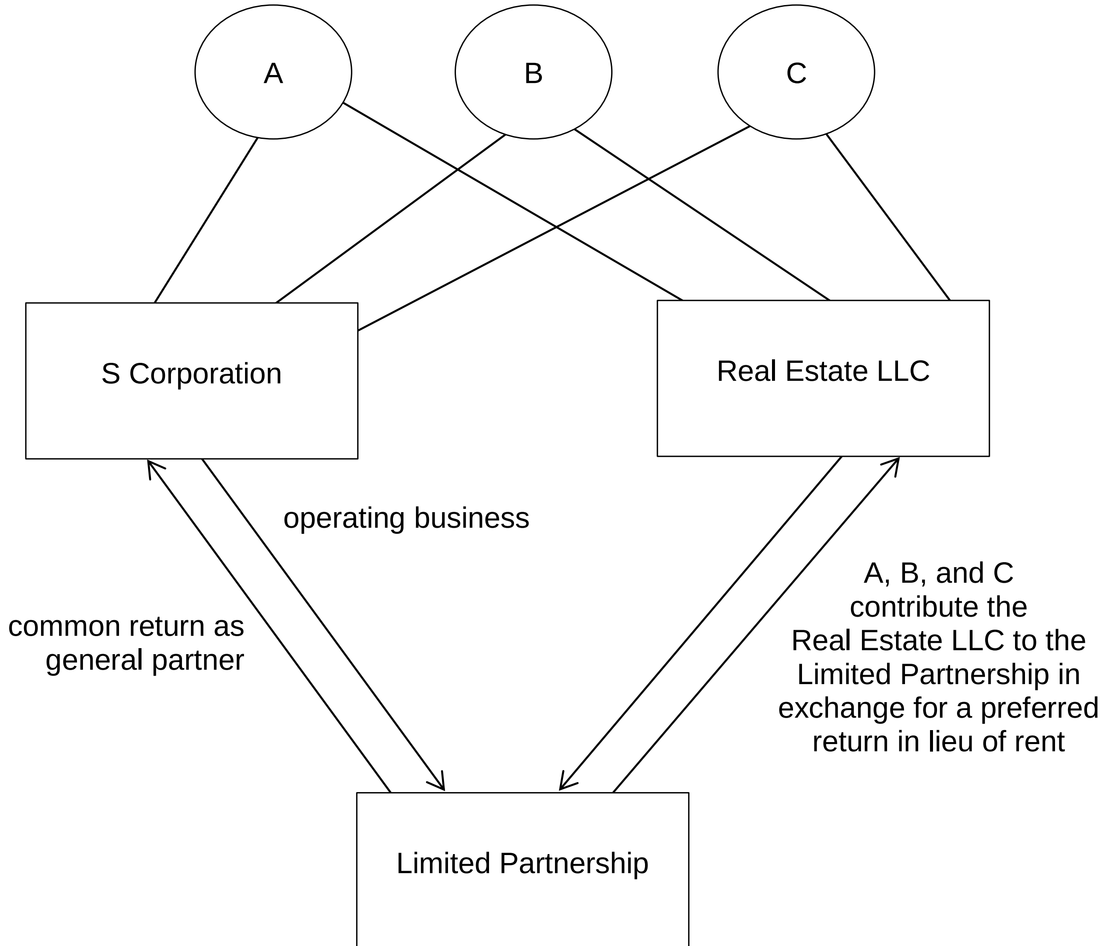
II.E.8.c. Migrating to LP with LLC Subsidiary Structure

Migrating from an LLC to an LP with LLC Subsidiary structure is much easier than migrating to my preferred recommended structure.[959]

The members of the LLC simply form the LP and then contribute their LLC interests to it. That transaction has no income tax consequences.[960] Both the LP and the LLC will continue to use LLC's tax ID – the LP because it has assumed the LLC's prior tax existence[961] and the LLC because it is a disregarded entity.[962] Presumably the LLC would need to obtain a new tax ID for payroll tax purposes, if it has its own payroll,[963] as well as for purposes of excise and certain other taxes.[964]

[957] See fn. 2896, found in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[958] Note the W-2 limitation mentioned in part II.G.25 Code § 199 Deduction for Domestic Production Activities especially fn. 1613.
[959] For the latter, see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.
[960] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.
[961] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another, especially fn. 441.
[962] See part II.B Limited Liability Company (LLC), especially fn. 306.
[963] See part II.B Limited Liability Company (LLC), especially fn. 312.
[964] See part II.B Limited Liability Company (LLC), especially fn. 315-316.

II.E.9. Real Estate Drop Down into Preferred Limited Partnership



Notes:

- Assume A, B, and C are active in business (more than 500 hours) and receive reasonable compensation from the general partner for services rendered to the corporation, which is the general partner of the limited partnership.

- A, B, and C assign their interests in the LLC to the limited partnership, converting the LLC into a disregarded entity and making A, B, and C directly hold interests as a limited partner.

- Similarly, the S corporation might contribute its assets to a single member operating LLC that the limited partnership then owns, which would then rent the property from the Real Estate LLC. The rental payments would be disregarded for income tax purposes, and the properties would be separate for asset protection purposes.

- Even better would be for the S corporation also to hold a preferred interest preferred based on the value of its assets (and a small common interest) and for A, B and C to hold some or most of the common interests, maximizing the partnership component to obtain a basis step-up at death and minimize tax on a seller-financed sale of the business.

- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

For more details on this drop-down structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.10. What if Self-Employment Tax Rules Change Unfavorably?

If self-employment tax would apply to the limited partners and the parties would prefer to have the operating business inside an S corporation structure, then the limited partnership dissolves.

The limited partners take all of the real estate LLC(s) and an appropriate portion of the operating LLC(s), with the S corporation taking its fair share of the operating LLC(s).[965]

Next, the limited partners contribute all of their interest in the operating LLC(s) to the S corporation.[966]

The final structure is the S corporation holding one or more LLCs that are disregarded for tax purposes and the individuals owning a real estate LLC taxed as a partnership. As a matter of state law, all of the transactions listed above are done by assigning LLC interests rather than more burdensome transfers of operating assets.

[965] If the business was started from scratch with only cash and labor, then generally this transaction will not be taxable. If a partner contributed any particular property within seven years of this dissolution, then it might be necessary for that partner to receive the LLC holding that property. For a general discussion of all of these ideas, see part II.Q.8 Exiting From or Dividing a Partnership.

[966] Code 351 precludes income taxation of this transaction.

II.H. Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property)

With the estate and gift tax rate at only 40%, one might consider whether ordinary income assets are better candidates for retention and basis step-up than assets that would generate capital gain. When one considers ordinary income rates, present and future, not only federal but also state and local income tax, one might determine that obtaining a basis step-up might be more important than saving estate tax on an ordinary income asset.[1660]

Also consider that perhaps estates might use assets not protected by GST exemption to pay the estate tax, and the assets with the stepped-up basis go to GST-exempt trusts.

Paul S. Lee of Northern Trust (formerly Bernstein), in various presentations with "Venn Diagrams" in the title, discusses the continuum of assets (regarding tax rates when various assets are sold) and approaches to obtaining basis increases.

At the 2015 Heckerling Institute, John Bergner's presentation, "Oh, What a Relief It Is: Curing Estate Plans That No Longer Make Sense in Light of the American Taxpayer Relief Act of 2012," mentioned basis step-up ideas. Another good source is Yuhas & Radom, "The New Estate Planning Frontier: Increasing Basis," *Journal of Taxation* (1/2015).[1661]

II.H.1. Ordinary Income Assets

Ordinary income assets include the following depreciable property:[1662]

- Equipment, furniture, and other tangible personal property, which is even more of a concern with recently expanded opportunities for Code § 179 write-offs and bonus depreciation[1663]
- Components of buildings that have been segregated into Code § 1245 assets as a result of a cost-segregation study geared toward having faster depreciation on those components than is permitted for buildings[1664]
- Amortizable goodwill, going concern value, and other intangibles[1665]
- Real property held for one year or less

[1660] Jerome M. Hesch suggested that estates of 2010 decedents might consider paying estate tax rather than electing out of estate tax and into basis carryover. "A 2010 Estate that Holds Depreciable Property Might Benefit from Paying Estate Tax," Steve Leimberg's Estate Planning Email Newsletter (Archive Message #1771).

[1661] Saved as document number 6108884 in my system.

[1662] PPC's *1040 Deskbook*, Table T801: Depreciation Recapture. I have not verified all of this.

[1663] Code § 1245.

[1664] Code § 1245(a)(3)(C) treats as Code § 1245 ordinary income recapture property "so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179A, 179B, 179C, 179D, 179E, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194…." For allocations involving such real property, see Notice 2013-59.

[1665] Code § 197. Amortizable goodwill is a not a capital asset, but other goodwill is. Letter Ruling 200243002. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1239.

- Real property held for more than one year described below (dates approximate):
  - Residential real property acquired 1981-1986, to the extent depreciated faster than straight-line would have allowed
  - Nonresidential real property held more than one year, with accelerated depreciation method used under ACRS (acquired 1981-1986)[1666]
  - Certain real property bought before 1981

See part II.G.18 Intellectual Property and Other Intangible Assets.

II.H.2. Basis Step-Up Issues

Assets includible in the decedent's gross estate for estate tax purposes are subject to a Code § 1014 basis adjustment.[1667] So is property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."[1668] It has been suggested that the latter applies to property held in an irrevocable trust, that is outside of the decedent's gross estate but was deemed owned by the decedent until death, because for income tax purposes the decedent is deemed to have held the assets.[1669] The IRS would argue that the basis adjustment provisions apply to transfers made for transfer tax purposes, not based on transfers made for income tax purposes.[1670] However, relying in part on the rule that foreign real property that is inherited by a United States citizen from a nonresident alien will receive a step-up in basis under Code § 1014(b)(1),[1671] Letter Ruling 201245006 held that Code § 1014(b)(1) applied on the termination of an irrevocable trust created by a nonresident alien who had retained the right to all of the trust's income and could receive principal distributions in the trustees' absolute discretion (the trustees being the grantor and an unrelated party).[1672]

[1666] Code § 1245(a)(5), repealed by the Tax Reform Act of 1986 but is said to apply to future dispositions of the property for which certain depreciation methods apply.

[1667] Code § 1014(b)(9).

[1668] Code § 1014(b)(1).

[1669] Rev. Proc. 2015-37 added to the list of areas with respect to which the IRS will not rule (which will show up in the annual revenue procedure regarding issuing private letter rulings):

> *Section 1014. Basis of Property Acquired from a Decedent*. Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code.

[1670] See fn. 5615, citing CCA 200937028 for the proposition that Code § 1014(b)(1) would not apply; see also fn. 5559, citing a letter ruling providing that assets in a GRIT received a Code § 1015(d) basis increase for gifts tax paid.

[1671] Rev. Rul. 84-139.

[1672] The facts were:

> Taxpayer, a citizen and resident of Country, proposes to transfer assets to Trust, an irrevocable trust subject to the laws of Country. The assets of Trust include cash and stock in Company 1 and Company 2 that are publicly traded in Country and on the New York Stock Exchange. Taxpayer and X, an unrelated party, are Trustees.
>
> Under the terms of Trust, Trustees are to pay all of the income of Trust to Taxpayer during his lifetime and may, in Trustees' absolute discretion, pay principal of Trust to Taxpayer. Article IV. Upon the death of Taxpayer, any income of Trust and any corpus remaining in Trust are to be paid or transferred to or in trust for one or more of Taxpayer's issue in such proportions as

A generation-skipping transfer (GST) might generate a new basis as well. If property is transferred in a taxable termination[1673] which occurs at the same time as and as a result of the death of an individual, the basis of property not protected by the allocation of GST exemption is adjusted in a manner similar to the manner provided under Code § 1014(a).[1674] For any other GST, the transferred property's basis is increased (but not above the fair market value of such property) by an amount equal to that portion of the GST tax imposed with respect to the transfer which is attributable to the excess of the fair market value of such property over its adjusted basis immediately before the transfer.[1675] This basis adjustment is applied after any Code § 1015 basis adjustment with respect to the transfer.[1676]

A taxable termination providing a basis step-up creates some powerful estate planning possibilities when the beneficiary's estate, outside of the trust, is significantly above the estate tax exemption. Not granting the beneficiary a (perhaps contingent) general power of appointment might save state estate tax (if any) and opens the door for "generation jumping." For an example of generation jumping, suppose Mom leaves a trust for Daughter that is not protected by Mom's GST exemption, Daughter has a large estate of her own, and Daughter has a nongeneral power of appointment. Daughter might choose to leave part or all of the trust to her own grandchildren or more remote descendants at Daughter's death. To the extent Daughter does that, the property incurs only one level of transfer tax even though it passed two or more generations below Daughter. Although the property is not included in Daughter's estate, it receives a new basis by reason of Daughter's death. Daughter would also have the option to direct property to her siblings or other nonskip persons, free from transfer tax but without a new basis. The main disadvantage to exposing property to GST tax instead of estate tax is that, although Code § 6166 allows deferral of estate tax on certain business interests,[1677] that deferral does not apply to GST tax. Also, the Code § 2013 credit for tax on prior transfers does not provide relief from GST tax.[1678] Giving a married beneficiary a general power of appointment permits a free basis step-up, but using a nongeneral power of appointment provides other benefits that one would carefully weigh.[1679]

> Taxpayer may appoint by deed or will. In default of appointment, corpus and accumulated income will be held in further trust for the benefit of Taxpayer's issue. Article V. Trust further provides that during Taxpayer's lifetime no adverse party within the meaning of § 672(a) is eligible to serve as Trustee. Article XI.

Letter Ruling 201544002 ruled that Code § 1014 when the nonresident alien grantors of a joint revocable trust died.

[1673] "Taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless immediately after such termination, a non-skip person has an interest in such property, or at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. Code § 2612.

[1674] Code § 2654(a)(2).

[1675] Code § 2654(a)(1).

[1676] Code § 2654(a)(1).

[1677] See part III.B.5.d.ii Code § 6166 Deferral.

[1678] Harrington, Plaine & Zaritsky, ¶ 3.06[2] No Credit for Property Previously Taxed, *Generation-Skipping Transfer Tax* (WG&L).

[1679] If the beneficiary has a general power of appointment, then estate tax is avoided at the beneficiary's death (when keeping the property in the family) only when the spouse receives a marital deduction bequest, which at a minimum entails giving the surviving spouse all of the income. If the beneficiary has a nongeneral power of appointment that includes the child's surviving spouse as an eligible appointee, the child can make the surviving spouse's interest in trust income discretionary, shift income to children and grandchildren at their presumably lower rates, make medical and tuition payments for grandchildren

A property's value used to determine federal estate tax when its owner dies is presumed to be the basis under Code § 1014, which presumption may be rebutted by clear and convincing evidence.[1680] However, Code § 1014 basis may not exceed the final value that has been determined for estate tax purposes,[1681] or, if not finally determined, the value shown on a statement has been furnished under Code § 6035(a) identifying the value of such property.[1682] This limitation applies only to property whose inclusion in the decedent's estate increased estate tax liability.[1683]

The cleansing effect of a basis step-up at death is a powerful planning tool.[1684]

For a discussion of the basis an owner has in an entity (outside basis) contrasted with the basis the entity has in the assets the entity owns (inside basis),[1685] see parts II.Q.8.e.iii.(a) Illustration of Inside Basis Issue and II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), the latter including a discussion on whether a basis increase by reason of gift tax paid generates a basis step-up.[1686]

For estate planning and income tax considerations when drafting bequests of a partnership or S corporation, see parts II.O.2 Spousal Issues in Buy-Sell Agreements and Related Tax Implications, III.A.3.c.iii Deadlines for QSST and ESBT Elections, and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

II.H.2.a. Free Basis Step-Up When First Spouse Dies

When the first spouse dies, assets included in the first spouse's estate for estate tax purposes generate a new tax basis,[1687] but the marital deduction can be used to avoid any estate tax at that time.[1688] Using a QTIP trust (a special type of marital deduction trust)[1689] allows the

---

and other skip persons that are excluded from GST tax, and include various flexibility and protections, while still deferring GST tax on the trust property until the child's surviving spouse's death.

[1680] Rev. Rul. 54-97. This ruling has been followed, distinguished, or questioned in a variety of cases. For a discussion of any duty of consistency, see *Van Alen v. Commissioner*, T.C. Memo. 2013-235.

[1681] Code § 1014(f)(1)(A). Code § 1014(f)(3) provides that basis of property has been determined for estate tax purposes if:

(A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

[1682] Code § 1014(f)(1)(B). Code § 6035(a) requires a statement by the executor (or, under Code § 6018(b), a beneficiary, if the executor if unable to make a complete return) of an estate required to file an estate tax return.

[1683] Code § 1014(f)(2).

[1684] See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate).

[1685] A discussion suitable for clients is in my blog, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

[1686] This discussion is in fn. 4742.

[1687] Code § 1014(b)(9).

[1688] Code § 2056.

executor[1690] to choose to keep all of the trust outside of the surviving spouse's estate for estate tax purposes, include all of the trust inside the estate tax system at the surviving spouse's death, or a combination.[1691] The executor makes the election on "the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date,"[1692] the latter suggesting that a surviving spouse might want to avoid filing an estate tax return until the surviving spouse has a better idea of whether estate tax inclusion or basis step-up would be more beneficial – even to the point of filing a late return many years after the first spouse's

---

[1689] Code § 2056(b)(7)(B) provides:

> *Qualified terminable interest property defined*. For purposes of this paragraph-
>
> (i) *In general*. The term "qualified terminable interest property" means property-
>   (I) which passes from the decedent,
>   (II) in which the surviving spouse has a qualifying income interest for life, and
>   (III) to which an election under this paragraph applies.
>
> (ii) *Qualifying income interest for life*. The surviving spouse has a qualifying income interest for life if-
>   (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and
>   (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.
>
> Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

Letter Ruling 8943005 approves of giving the surviving spouse an inter vivos power of appointment that the surviving spouse can exercise in favor of others, notwithstanding Code § 2056(b)(7)(B)(ii)(II).

[1690] Reg. § 20.2056(b)-7(b)(3).

[1691] Reg. § 20.2056(b)-7(b)(2) provides:

> Property for which an election may be made.
>
> (i) *In general*. The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.
>
> (ii) *Division of trusts*.
>   (A) *In general*. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.
>   (B) *Manner of dividing and funding trust*. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.
>   (C) *Local law*. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

[1692] Reg. § 20.2056(b)-7(b)(4)(i). However, if the estate tax return preparer put the QTIP trust on the wrong part of Schedule M, classifying it as marital deduction property not subject to a QTIP election, then the IRS might allow a supplemental estate tax return to correct that mistake. Letter Ruling 201714020.

death. (This ability to make a late-filed QTIP election applies for estate tax purposes but not for gift tax purposes.)[1693] Some people had expressed concern that the IRS might use Rev. Proc. 2001-38, which had allowed taxpayers to undo certain unnecessary QTIP elections made by mistake, to undo a QTIP election that the taxpayer did not need to save estate tax but is using to achieve a basis step-up. However, Rev. Proc. 2016-49 revoked Rev. Proc. 2001-38 and provided a new procedure that clearly avoids this concern.

"Portability" allows the surviving spouse to use the first spouse's estate/gift tax exemption,[1694] but not the first spouse's GST exemption; to use the latter, use a QTIP marital deduction trust with a Code § 2652(a)(3) "reverse QTIP" election. The executor of the estate of the first spouse to die might elect to take a marital deduction beyond that needed for estate tax purposes, so that the property will get a basis step-up at the surviving spouse's death without any estate tax being due, if the surviving spouse's taxable estate does not exceed the sum of the first spouse's estate/gift tax exemption (if and to the extent available)[1695] and the surviving spouse's estate tax exemption. A disadvantage of portability is keeping open until the surviving spouse's death the statute of limitations for determining the value of assets in the first spouse's estate to the extent that they determine the first spouse's unused exemption.[1696] Another possible disadvantage of portability might be loss of the state estate tax exemption of the first spouse to die, if and to the extent that the estate plan fails to use all of the first spouse's state estate tax exemption.[1697] Also, generally state death taxes do not apply portability.

Portability requires filing a timely estate tax return.[1698] However, this election is one for which the IRS may grant administrative relief.[1699] One might be able to filing an untimely request for

---

[1693] Letter Ruling 201109012, retroactively revoking Letter Ruling 201025021:

> The time for filing the inter vivos QTIP election is expressly prescribed by § 2523(f)(4). Because § 301.9100-3 is applicable only to requests for extensions of time fixed by regulations or other published guidance, the Service does not have the discretion to grant an extension of time under § 301.9100-3 to make the QTIP election under § 2523(f)(4) for the Year 1 transfer to Trust.

[1694] Code § 2010(c)(2)(B).

[1695] In addition to using the deceased spouse's exemption, the surviving spouse would lose it if and to the extent the surviving spouse remarries, does not use that exemption, and the new spouse predeceases the surviving spouse. Code § 2010(c)(4)(B)(i).

[1696] Reg. § 20.2010-2(d) provides:

> *Authority to examine returns of decedent*. The IRS may examine returns of a decedent in determining the decedent's DSUE amount, regardless of whether the period of limitations on assessment has expired for that return. See § 20.2010-3(d) for additional rules relating to the IRS's authority to examine returns. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.

[1697] A state death tax chart is at http://www.actec.org/resources/state-death-tax-chart. The executor files the estate tax return. Reg. § 20.2010-2(a)(6).

[1698] Code § 2010(c)(5)(A) provides, "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return."

[1699] Reg. § 20.2010-2(a)(1) provides:

> *Timely filing required*. An estate that elects portability will be considered, for purposes of subtitle B and subtitle F of the Internal Revenue Code (Code), to be required to file a return under section 6018(a). Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). See §§ 20.6075-1 and 20.6081-1 for additional rules relating to the time for filing estate tax returns. An extension of time to elect portability under this paragraph (a) will not be granted under § 301.9100-3 of this chapter to an

an extension and get retroactive relief within 15 months after death, without obtaining a private letter ruling; however, for a period of time after the spring of 2016, relief without a private letter ruling was unlikely.[1700] Fortunately, Rev. Proc. 2017-34 provides an automatic extension for

---

> estate that is required to file an estate tax return under section 6018(a), as determined without regard to this paragraph (a). Such an extension, however, may be available under the procedures applicable under §§ 301.9100-1 and 301.9100-3 of this chapter to an estate that is not required to file a return under section 6018(a), as determined without regard to this paragraph (a).

Letter Ruling 201532002 allowed an extension where the sum of the gross estate and taxable gifts was less than the basic exclusion amount. No explanation for reasonable cause was listed – the ruling stated only, "The estate discovered its failure to elect portability after the due date for making the election." The ruling granted an extension until 120 days after the date of the ruling. The taxpayer sought the ruling in 2015. The IRS conditioned the relief, "If it is later determined that, based on the value of the gross estate and taking into account any taxable gifts, Decedent's estate is required to file an estate tax return pursuant to § 6018(a), the Commissioner is without authority under § 301.9100-3 to grant to Decedent's estate an extension of time to elect portability and the grant of the extension referred to in this letter is deemed null and void." Similar relief was granted in Letter Rulings 201535004 (same), 201626008 (same), 201706003 (same), 201706016 (same), and 201536002 (attorney who prepared timely filed estate tax return failed to make QTIP election; no condition based on size of estate).

[1700] Given that Reg. § 20.2010-2(a)(1) refers to Reg. § 20.6081-1, let's look at Reg. § 20.6081-1(c):

> *Extension for good cause shown*. In its discretion, the Internal Revenue Service may, upon the showing of good and sufficient cause, grant an extension of time to file the return required by section 6018 in certain situations. Such an extension may be granted to an estate that did not request an automatic extension of time to file Form 706 prior to the due date under paragraph (b) of this section, to an estate or person that is required to file forms other than Form 706, or to an executor who is abroad and is requesting an additional extension of time to file Form 706 beyond the 6-month automatic extension. Unless the executor is abroad, the extension of time may not be for more than 6 months beyond the filing date prescribed in section 6075(a). To obtain such an extension, Form 4768 must be filed in accordance with the procedures under paragraph (a) of this section and must contain a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date. Form 4768 should be filed sufficiently early to permit the Internal Revenue Service time to consider the matter and reply before what otherwise would be the due date of the return. Failure to file Form 4768 before that due date may indicate negligence and constitute sufficient cause for denial of the extension. If an estate did not request an automatic extension of time to file Form 706 under paragraph (b) of this section, Form 4768 must also contain an explanation showing good cause for not requesting the automatic extension.

Instructions for Form 4768 (Rev. August 2012), which have a spirit that seems more generous to the taxpayer than the tone of the regulation authorizing the extension, provide:

> **Extension for cause**. If you have not filed an application for an automatic extension for Form 706, and the time for filing such an application has passed, an extension of time to file may still be granted if good cause is shown. File Form 4768, along with explanations of why the automatic extension was not requested and why a complete return was not filed by the due date, as soon as possible.

They also say the following:

> We will contact you only if your request for extension of time to file is denied. Keep a copy of the form for your records.

Consider obtaining a transcript or other verification that the extension was approved.

An attorney reported to me filing a late Form 4768 on March 31, 2016 and on April 19, 2016 receiving a denial of the extension, with the explanation, "An error made by the office of your attorney in determining and meeting the due date of Form 4768 is not exercising ordinary business care and prudence standards." When called, the IRS responded that the denial could be appealed or they should obtain a private letter ruling. The attorney opted for the latter and received one in early October 2016, and the estate qualified for a reduced filing fee ($6,500).

estates that were not required to file and did not file timely;[1701] the extension is until the later of January 2, 2018 or the second annual anniversary of the decedent's date of death.[1702] One might also be able to obtain automatic administrative relief within six months after the original due date if one discovers that one inadvertently opted out of portability.[1703]

An estate that is not required to file an estate tax return has reduced reporting requirements regarding marital or charitable deduction property.[1704] For such property, the return is "required to report only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the" marital or charitable deduction,[1705] so long as the "the executor exercises due diligence to estimate the fair market value of the gross estate, including the property" subject to the reduced reporting requirements.[1706] The executor should include evidence that either that particular property[1707] or

---

[1701] Section 3.02 denies relief to timely filed returns. A governmental official pointed out that any untimely filed return needs to be re-filed with an original signature to comply with this procedure; presumably this is required by Section 4.01(1).

[1702] Section 3.01 imposes the following requirements:

(1) The decedent:
  (a) was survived by a spouse;
  (b) died after December 31, 2010; and
  (c) was a citizen or resident of the United States on the date of death.
(2) The executor is not required to file an estate tax return under § 6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;
(3) The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return; and
(4) The executor satisfies all requirements of section 4.01 of this revenue procedure.

Section 4.01 imposes the following requirements:

(1) A person permitted to make the election on behalf of the estate of a decedent—that is, an executor described in § 20.2010-2(a)(6)—must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the later of January 2, 2018, or the second annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7).
(2) The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

[1703] Reg. § 301.9100-2(b).

[1704] Reg. § 20.2010-2(a)(7)(ii)(A), referring to property the value of which is deductible under Code § 2056, 2056A, or 2055(a).

[1705] Reg. § 20.2010-2(a)(7)(ii)(A), referring to "§§ 20.2056(a)-1(b)(i) through (iii) and 20.2055-1(c), as applicable."

[1706] Reg. § 20.2010-2(a)(7)(ii)(B) provides:

> *Return requirements when reporting of value not required for certain property*. Paragraph (a)(7)(ii)(A) of this section applies only if the executor exercises due diligence to estimate the fair market value of the gross estate, including the property described in paragraph (a)(7)(ii)(A) of this section. Using the executor's best estimate of the value of properties to which paragraph (a)(7)(ii)(A) of this section applies, the executor must report on the estate tax return, under penalties of perjury, the amount corresponding to the particular range within which falls the executor's best estimate of the total gross estate, in accordance with the Instructions for Form 706.

[1707] Reg. § 20.2010-2(a)(7)(ii)(C), Example (1), provides:

the entire residue[1708] passes to the surviving spouse. However, that reduced reporting rule does not apply to marital or charitable deduction property if:[1709]

(1) The value of such property relates to, affects, or is needed to determine, the value passing from the decedent to a recipient other than the recipient of the marital or charitable deduction property;

(2) The value of such property is needed to determine the estate's eligibility for the provisions of sections 2032, 2032A, or another estate or generation-skipping transfer tax provision of the Code for which the value of such property or the value of the gross estate or adjusted gross estate must be known (not including section 1014 of the Code);

(3) Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

(4) A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

(i) *Facts*. The assets includible in H's gross estate consist of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no taxable gifts during his lifetime.

(ii) *Application*. E files an estate tax return on which these assets are identified on the proper schedule, but E provides no information on the return with regard to the date of death value of these assets in accordance with paragraph (a)(7)(ii)(A) of this section. To establish the estate's entitlement to the marital deduction in accordance with § 20.2056(a)-1(b) (except with regard to establishing the value of the property) and the instructions for the estate tax return, E includes with the estate tax return evidence to verify the title of each jointly held asset, to confirm that W is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

[1708] Reg. § 20.2010-2(a)(7)(ii)(C), Example (2), provides:

(i) *Facts*. H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that H's entire estate is to be distributed outright to W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime.

(ii) *Application*. E files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. In the case of the probate assets and the IRA, no information is provided with regard to date of death value in accordance with paragraph (a)(7)(ii)(A) of this section. However, E attaches a copy of H's will and describes each such asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and § 20.2056(a)-1(b) (except with regard to establishing the value of the property). In the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of such asset, apply. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

[1709] Reg. § 20.2010-2(a)(7)(ii)(A).

For example, if half of the residue passes to marital deduction trust and half passes to a nonmarital trust, the residue is not eligible for the reduced reporting requirements.[1710] Thus, a formula bequest to marital deduction and nonmarital trusts would not qualify for portability. However, a one-lung plan – described below – would be eligible.

I quite often draft estate plans where the entire residue goes into a trust for the surviving spouse that is eligible for the QTIP election – sometimes called a one-lung plan. For a number of reasons, this type of plan provides significant flexibility. Extra caution is required, however, when a surviving spouse who has estate planning goals that might not necessarily be consistent with the first spouse's goals (for example, the surviving spouse is not a parent of the decedent's children). A trust for which a QTIP election is made is included in the surviving spouse's estate for estate tax purposes,[1711] and generally it pays estate tax equal to the excess of the amount due with inclusion over the amount due if the trust were not included in the surviving spouse's taxable estate.[1712] No law requires the surviving spouse to use the deceased spouse's estate/gift tax exemption to protect the QTIP trust's assets from estate tax. Sometimes, the first spouse to die might consider making any trust for the surviving spouse ineligible for the QTIP election to the extent that doing so will exhaust the first spouse's remaining estate/gift tax exemption; although these issues might be contractually addressed, contractual obligations might be impractical or impossible to enforce, even with excellent drafting. Situations of concern include:

- Benign Neglect. The surviving spouse has an estate – beyond the QTIP trust - that exceeds the surviving spouse's estate own gift/tax exemption. The first spouse's estate tax exemption will be used against the surviving spouse's bequest, leaving the QTIP with the requirement to pay estate tax.

- Potentially Unfair Actions. The surviving spouse uses all the first spouse's estate/gift tax exemption and the surviving spouse's estate tax exemption to make gifts to those the surviving spouse wishes to benefit. No estate/gift tax exemption remains to shelter the QTIP trust from estate tax.

Suppose, to protect against this situation, the executor decides not to make a QTIP election, but the estate has unused exemption. Is the executor required to file a return to elect portability? The Oklahoma Supreme Court affirmed a trial court's order compelling the executor to file a federal estate tax return and elect portability, notwithstanding a prenuptial agreement waiving inheritance rights (but not referring to portability).[1713]

II.H.2.b. Basis Step-Up for All Property When First Spouse Dies

Consider using community property or a marital estate trust.

[1710] Reg. § 20.2010-2(a)(7)(ii)(C), Example (3), reasoning:

> The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. Therefore, the value of the property of the marital trust relates to or affects the value passing to the trust for W and the descendants of H and W.

[1711] Code § 2044.

[1712] Code § 2207A.

[1713] *Estate of Vose*, 2017 WL 167587, --- P.3d ---- (1/17/2017).

II.H.2.b.i. Community Property

Community property receives a new basis for both spouse's halves when the first spouse dies.[1714] This rule applies whether the property is held as an individual or through a joint revocable trust that constitutes community property under applicable state law.[1715] Beware, however, that converting property to community property may subject it to both spouses' creditors.[1716]

If each spouse is treated as owning one-half of each asset held as community property, valuation discounts would reduce the new basis, relative to what it would have been had the property not been fractionalized.[1717] It has been suggested that, if state law or the trust

---

[1714] Code § 1014(b)(6).

[1715] Rev. Rul. 66-283, involving the following facts:

> H and W are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; *Mears v. Mears* (1960) 4 Cal. Rptr. 618; *Tomaier v. Tomaier* (1944) 146 P.2d 905. Under California law, community property may also be held by a trustee without losing its character as such. *Berniker v. Berniker* (1947) 182 P.2d 557. In 1958 H and W executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under the terms of the trust, H and W, as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to H and W as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.
>
> Upon the death of either H or W, the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of H, and the other of the community interest of W. During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent's share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor's community interest may be altered, amended, or revoked by the survivor at any time.

It held:

> In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.

[1716] See fn. 6079 in part III.B.5.d.iv.(a) Imposition of the Estate Tax Lien.

[1717] *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) (15% discount under California law; valuing separately was the issue – amount of discount was not challenged). In upholding the taxpayer's legal arguments that valuation discounts applied to each half, *Estate of Bright v. U.S.,* 658 F.2d 999 (5th Cir. 1981), held:

> First, the government argues that the property to be valued for estate tax purposes is an undivided one-half interest in the control block of 55% of the stock, and that the proper method of valuation would be to value the 55% control block, including a control premium, and then take one-half thereof. Both parties agree that the estate tax is an excise tax on the transfer of property at death, and that the property to be valued is the property which is actually transferred, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death. *United States v. Land*, 303 F.2d 170 (5th Cir. 1962). See also *Ithaca Trust Co. v.*

agreement has adopted the aggregate theory of community property, one can argue that a partial interest discount does not apply.[1718] One might consider using a community property

United States, 279 U.S. 151, 49 S.Ct. 291, 73 L.Ed. 647 (1929); *Edwards v. Slocum*, 264 U.S. 61, 44 S.Ct. 293, 68 L.Ed. 564 (1924); *Connecticut Bank and Trust Company v. United States*, 439 F.2d 931 (2nd Cir. 1971); *Walter v. United States*, 341 F.2d 182 (6th Cir. 1965); *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958). Both also agree that state law, Texas in this case, determines precisely what property is transferred. *Morgan v. Commissioner*, 309 U.S. 78, 60 S.Ct. 424, 84 L.Ed. 585 (1940); *Duncan v. United States*, 247 F.2d 845 (5th Cir. 1957). Both parties agree that, under Texas law, the stock at issue was the community property of Mr. and Mrs. Bright during her life, that Mrs. Bright's death dissolved the community, that upon death the community is divided equally, that each spouse can exercise testamentary disposition over only his or her own half of the community, and that "only the decedent's half is includable in his gross estate for federal tax purposes." *Commissioner v. Chase Manhattan Bank*, 259 F.2d at 239. Under Texas law, upon the division of the community at death, each spouse owns an undivided one-half interest in each item of community property. *Caddell v. Lufkin Land & Lumber Co.*, 255 S.W. 397 (Tex. Com. App., 1923).

> In its brief the government argued that, because the interest to be valued was an undivided one-half interest in the full 55% control block, the proper method would be to value the whole, including its control premium, and then take one-half thereof to establish the value of the estate's undivided one-half interest. The estate points out that the government's argument overlooks the fact that the block of stock is subject to the right of partition under Texas law at the instance of either the surviving spouse or the estate of the deceased's spouse. Tex. Prob. Code Ann. § 385 (Vernon 1980). The government has not argued that partition would not be freely granted in a case involving fungible shares, such as this case. Thus, the estate has no means to prevent the conversion of its interest into shares representing a 27½% block, and we conclude that the estate's interest is the equivalent of a 27½% block of the stock. Accordingly, we reject the government's approach of valuing the 55% control block, with its control premium, and then taking one-half thereof. Accord *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

The *Bright* dissent was troubled that the legal and not the factual valuation issues were addressed. The dissent portrayed the valuation discount as 50% for illiquidity and unmarketability of minority interest and 23% to take into account term loan agreements, guarantees and pledges that affect the stock's value, for a cumulative 73% discount.

[1718] It has been suggested that Alaska (Sec. 34.77.155), Arizona (ARS §§ 14-3916, 14-10816(22)), and Nevada have adopted the aggregate theory. It has been suggested that one read "The Modified Item Theory: An Alternative Method of Dividing Community Property Upon the Death of a Spouse," 28 Idaho L. Rev. 1047 (1991-1992), for an explanation of the item theory and aggregate theory. I invite readers to email me with citations or any other further information.

One California lawyer commented about California law:

> Technically is an item theory state, based on older case law. It was believed that two living spouses could affirmatively enter into a marital agreement opting out of item theory treatment and establishing different rules governing the division of community property at the first death. Probate Code § 100 was enacted in 1990 to confirm that this is allowed.
>
> Probate Code § 104.5 was enacted in 1999, which provides that a transfer of community property to revocable trust is presumed to be an agreement pursuant to § 100. The legislative history suggests that the agreement so presumed is that the aggregate theory applies to division, rather than the item theory; but the language in the statute is a little dodgy, stating, "an agreement, for purposes of § 100 …, that those assets retain their character in the aggregate for purposes of any division under the trust." If ability to divide using aggregate theory approach is desired (and who wouldn't want this), the best practice is to explicitly provide in trusts and Wills and not rely on § 104.5.

agreement to govern the rights of all community property, whether or not in trust, which property may include IRAs.[1719]

If residents of a community property state buy real property in that state using common law titling and under that state's law the property retains the community property character of the funds used to buy the property, the real property receives a new basis as to both halves; in that case, the property was titled as joint tenants with right of survivorship and received a basis equal to the property's full value (undiscounted for community property fractional interest).[1720] To avoid proof issues when that occurs,[1721] consider titling using a community property trust.

If spouses owning community property move to a common law state, the property does not lose its community character; similarly, merely moving from a common law state to a community property state does not cause separate property to become community property.[1722]

[1719] See Letter Ruling 199925033.

[1720] Rev. Rul. 87-98; *Estate of Wayne-Chi Young v. Commissioner*, 110 T.C. 297 (1998) (taxpayers failed in their attempt to characterize jointly held property as community property to obtain a discount for property passing to a noncitizen spouse).

[1721] Rev. Rul. 87-98, which ruled in favor of community property status, illustrated this issue:

> D and D's spouse S, residents of community property state X, purchased real property in X with community funds and took title as joint tenants with rights of survivorship. However, D and S later executed joint wills in which they declared the property to be a community asset.
>
> Although X is a community property state, under the laws of X, spouses may hold property in joint tenancy or other common law estate. Because the laws of X do not make specific provision for the coexistence of a common law estate and a community property interest, taking title in a common law estate raises the presumption that the spouses intended to terminate the community interest, effectively transmuting the property's character from community to separate. This presumption is overcome by evidence that the spouses intended for the property not to be transmuted to separate property, in such a case, the community nature of the property is preserved. Under the law of X, an express statement of such intent in joint wills precludes transmutation by reason of taking title in joint tenancy.

Rev. Rul. 87-98 deferred to the state law characterization.

[1722] *Quintana v. Ordono*, 195 So.2d 577 (Fla. App. 3rd D. 1967); Restatement (First) of Conflict of Laws § 290 (1934) ("Interests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicil of the parties when the movables are acquired."); Restatement (Second) of Conflict of Laws § 259 Removal of Movables of Spouses to Another State (A marital property interest in a chattel, or right embodied in a document, which has been acquired by either or both of the spouses, is not affected by the mere removal of the chattel or document to a second state, whether or not this removal is accompanied by a change of domicil to the other state on the part of one or both of the spouses. The interest, however, may be affected by dealings with the chattel or document in the second state.") and Comments a and b thereto:

> a. *Rationale*. Considerations of fairness and convenience require that the spouses' marital property interests in a chattel or right embodied in a document should not be affected by the mere removal of the chattel or document to another state. Likewise these interests are not affected by a change of domicil to another state by one or both of the spouses. Similarly, an interest in a right not embodied in a document that was acquired by either or both of the spouses during the marriage is not affected by a subsequent change of domicil to another state by one or both of the spouses. The rule of this Section is an application of that of § 247.
>
> b. *Dealings with movable upon interests of spouses*. When a chattel or document is taken into a second state and is there exchanged for some other movable or immovable, the spouses acquire the same interests therein as they had in the original chattel or document. Thus, when a husband takes an automobile, which is his alone, from a separate property state to a community property

II.H.2.b.ii. Marital Estate Trust

In a common law state, consider a marital estate trust.[1723] H creates a trust for W, with discretionary distributions to W. On W's death, the trust passes to W's estate. If H terminates the trust before W's death, the trust goes outright to W. The trust qualifies for the marital deduction because it cannot pass to anyone other than W.[1724] The gift is completed because the beneficiary is known with certainty.[1725] The trust is includible in H's estate under Code § 2038[1726] and in W's estate as an asset. Thus, it gets a new basis at the death of the

---

> state and then, having sold the automobile, uses the proceeds to purchase a truck, the truck will be the husband's separate property. On the other hand, if the husband had originally held the automobile in community with his wife and had exchanged it for a truck in a separate property state, the wife's interests in the truck would be the same as those she had previously had in the automobile.

Kingma, "Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States," 35 ACTEC J. 74, 80 (Summer 2009), states:

> With respect to personal property acquired during marriage or coverture, courts held that the law of the marital domicile at the time the property was acquired governs the character of such property and related property rights.[56] Moving from a common law state to a community property state, or vice versa, does not change the character or interests in that property.[57] The Supreme Court of Ohio summarized this rule in Estate of Kessler:[58]
>
> > "It is generally recognized that the character of community property, even though it is personalty, does not change as to the nature of the holding, where the married couple remove themselves from a community-property state to a common-law state. The converse is also true, that is, the character of property acquired in a common-law state is not altered merely by the removal of the couple to a community-property state."
>
> [56] RESTATEMENT (SECOND) CONFLICT OF LAWS § 258 (1971); 15A Am. Jur. 2d *Community Property* §§ 16-18 (2008); A.M. Swarthout, ANNOTATION, CHANGE OF DOMICILE AS AFFECTING CHARACTER OF PROPERTY PREVIOUSLY ACQUIRED AS SEPARATE OR COMMUNITY PROPERTY, 14 A.L.R.3d 404 (2008). *See also* Estate of Crichton, 49 Misc.2d 405, 408-09 and 412-13, 267 N.Y.S.2d 706 (1966) (providing that when spouses have separate domiciles, conflict-of-law rules provide that the law of the state of domicile of the spouse who acquired the personal property controls as to the ownership of the property).
>
> [57] RESTATEMENT (SECOND) CONFLICT OF LAWS § 259 (1971). However, marital property interests may be affected by subsequent dealings with such property in the second state. *Id.*
>
> [58] Estate of Kessler, 177 Ohio St. 136, 138, 203 N.E.2d 221 (1964). For additional authorities regarding spouses migrating to a common law state from a community property state, *see* the treatises and case law cited in Rev. Rul. 72-443, 1972-2 C.B. 531.

[1723] Handler and Dunn, "The Estate Trust Revival: Maximizing the Full Basis Step-Up for Spouses," *Trusts & Estates* (8/2001).

[1724] Reg. §§ 25.2523(b)-1(a)(2) (gift tax), 20.2056(b)-1(c)(1) (estate tax).

[1725] Reg. § 25.2511-2(d).

[1726] Reg. § 20.2038-1(a), which includes the following statement:

> For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.

Note that, because the income and principal are discretionary, the Code § 2038 power extends to both income and principal and the basis change is plenary.

Letter Rulings 200919008, 200919009, and 200919010 (and, I am told, 200247037 and 200303016) held that the modification of an irrevocable trust by all interested parties did not implicate Code § 2038, so make the grantor's exercise of the power exercisable alone.

first to go of H or W.[1727] Note, however, that a reverse-QTIP election[1728] would not be available to preserve H's GST exemption with respect to this trust.

II.H.2.c. QTIP Trusts - Code § 2519 Trap

If the spouse makes a disposition of all or part of a qualifying income interest for life in a QTIP trust, he or she is treated gift and estate tax purposes as transferring all interests in property other than the qualifying income interest.[1729] Thus, the spouse is treated as making a gift under Code § 2519 of the entire trust less the qualifying income interest, and is treated for purposes of Code § 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable.[1730] Code § 2702 provides in valuing the gift made by the spouse under Code § 2519.[1731] However, litigation might cause the gift not to be a gift.[1732]

Unless the spouse establishes to the contrary, Code § 2519 applies to the entire trust at the time of the disposition.[1733] One can avoid this result by dividing the trust, so that Code § 2519 applies only to the trust that was severed and is subject to that gift.[1734]

The exercise by any person of a power to appoint property to the spouse is not treated as a disposition under Code § 2519, even though the spouse subsequently disposes of the appointed property.[1735] Thus, distributing the property to the spouse, free from trust, might be the only way to remove the future possible application of Code § 2519.

[1727] Reg. § 1.015-1(c) provides, "The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee." Query whether the IRS might argue that H's authority to terminate the trust means that H continues to have dominion over the property, thereby triggering Code § 1014(e) on W's death, even though for gift tax purposes H has relinquished dominion and control.
Code § 1014(b)(3) is among the grounds for including it in H's estate.

[1728] Code § 2652(a)(3).

[1729] Code § 2519; Reg. § 25.2519-1(a).

[1730] Reg. § 25.2519-1(a).

[1731] Reg. § 25.2519-1(a).

[1732] FSA 199916025 described what happened when H, the surviving spouse, quarreled with S, the son of marriage to the deceased grantor:

> Although the inter vivos disposition of the qualifying income interest under section 2511 may be characterized as a transfer of property made in the ordinary course of business under Treas. Reg. § 25.2512-8, that does not affect the application of section 2519.
>
> The facts and documents provided indicate that there was animosity between H and S. Litigation was pending, pleadings were filed, temporary restraining orders were obtained, and negotiations ensued. Based on the facts presented, it appears that the transfers were free from donative intent, and the transfers may have been at arm's length and bona fide due to the acrimonious relationship. Without further factual development, we do not believe H made a gift of the qualifying income interest under section 2511 and express no opinion whether the terms of the marital trust satisfied the requirements of section 2056(b)(7)(B).

[1733] Reg. § 25.2519-1(b).

[1734] Reg. § 25.2519-1(c)(5). See Letter Ruling 201426016 and various others cited in Zaritsky, ¶ 6.03[3][g] Making Gifts From QTIP Funds, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms* (WG&L).

[1735] Reg. § 25.2519-1(e).

Rev. Rul. 98-8 held that, if a surviving spouse acquires the remainder interest in a QTIP trust by transferring property or cash to the holder of the remainder interest, the surviving spouse makes a gift equal to the greater of (i) the value of the remainder interest under Code § 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest under Code §§ 2511 and 2512. Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

In a second marriage situation, note that any inter vivos gift by the surviving spouse would be detrimental to the surviving spouse, if the surviving spouse has a taxable estate. For example, suppose the estate and lifetime gift tax exemption is $5M, estate tax is 40%, the surviving spouse has a $5M estate of her own and a QTIP life estate in a $1M asset. Suppose the spouse considers buying the remaindermen's interest for its $400K actuarial value. If the surviving spouse had not done anything, the surviving spouse's taxable estate would have been $6M ($5M own assets pays $1M QTIP asset), generating a $400K estate tax (40% multiplied by the $1M excess of $6M estate over $5M exemption), all of which is payable out of the QTIP assets under Code § 2207A(a). If the surviving spouse buys the remaindermen's interest, then she is deemed to have made a $400K taxable gift (paying no gift tax because of her lifetime gift tax exemption)[1736] and has $5.6M assets remaining ($6M own assets plus $1M former QTIP assets minus $400K paid to remaindermen and her estate will have to pay the $400K estate tax (based on a $4.6M exemption after using up $400K of her exemption on the deemed gift, leaving her estate of $5.6M being $1M over her $4.6M exemption, which $1M excess is taxed at 40%). Thus, by buying the remainder, she has shifted $400K estate tax from the remaindermen to the beneficiaries of her estate.

If avoiding Code § 2519 is important, one might also consider applying for relief under Rev. Proc. 2016-49 if the QTIP election was unnecessary.

II.H.2.d. Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate

Suppose property receives a basis adjustment because it is "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate."[1737] If the property is acquired before the death of the decedent, that basis adjustment is reduced by the amount allowed to the taxpayer as deductions in computing taxable income for depreciation, amortization, depletion, etc. on such property before the decedent's death.[1738] Note that, if and to the extent that the trust is a grantor trust with respect to those deductions, the trust is not the taxpayer to whom the deductions are allocated, so this basis adjustment would not apply regarding those deductions.

[1736] If she had used up her gift tax exemption before the transaction, the remaindermen would have had to pay the gift tax. Code § 2207A(b).
[1737] Code § 1014(b)(9).
[1738] Code § 1014(b)(9). See Reg. § 1.1014-6.

I am uncertain how this rule might apply to marital deduction trusts when the surviving spouse dies. The property is eligible for a new basis.[1739] Presumably only the depreciation allocated to the remaindermen would be subject to this rule; that allocation occurs only if the trustee maintained a reserve for depreciation and the trust is not a grantor trust.[1740]

II.H.2.e. IRD Assets Not Eligible for a Basis Step-Up

Property which constitutes a right to receive an item of income in respect of a decedent (IRD) under Code § 691 does not receive a basis step-up.[1741]

For whether property constitutes IRD, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured, fns. 3660-3673.

The basis step-up for a partnership interest is affected by the partnership's IRD items.[1742] The basis step-up for S corporation stock is affected by the corporation's IRD items.[1743] For more on S corporation stock basis, see https://www.irs.gov/pub/int_practice_units/sco_c_53_04_01_02_02.pdf.

Farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return.[1744]

[1739] Code § 1014(b)(10).

[1740] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[1741] Code § 1014(c).

[1742] See part II.H.2.g Partnership Basis Adjustments, especially the text accompanying fn. 1753.

[1743] Code § 1367(b)(4); Reg. § 1.1367-1(j).

[1744] *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016), holding that the tax benefit rule factors of the companion cases of *Hillsboro Nat'l Bank v. Commissioner* and *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983), did not cause the tax benefit rule to apply here. The court viewed Code § 1014 as so fundamental that, when applying the *Bliss Dairy* considerations, the basis step-up controlled. The Tax Court quoted *Bliss Dairy*, 460 U.S. at 386 n. 20:

> An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, *but cf. Campbell v. Prothro*, 209 F.2d 331, 335 (CA5 1954). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 250(d)(1), (2), which are a partial codification of the tax benefit rule, and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rule s. Although there may be an inconsistent event in the personal use of an expensed asset, that event occurs in the context of a nonrecognition rule, and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails. [Some citations omitted.]

(Regarding Code § 1245 assets receiving a basis step-up, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured, fn. 3673.) The Tax Court concluded:

> It is telling that the depreciation recapture rules, which, we are reminded, are "a partial codification of the tax benefit rule," *Bliss Dairy*, 460 U.S. at 386 n. 20, do not extend to transfers at death. The regulations bespeak this by omitting from the list of nonrecognition Code sections overridden by the depreciation recapture provisions of sections 1245 and 1250 those sections

If an IRD asset is likely to appreciate after death, consider triggering income recognition under Code § 691(a)(2),[1745] so that future increases in growth may receive capital gain treatment.[1746]

II.H.2.f. Partnership Basis Shifting Opportunities

Part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property how to shift basis from a low basis asset to a higher basis asset.

Part II.Q.8 Exiting From or Dividing a Partnership describes partnership tax rules and explains why a person with multiple business assets outside of a corporate structure might want to form a master partnership to facilitate future basis shifting opportunities.

Part II.Q.7.h Distributing Assets; Drop-Down into Partnership discusses how to move corporate assets into a partnership structure.

II.H.2.g. Partnership Basis Adjustments

A Code § 754 election provides a basis adjustment when a partner dies.[1747] Also see parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership, to which part III.A.6 Post-Mortem Trust and Estate Administration briefly refers.

> governing the treatment of a decedent's property. See secs. 1.1245-6(b), 1.1250-1(c)(2), Income Tax Regs. In *Bliss Dairy*, 460 U.S. at 398, the Supreme Court observed that depreciation recapture under sections 1245 and 1250 was an important exception to the nonrecognition statute at issue there. This is not the case with transfers at death, to which the depreciation recapture rules do not apply. Since sections 1245 and 1250 codify the tax benefit rule as it relates to depreciated property and expressly exclude transfers at death from the rule's scope, see *id.* at 386 n. 20 ("[Sections] 1245(b)(1), (2), and 1250(d)(1), (2) … are a partial codification of the tax benefit rule … [and] exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules."), it follows that the uncodified remainder of the common law tax benefit rule, with which we are concerned in this case, operates in a similar fashion….

[1745] Code § 691(a)(2) provides:

> If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

[1746] *Hurford Investments No 2, Ltd. v. Commissioner*, cited in fn. 1294 in part II.G.7 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A, holding that a contribution to a partnership attained this result, without mentioning that Code § 721(a) ordinarily blocks income recognition.

[1747] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

The basis adjustment wipes out so-called "negative basis" (a technically inaccurate term describing a situation where partners would recognize what they view as "phantom income" when a partnership interest is sold).[1748]

A "negative basis" situation arises as follows:

- A partnership borrows money, increasing the partners' adjusted basis.[1749] They then distribute the loan proceeds, which simply reduces the tax basis rather than triggering income.[1750] Now the partnership has liabilities without retaining the assets that triggered the liabilities. A discharge of liabilities is a deemed distribution to the partners,[1751] who already used their basis against prior distributions, so the discharge of liability can trigger income to the extent that the deemed cash distribution exceeds their remaining basis. Partners view this as an unfair result, but it really isn't, because if they simply put back the money they had taken out then they would have enough basis to avoid the tax.[1752] As described further below, this equity stripping can be very beneficial. However, when one engages in such an approach, one needs to consider ways to trigger estate inclusion to purge possible negative income tax effects.

- Alternatively, a partnership borrows money to fund losses.

For more details on when partnership distributions trigger gain recognition and when they don't, see part II.Q.8.b.i Distribution of Property by a Partnership.

Note that partnership interests do not receive a basis step-up to the extent the underlying property constitutes income in respect of a decedent (IRD),[1753] consistent with part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

II.H.2.h. Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes

When property is held outside an entity,[1754] assets and associated liabilities are reported on an estate tax return as follows:[1755]

[1748] See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate) and Reg. § 1.742-1 (basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such value is attributable to IRD). Any increase in the basis of the partnership interest generates an increase in the basis of the partnership's assets other than IRD only to the extent the basis of the partnership interest is not attributable to partnership liabilities. Reg. § 1.755-1(a)(4)(i)(A), incorporated by reference by Code § 743(c) and Reg. § 1.755-1(e). For more details on Reg. § 1.742-1, see fn 4753 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[1749] Code § 752(a).
[1750] Code § 731(a)(1).
[1751] Code § 752(b).
[1752] Code § 722
[1753] See fns. 4754, 4815, and 4843.
[1754] "Entity" includes a single member LLC, which exists as a separate entity for transfer tax purposes. See fn. 3423, found in part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa.

- If the debt is recourse, then the asset and its associated liability are reported on separate asset and liability schedule.

- If the debt is nonrecourse, the asset and liability are netted and reported as a net asset. For income tax purposes,[1756] in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property cannot be less than the amount of any nonrecourse indebtedness to which such property is subject.

The distinction between recourse and non-recourse debt can also be significant for nonresident aliens, when the deduction for recourse debt gets pro-rated and diluted as any other debt, making nonrecourse debt important for any U.S. real estate.

A 2006 article suggested that recourse debt provides a better fractional interest discount than nonrecourse debt, because the discount is calculated on the gross value for recourse debt but only on the net value for nonrecourse debt.[1757] For example, one's proportionate value of the underlying real estate is $1M and of the liability is $400K, for a $600K net equity. Under this theory, if a 20% discount were applied, the discount for recourse property would be $200K (20% of $1M) and for nonrecourse property would be $120K (20% of $600K). Therefore, when property is held as tenants-in-common, discounting works better for recourse than nonrecourse property.

Note that the netting that the article suggests applies to nonrecourse liabilities applies to assets and (recourse and nonrecourse) liabilities held inside an entity. Thus, if one would like a larger deduction for liabilities, one should take the liabilities out of the entity and be subject to them directly. Of course, business issues might very well make such a suggestion a bad idea; however, if all parties are on the hook for loan guarantees, the suggestion might be more realistic.

Once a single-member LLC is valued, its value is allocated among its assets and liabilities to determine basis. See fns. 307-308 in part II.B Limited Liability Company (LLC).

[1755] See Reg. §§ 20.2031-1(b), 20.2053-7; *Estate of Stevens v. Commissioner*, T.C. Memo. 2000-53, *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Fung v. Commissioner*, 117 T.C. 21 (2001); Letter Ruling 8423007. Reg. § 20.2053-7 provides:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate.

[1756] Code § 7701(g).

[1757] See Schiller, "Leveraged Tenancies in Common - The Next Great Great Planning Tool?" (subtitled "Valuation Benefits with Leveraged Co-Ownerships May Exceed Benefits of Entity-Related Valuation Adjustments for Minority Interests"), *Steve Leimberg's Estate Planning Email Newsletter* (Archive Message #1057), available at http://www.leimbergservices.com. I agreed with the article when it was written.

However, the article appears wrong regarding any effect on basis that netting nonrecourse liabilities may have when the property is owned directly instead of inside a separate entity. *Crane v. Commissioner* provides that nonrecourse debt does not affect the basis of property included in the decedent's estate, even though the debt is netted for estate tax reporting purposes.[1758] Although the Code § 1014(f)(1)(A) basis consistency rule provides that basis cannot exceed the finally determined estate tax value, which might seem to conflict with *Crane* to the extent that only the net value is reported for property subject to nonrecourse debt, Prop. Reg. § 1.1014-10(a)(2) provides, "The existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported." Furthermore, if the property is sold, the buyer is going to buy it free and clear of the debt, so that fractional interest should not be affected by the debt's existence. Thus, valuation discounts should be the same, without regard to the recourse or nonrecourse nature of the debt.

II.H.2.i. Avoiding a Basis Step-Down

Suppose property has basis in excess of value. That property would get a reduced basis at death.

Once solution is to sell the property for a loss and obtain current income tax benefits (to the extent available). That applies not only to property held directly but also property held in a partnership. If a partnership has a built-in loss exceeding $250,000, then a partner's death (or post-mortem trust funding)[1759] generally would trigger an inside basis reduction,[1760] even if a Code § 754 election is not in place.[1761] Therefore, a partnership with a substantial built-in loss might consider selling its loss assets to avoid this unfortunate result.

Another way to avoid a basis step-down is to transfer that property by gift or sale to an irrevocable grantor trust. The donee or trust would be unable use the built-in loss if the property if the property is sold for less than its basis, but it would be able to use the full basis for purposes of determining gain on sale.[1762] However, if the donee is the donor's spouse (or perhaps former spouse), then the donee would be able to use the built-in loss.[1763]

II.H.2.j. Effect of Chapter 14 on Basis Step-Up

Chapter 14 increases the value of business entities and other arrangements for the following purposes:

1758 331 U.S. 1 (1947).

1759 See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

1760 See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

1761 See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

1762 Code § 1015(a); Reg. § 1.1015-1(a)(1).

1763 Code § 1015(e).

- Code § 2701 Anti-Freeze: Any increases in value provided under part III.B.7.b Code § 2701 Overview[1764] apply solely for gift tax purposes (including whether a sale includes a gift element).[1765]

- Code § 2703 Buy-Sell Provisions: Any increases in value provided under part III.B.7.e Code § 2703 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[1766]

- Code § 2704 Restrictions on Cashing Out: Any increases in value provided under part III.B.7.f Code § 2704 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[1767]

Code § 1014 determine basis by referring to property's "fair market value." As noted above, Chapter 14 applies for transfer tax purposes, not for income tax purposes.

However:

- If an estate tax return is required to be filed because the gross estate exceeds the relevant threshold, the basis of certain property is determined with reference to its estate tax value.[1768]

- For other property, the value shown on an estate tax return controls.[1769]

[1764] See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[1765] Code § 2701(a)(1) ("Solely for purposes of determining whether a transfer … is a gift (and the value of such transfer)"); Reg. §§ 25.2701-1(a)(1), 25.2701-1(b)(1), the latter providing:

> *Completed transfers*. Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, section 2701 applies to a transfer that would not otherwise be a gift under chapter 12 because it was a transfer for full and adequate consideration.

Note that Code §§ 2703(a)(1) and 2704(a)(1) provide "for purposes of this subtitle," so query whether Code § 2701(a)(1) not referring specifically to Chapter 12 has any significance. However, note that Reg. § 25.2701-2(a) refers to Chapter 12:

> *In general*. In determining the amount of a gift under § 25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701-6 regarding the indirect holding of interests.

Reg. § 25.2701-5 provides estate tax mitigation rules relating to Code § 2701 gifts.

[1766] Code § 2703(a)(1); Reg. § 25.2703-1(a)(1).

[1767] Code § 2704(a)(1). The 2016 proposed regulations refer to applying for "purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes)".

[1768] Code § 1014(f).

[1769] Reg. § 1.1014-3(a) provides:

> *Fair market value*. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

Thus, to tax advantage of estate tax values inflated by Chapter 14, the subject property seems to need to be reported on an estate tax return.

II.H.2.k. Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap

Property included in one's estate for estate tax purposes receives a new basis, even if a power of appointment is the only trigger for estate inclusion.[1770]

To the extent of its inclusion ratio (and therefore subject to GST tax), property subject to a taxable termination[1771] also receives a new basis based on fair market value.[1772]

If estate tax and GST tax are repealed and Code § 1014 is not changed, presumably the above provisions would not generate a basis step-up. However, other parts of Code § 1014 may generate a basis step-up, including:

- "Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;"[1773]
- "Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;"[1774]
- "In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;"[1775] and

[1770] Code § 1014(b)(9) refers to "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939." Reg. § 1.1014-2(b)(1).

[1771] Code § 2612(a) provides:

(1) *General rule*. For purposes of this chapter, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless—
  (A) immediately after such termination, a non-skip person has an interest in such property, or
  (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

(2) *Certain partial terminations treated as taxable*. If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

[1772] Code § 2654(a)(2).

[1773] Code § 1014(b)(1).

[1774] Code § 1014(b)(2).

[1775] Code § 1014(b)(3).

- "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will."[1776]

Note that, if there is no estate tax, the basis step-up for a general power of appointment applies only if the decedent actually exercised the power. Similarly, for federal income tax purposes, a general power of appointment shifts the grantor, from the settlor to the person holding the power, only if exercised.[1777] If shifting the grantor for federal purposes also shifts it for state income tax purposes, consider whether shifting the grantor for state income tax purposes is desirable or undesirable.[1778] If that shift is undesirable and the estate tax is in effect, consider:

- Using the Delaware Tax Trap[1779] to trigger estate inclusion, as the Delaware Tax Trap is the exercise of a limited power of appointment in a way that triggers estate inclusion under the general power of appointment rules, or

- Planning for a taxable termination instead of using a general power of appointment. Using a taxable termination allows the decedent to exercise a power of appointment without shifting the grantor.

If the estate tax exists, then a general power of appointment is an easy way to obtain a new basis at death. If a formula general power of appointment is vested and is based on factors within the power-holder's control, then consider whether the power-holder's actions may constitute the release of a general power of appointment. In *Estate of Kurz v. Commissioner*, 101 T.C. 44 (1993), the decedent had a 5% withdrawal right in a bypass trust, exercisable only if the marital trust had been exhausted, and the decedent also had an unlimited right to withdraw the marital trust. Thus, the decedent controlled whether the 5% withdrawal right applied. The court concluded:[1780]

[1776] Code § 1014(b)(4).

[1777] Reg. § 1.671-2(e)(5).

[1778] See part II.J.3.e State and Local Income Tax.

[1779] Code § 2041(a)(3). For how to exercise the Delaware Tax Trap, see Trytten, Blattmachr, Davis, and Gorin, "Yes, I'll Order That Trust 'Fully Loaded,'" pages II-B-(1)-98 (100th page of PDF) through II-B-(1)-100, Special Session II-B, 51st Annual Heckerling Institute on Estate Planning (2017), which is also saved as my document no. 6456656.

[1780] The court reasoned at 58-60:

> Neither the statute (last sentence of section 2041(a)(2)) nor the pertinent regulation (section 20.2041-3(b), Estate Tax Regs.) expressly requires that the event or contingency be "beyond the decedent's control". We are not persuaded by respondent's efforts to construct such a requirement from bits and pieces of other regulations either defining a type of power of appointment[4] or governing retained powers (section 2038) rather than powers of appointment (section 2041). Since respondent added such a requirement to the retained-powers regulation (section 20.2038-1(b), Estate Tax Regs.) and at the same time failed to include that language in the powers-of-appointment regulation (section 20.2041-3(b), Estate Tax Regs.), we decline to engraft this language into the regulation.
>
> [4] Respondent also argues that her position is supported by section 20.2041-1(b)(1), Estate Tax Regs., which provides in part:
>
> > A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and

We do not think that, where the general power of appointment is the right to withdraw principal from a trust, Congress intended that application of section 2041(a)(2) could be avoided by stacking or ordering the withdrawal powers; *i.e.*, exercising the power to withdraw a certain number of dollars before the power to withdraw the next portion comes into operation. A condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for her own benefit does not prevent practical

---

appoint any other person including himself, the decedent is considered as having a power of appointment….

Respondent argues that the regulation attributes a general power to a decedent, even though the decedent would have been required to remove the trustee and substitute himself before he could exercise his power. Respondent thus concludes that the "regulations make clear, however, that a decedent possesses, for purposes of I.R.C. section 2041, a power of appointment notwithstanding the failure by a decedent to perform an act necessary to exercise the power if the decedent had the power to perform that act."

However, the above-quoted regulation language merely defines a particular type of general power of appointment. The particular type of general power of appointment involved in this case is the power to consume principal. There is no question that that is a general power of appointment. The only question in this case is whether that power was in existence at the time of decedent's death.

Petitioner argues that, pursuant to section 20.2041-3(b), Estate Tax Regs., because decedent's power to withdraw 5 percent of the principal from the Family Trust Fund was exercisable only upon the occurrence during decedent's lifetime of an event or a contingency (complete exhaustion of the entire principal of the Marital Trust Fund), which did not in fact occur during decedent's lifetime, the power did not exist on the date of decedent's death. Petitioner argues that the regulation requires that a condition precedent cannot be deemed to have occurred but must have in fact occurred. Petitioner concludes, therefore, that at the time of her death, decedent did not have a general power of appointment over any portion of the principal of the Family Trust Fund that would be includable in her gross estate.

Respondent counters that petitioner's interpretation of the regulation is overly broad and "does violence to the intent of the statute". We agree, but we do not accept respondent's own overbroad view that whether the event or contingency is beyond the control of the decedent is the determinative factor.

However, although we decline to read into the statute a requirement that the event or contingency must necessarily be beyond a decedent's control, the event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent's ability to exercise the power. The legislative history, however, clearly indicates that all property of which the decedent on the date of his death had practical, if not technical, ownership is to be included in his estate. We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for his own benefit is illusory. For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of "independent significance", whose effect on the trust is "incidental and collateral", such acts are also deemed to be beyond the decedent's control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of "independent significance", whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); see also *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038.

> ownership; it is illusory and should be ignored. We conclude that for purposes of section 2041, although the condition does not have to be beyond the decedent's control, it must have some significant non-tax consequence independent of the decedent's power to appoint the property. Petitioner has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent's power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the section 20.2041-3(b), Estate Tax Regs.
>
> We hold that, if by its terms a general power of appointment is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent's ability to exercise the power, the power exists on the date of decedent's death, regardless of whether the event or contingency did in fact occur during such time. Because petitioner has failed to demonstrate any significant non-tax consequence independent of decedent's right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041.
>
> Decedent's power of appointment over 5 percent of the Family Trust Fund was in existence on the date of her death regardless of the fact that the principal of the Marital Trust Fund had not been completely exhausted by that date. Hence, 5 percent of the Family Trust Fund was includable in her gross estate.

In other words, if the decedent could have unilaterally determined the scope of the general power of appointment, the power existed to the extent of the maximum amount over which the power could have been exercised. Because of this issue, consider allowing a nonadverse party to revoke the power-holder's power, so that the power does not vest until death. That approach would eliminate any gift tax issues regarding whether a general power was released during life.

II.H.3. Valuation Discounts – Friend or Enemy

Adjustments for lack of control and lack of marketability are not really some magical artificial value reduction – they merely reflect proper valuation. Nevertheless, the fact that the value of an interest in an entity often is smaller than a pro rata share of the entity's underlying assets is popularly referred to as a discount, so we will reluctantly use that term here.

Although a discount might save estate taxes, it also causes a reduced basis. If the discount does not save estate tax, then it reduces the basis of a discounted asset included in one's estate. If this is unfavorable and the taxpayer wants to engage in an uphill battle to argue that Code § 2036 causes estate tax inclusion,[1781] see fn 4767 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

[1781] For when an entity is disregarded and Code § 2036 (an issue into which this document does not delve), see fn 99 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

Although partnerships work better than other entities on a few levels,[1782] having a discounted partnership interest included in one's estate can cause an unfavorable basis change in assets held in the partnership (an "inside basis"):[1783]

- if the partnership has a Code § 754 election in place, or
- if the partnership's assets (in the aggregate) have a basis that exceeds their value by more than $250,000.

This effect on inside basis depends on whether the asset has unrealized gain or loss:[1784]

- If the asset has an unrealized gain, the valuation discount can reduce or eliminate a basis increase but cannot generate a basis reduction.
- If the asset has an unrealized loss, the valuation discount can generate a basis reduction, but not below the asset's value.

Also see part III.C Fairness Within Families; Valuation.

II.H.4. How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S corporation

Self-created goodwill (goodwill created through business entity operations rather than purchased from the seller of a business) generally has a zero tax basis yet very substantial value. A partnership structure is important to secure the basis step-up or to facilitate a tax-efficient seller-financed sale.[1785]

Some entities do not have any significant goodwill. Goodwill generally is measure by an entity's rate of return in excess of what an owner could earn investing capital in other places. An entity that is not an operating business generally would not have goodwill. Also, some businesses do not generate a high enough rate of return on their capital to have significant goodwill; they earn just enough to pay their owners and employees reasonable compensation for services provided and perhaps a very modest profit on invested capital. See parts II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? and II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

If a partnership or an S corporation has no significant goodwill and its other assets have values close to basis, then the basis of owner's interest in the company might be relatively close to a proportionate share of the basis and fair market value of the assets that the company owns. In that case, including the owner's interest in the company in the owner's estate might produce no

[1782] See part II.E Recommended Structure for Entities.
[1783] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations.
[1784] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, especially fn. 4807.
[1785] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis. See also parts II.E Recommended Structure for Entities and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

significant basis increase or might even produce a basis decrease when the owner dies; see part II.H.2.i Avoiding a Basis Step-Down.

Note that goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[1786]

Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income.[1787] Using a partnership that essentially allows one to deduct the goodwill's value in a manner that avoids capital gain on the sale of goodwill prevents this result.[1788]

II.H.5. Irrevocable Trust Planning and Basis Issues

II.H.5.a. Irrevocable Trust Planning and Basis Issues - Generally

For various strategies involving grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.[1789] One of the problems with those techniques is that the estate tax saved might not make up for the lack of basis step-up on death, if the techniques use low-basis assets. If that is a concern, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

If the grantor trust has high basis assets (including businesses whose assets have values that are not in excess of basis; see parts II.H.2.i Avoiding a Basis Step-Down and II.H.4 How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S corporation), keeping them outside the estate tax system might make a lot of sense, in that the grantor is paying the income tax on each year's earnings (which earnings add to the basis in the trust's assets).

It has been suggested that one should not use one's estate tax exemption to give away assets to avoid estate tax on their appreciation. Generally, a leveraged transaction, such as a GRAT or a sale to an irrevocable grantor trust, would be better. However, if the asset has a high basis and will continue to have a high basis and the client does not want to mess with a sale, then a gift to an irrevocable grantor trust might be appropriate.

II.H.5.b. Moving Real Estate from Irrevocable Trust to Grantor

If a grantor trust has a low basis asset, consider selling it to the grantor for a high basis asset.

If an irrevocable trust is not a grantor trust, consider establishing an identical trust that is a grantor trust (perhaps using a swap power) and merging the nongrantor trust into the grantor

[1786] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4755.
[1787] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 4240-4244.
[1788] See parts II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[1789] Especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, and III.B.2.j Tax Allocations upon Change of Interest in a Business, especially part III.B.2.j.i Changing Grantor Trust Status.

trust, so that the above sale can be done.[1790] However, if the existing trust has liabilities in excess of basis, consider any income tax consequences that might result from such a merger.

If the grantor is buying the assets using debt, not everyone is comfortable using a promissory note that the grantor owes the trust, out of concern over the note's basis; if the note has a basis less than its face value, the market discount rules may treat any difference as ordinary income[1791] to any holder other than the original holder.[1792] To avoid this concern, consider having someone other than the trust loan the money to the grantor. A bank would be willing to loan 100%, if it keeps a security interest in the loan proceeds. For a full description of this strategy, see part II.H.10 Extracting Equity to Fund Large Gift; however, where part II.H.10 suggests the donor paying a guarantee fee to the donee, in this case the grantor would pay a guarantee fee to the trust.

II.H.5.c. Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S corporation

Suppose the client has determined that an S corporation needs to be moved outside of the estate tax system using, for example, part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[1790] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, fn. 5560.

[1791] The IRS might argue that the note has basis equal to the basis of the common interest. Before the grantor dies, for income tax purposes the trust didn't exist. For income tax purposes, the grantor – not the trust – owned whatever property was in the trust until the grantor died. So, the grantor's death should be taken as the event that first created the trust for income tax purposes. For income tax purposes, there was no sale – simply a gift or bequest by the grantor of a note to the trust. Therefore, such an IRS argument would appear not to work. However, given that no authority directly addresses this issue, let's consider it: If the IRS were to win that argument and the Code § 1276 market discount rules were to apply, any principal payments in excess of basis would have a character similar to that of interest income.

[1792] Code § 1278(a)(1)(D) provides:

- (i) *In general*. Except as otherwise provided in this subparagraph or in regulations, the term "market discount bond" shall not include any bond acquired by the taxpayer at its original issue.
- (ii) *Treatment of bonds acquired for less than issue price*. Clause (i) shall not apply to any bond if—
  - (I) the basis of the taxpayer in such bond is determined under section 1012, and
  - (II) such basis is less than the issue price of such bond determined under subpart A of this part.
- (iii) *Bonds acquired in certain reorganizations*. Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes of section 1276, the preceding sentence shall not apply if such other bond was issued on or before July 18, 1984 (the date of the enactment [7/18/84] of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.
- (iv) *Treatment of certain transferred basis property*. For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue.

Although the debtor changes when the grantor dies, the trust would be the original holder and presumably would receive capital gain treatment, as would any residual beneficiary of the trust who does not receive the note in a pecuniary bequest.

Generally, the S corporation's assets do not receive an inside basis step-up on the client's death or even on the trust's sale of its stock in the S corporation. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations.

Although an S corporation might in certain limited circumstances replicate an inside basis step-up upon death, that strategy does not necessarily work well. See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation.

Therefore, in conjunction with the sale, the S corporation might form a preferred partnership.[1793] For a general explanation of preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. For migrating into a preferred partnership, see part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, as well as part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

The irrevocable grantor trust would need to be funded with or borrow from a bank or a related party enough cash to contribute to invest in the 99% common interest in the partnership (the S corporation would retain a 1% common interest, perhaps as a general partner, in the partnership). See also part II.M.3 Buying into or Forming a Partnership.

Eventually, the grantor might buy the common interest from the irrevocable grantor trust, preferably borrowing from a bank in a manner similar to that described in part II.H.10 Extracting Equity to Fund Large Gift, not only to fund the grantor's purchase but also to strip the increase in equity that might occur if the property increases in value. This strategy would provide for a basis step-up at little or no estate tax cost.

II.H.6. Basis Shifting Opportunities Other Than Grantor Trusts

One could simply distribute low-basis property to a partner in redemption of the low basis partnership interest of a partner with a short life expectancy, to better focus basis step-up at the partner's death or avoid the need to make a Code § 754 election.

See parts II.Q.8.a Partnership as a Master Entity and II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, which also discusses like-exchanges, for opportunities to:

- Shift basis from assets that are intended to be held for a while to assets that likely to sold in the near future, or

- Strip basis from high basis property to property that is then distributed to a partner with a short life expectancy, so that basis step-up at death is focused on targeted assets.

A gift to a person with a short life expectancy would be eligible for a basis step-up, so long as the donee does not die within one year of the gift or the gifted property does not pass back to the donor.[1794]

[1793] Formation of the preferred partnership when the sale occurs is not required, but doing so would provide more efficiency in appraisal fees incurred.
[1794] Code § 1014(e). The legislative history says that a bargain sale is subject to the provision to the extent of the gift element.

II.H.7. Passive Losses – When Basis Step-Up Might Not Be Favorable

A decedent's suspended passive losses are lost to the extent that the asset generating the passive losses received a basis step-up at the decedent's death.[1795]

In planning for basis step-up, consider which is more valuable - the suspended passive losses or the basis step-up.

If the former, consider using a beneficiary grantor trust to hold the passive asset.[1796]

II.H.8. Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation; Possible Way to Attain Basis Step-Up

As described in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations, S corporation assets do not receive a new basis when a shareholder dies or sells stock.

However, S corporations can sometimes replicate the equivalent of a basis step-up when the sole owner dies. For how to get property out of a corporation to enable it to receive a basis step-up without going through this analysis, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a. Depreciable Real Estate in an S corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly

II.H.8.a.i. Solution That Works for Federal Income Tax Purposes (To an Extent)

II.H.8.a.i.(a). Model for Attempting to Replicate an Inside Basis Step-Up

Although a partner's share of partnership assets can obtain a basis step-up at that partner's death,[1797] no such relief is available with respect to the assets of a corporation (whether C or S).

Generally, an S corporation can replicate the basis step-up if it holds nondepreciable property in a separate entity, by liquidating after death. That is because the capital gain on the shareholder's K-1 is offset by a capital loss when the corporation is liquidated.[1798]

[1795] See part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Losses.

[1796] See text accompanying fn. 2776 for an explanation; see also parts III.B.2.i Code § 678 (Beneficiary Grantor) Trusts and III.A.3.e QSSTs and ESBTs (a QSST is a type of beneficiary grantor trust).

[1797] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[1798] Letter Rulings 9218019, 9622012.

Sale of Depreciable Property to Third Party
or
Liquidation of Real Property
(Zero basis, $1M value)

Proceeds from sale	$ 1M
Basis of real estate	0
Gain on K-1	$ 1M
Stock basis after death	$ 1M
Gain on K-1	$ 1M
Stock basis after sale of real estate	$ 2M
Liquidation proceeds	$ 1M
Stock basis	($ 2M)
Loss on liquidation	($ 1M)
Long-term capital gain on K-1	$ 1M
Long-term capital loss on liquidation	($ 1M)
Net long-term capital gain (loss)	$ 0

II.H.8.a.i.(b). Challenging Issues When S Corporate Liquidates Holding Depreciable Property or Other Ordinary Income Property

If the property is depreciable and the corporation liquidates, then Code § 1239 might apply to convert the K-1 income to ordinary income.[1799] Being a related party transaction might also preclude capital gain treatment given patents in certain situations.[1800] Furthermore, if the taxpayer previously sold depreciable property and took an ordinary loss under Code § 1231, gains on the sale of depreciable property will be taxed as ordinary income to the extent of those prior ordinary losses (referred to as Code § 1231 recapture). Finally, the recapture of depreciation deductions taken on personal property constitutes ordinary income under Code § 1245 (see part II.H.8.b Depreciable Personal Property in an S corporation).

Depreciable property is not the only concern. Consider an S corporation that holds marketable securities. Depending on the nature of a security, its sale might generate ordinary income. For example, if and to the extent that gain on sale of a bond (whether or not the interest is exempt from income tax) results from basis below the bond's face amount, the gain might be taxed as ordinary income under the market discount rules.[1801]

In these cases, the K-1 would include ordinary income, which cannot be offset in any significant measure by the long-term capital loss on liquidation.

With multiple depreciable real properties in an S corporation, one might not be able to sell all the property to a third party in one year, and liquidation would cause this mismatch for the remaining properties. Thus, depreciable real estate should be spun off into a separate

[1799] Code § 1239 is discussed at part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[1800] See part II.G.18.c Patents, especially fn. 1413.
[1801] See Code § 1276.

S corporation for each property; it's best to do the spin-off at least five years before death;[1802] even then, establishing the required business purpose for a spin-off in real estate might be challenging when

To avoid these complications for an S corporation, and to try to get some benefits for real estate currently held in a C corporation, consider getting the real estate or other assets out of the corporation into an entity taxed as a partnership, as described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a.ii. State Income Tax Disconnect

Suppose the owner of the S corporation lives in a state (the "owner's state") that is not the same as the state where the S corporation is domiciled and the property is sold (the "business state").

Generally, the business state will tax the gain on the sale of the real estate.

However, the owner's disposition of the S corporation's stock will not be considered activity in the business state, because generally only the owner's state can tax the sale of intangible personal property (and stock is intangible personal property).

In the planning stages, taxpayers might try two approaches to avoid this problem, which might or might not work:

- Change the Owner's Residence. If the owner resides in the business state, the loss will be allowed. This might not be easily solved if the owner indirectly holds real estate in many states. On the other hand, suppose the owner is a trust. The trustee could divide the trust, moving to the business state the part of the trust attributable to the property located in that state. Whether this strategy works depends on whether the business state allows a trust to be a resident trust when its grantor was not domiciled in the state when the trust was created.[1803]

- Change the Corporation's Domicile. Some states do not tax the sale of a business, even though they tax the business' operations, because the sale of the business itself is not considered in the ordinary course of business. If the corporation is not domiciled in the state in which the property is located, the gain on sale of the real estate might not be taxable to the state in which the real estate is located.

Unless one wants to research all of the above issues, one might consider planning with the following assumptions:

- If one is forming a business entity to hold property in another state, one should consider forming the entity in the owner's state of residence or in a state that does not impose income tax. Depending on state law, creating domicile in the other state might give it grounds for taxation of certain transactions that might not otherwise exist.

[1802] See part II.Q.7.f Corporate Division.

[1803] See "State Income Taxation of Trustees: Some Updates," TM Memorandum (BNA), Vol. 54, No. 11 (6/3/2013) and "2013 Trust Nexus Survey," Tax Management Weekly State Tax Report (Vol. 2013, No. 34, 8/23/2013).

- If the trustee of a nongrantor trust is aware of the need for the planning described in part II.H.8.a Depreciable Real Estate in an S corporation, consider researching splitting the trust if the trust is in a different state than the business state and the real estate is in one of the states listed above. Note that splitting the trust in this manner would work best if each S corporation owns property in only one state. As mentioned above, depreciable real estate should be spun off into a separate S corporation for each property; it's best to do the spin-off at least five years before the grantor's death,[1804] even if the trust division does not occur until the sale is contemplated and before any contract is signed.

- If the S corporation formed a new partnership to hold the real estate, then the S corporation might sell its partnership interest and avoid state income tax on the sale of real estate. The partnership would probably not be formed well in advance of the transaction, because the buyer probably would not want to assume the liabilities of an ongoing entity. This in turn might cause step transaction issues at the state level.

II.H.8.b. Depreciable Personal Property in an S corporation

The disposition of most depreciable personal property, including certain building components depreciated as personal property, will be taxed as ordinary income, whether or not sold to a related party.[1805] Thus, all the problems in part II.H.8.a, Depreciable Real Estate in an S corporation, apply and cannot be avoided for personal property inside an S corporation.

This issue is even more of a concern with current tax laws that allow very quick write-offs on purchases of tangible personal property. Heavy equipment creates a larger concern in that it tends to retain its value for longer.

A solution might be to form an LLC taxed as a partnership that is the original purchaser and leases the equipment to the business. The LLC might even borrow from the S corporation at the AFR. When an owner dies, his or her share will receive a new basis if a Code § 754 election is in place.[1806] A disadvantage of this strategy for higher-income taxpayers is that rental might be classified as a passive activity,[1807] which means that the rental income would be subject to the 3.8% supplemental tax[1808] unless an exception is satisfied.[1809] This tax would not apply if the property were merely held inside the S corporation in which the taxpayer actively operates the business.

II.H.8.c. Basis Step-Up for Publicly-Traded Stock and Other Nondepreciable Property

Generally, liquidating an S corporation that holds publicly-traded stock and other nondepreciable property will provide a new basis to its assets by reason of a deemed sale (but

[1804] See part II.Q.7.f Corporate Division.
[1805] Code § 1245.
[1806] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[1807] Code § 469(c)(2). An exception applies to active rental of real estate, not personal property. See Code § 469(c)(7).
[1808] See II.I 3.8% Tax on Excess Net Investment Income.
[1809] For whether rental constitutes a passive activity, see II.K.1.e Rental Activities. For other exceptions, see II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

perhaps with no taxable income generated), as described in part II.H.8.a.i.(a) Model for Attempting to Replicate an Inside Basis Step-Up, subject to the concerns described in part II.H.8.a.ii State Income Tax Disconnect, but perhaps without the concerns described in part II.H.8.a.i.(b) Challenging Issues When S Corporate Liquidates Holding Depreciable Property or Other Ordinary Income Property.

The corporation could do a formless conversion or merger into an LLC taxed as a disregarded entity or partnership, as described in part II.P.3.a From Corporations to Partnerships and Sole Proprietorships. If the entity is an LLC taxed as a corporation, it might effectuate this change retroactively for two months and 15 days by filing IRS Form 8832.

II.H.9. Basis Step-Up In S corporations That Had Been C Corporations

An S corporation that used to be a C corporation generate dividend income to its shareholders to the extent that distributions exceed its accumulated adjustments account (AAA). See part II.P.3.b.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

A basis step-up does not change this result, even if it results from the S corporation receiving life insurance proceeds. See part II.Q.7.b.iv S corporation Distributions of, or Redemptions Using, Life Insurance Proceeds.

Furthermore, some redemptions are taxed as distributions, resulting in similar dividend issues.[1810]

However, if the S corporation has never been a C corporation or otherwise does not have any C corporation earnings and profits (E&P), these concerns do not arise.[1811]

II.H.10. Extracting Equity to Fund Large Gift

II.H.10.a. General Concept of Extracting Equity to Fund Large Gift

Consider extracting the fair market value equity from depreciated property, take steps to get the extracted equity out of the estate tax system, and exposing the small net value property to the estate tax system to get a very low cost basis stepped-up. This is done in three steps:

(1) Borrow against the property and distribute the cash to the owner(s). The debt reduces the impact of including the property in the taxpayer's gross estate, either as a debt deduction (recourse debt)[1812] or by reason of being netted against the property's value (nonrecourse),[1813] with the secured property receiving a full basis step-up in either

---

[1810] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4069-4071.

[1811] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially the paragraph of text accompanying fn. 4073, the latter explaining how to eliminate E&P.

[1812] Code § 2053(a)(4).

[1813] Reg. § 20.2053-7 provides:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate . If the decedent's estate is liable for the amount of the mortgage or indebtedness,

case.[1814] A bank might very well require loan guarantees from other entities that would post collateral. See part II.H.10.c Consider Use of Guarantee Fee. Alternatively, a related party might make the loan at the AFR.

(2) Each owner invests the proceeds in taxable income-producing property. This is important for income tax purposes. If the owner simply gives away the cash, the debt would be incurred for personal purposes and the interest would be nondeductible personal interest. The owner needs to invest first in taxable investments;[1815] tax-free investments, such as municipal bonds, would also make the interest expense nondeductible.

(3) Each owner then makes annual exclusion gifts or otherwise engages in leveraged estate planning techniques. If the plan will take some time to accomplish and the owner has an irrevocable grantor trust with low basis assets, consider using the cash to buy those low basis assets so that those assets can get a basis step-up as well.

If the real estate is in an entity taxed as a partnership and the partnership is distributing cash from the loan to a partner, beware of the disguised sale rules. Absent an exception, if the partner contributed property to the partnership within 2 years of receiving the distribution or if a partner borrows against the property within two years, a disguised sale of the contributed property is presumed to have taken place.[1816]

This strategy may also work with low basis marketable securities, which might be monetized without generating capital gain tax.[1817]

II.H.10.b. Example: Leveraging Property to Extract Equity to Fund Large Gift

Suppose property with a $10M fair market value was fully depreciated as to the value of the building, with $2M of land value remaining:

1. Borrow $9M against the building and transfer the $9M using leveraged estate planning techniques as described above (after first having invested the borrowed money in taxable investments).

2. Keep the $1M ($10M value minus $9M liabilities) until death, and pay estate tax on the $1M.

---

the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth. See § 20.2043-1. Only interest accrued to the date of the decedent's death is allowable even though the alternate valuation method under section 2032 is selected. In any case where real property situated outside the United States does not form a part of the gross estate, no deduction may be taken of any mortgage thereon or any other indebtedness in respect thereof.

[1814] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[1815] Code § 163(d)(3), which is reproduced in fn. 1900, which is found in part II.I.6 Deductions Against NII.

[1816] Reg. § 1.707-3(c). See part II.M.3.e Exception: Disguised Sale.

[1817] See part II.A.1.d Monetizing Founder's Remaining Shares After Going Public.

3. The $8M of building ($10M total value minus $2M land value) receives a basis step-up from zero to $8M:[1818]

   - At a 40% income rate, this basis step-up secures tax deductions worth $3.2M (40% of $8M).

   - Even if the property were later sold, the capital gain tax savings would likely be $2.4M (30%[1819] of $8M) or more.

4. Possible estate tax on $1M is a small price to pay for that income tax savings.

II.H.10.c. Consider Use of Guarantee Fee

A loan guarantee is not a gift. For gift and income tax issues related to guarantees, see part III.B.1.a.ii Loan Guarantees.

However, if the loan guarantee is from a donee, the IRS might claim that the donor has retained an interest in the gifted property and asset Code § 2036 inclusion.

Therefore, consider paying a market-rate guarantee fee so that the grantor pays adequate and full consideration for the use of the credit instead of possibly appearing to have retained the use of the gifted property. Consider the following commercial models:

- Home equity lines of credit charge no maintenance fees. They are well-secured, simple loans.

- Commercial lines of credit might involve maintenance fees. They are well-secured, complex loans.

- If the borrower has little equity or income outside of an asset that is being purchased, then the lender's or guarantor's risk increases dramatically when the loan-to-value ratio is high. If the asset being purchased is being appraised, consider asking the appraiser to also determine a reasonable guarantee fee.

II.H.10.d. Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee

If the loan proceeds are transferred using leveraged estate planning techniques, tracking the lender's security interest might become tricky.

For example, suppose one uses a series of 2-year GRATs to transfer marketable securities, establishing a separate GRAT each year for each asset class.[1820] The number of accounts could quickly multiply. One might consider establishing an LLC to hold each asset class, so that

---

[1818] If held in a partnership, a Code § 754 election would need to be made. See II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[1819] This example assumes that state and local income tax increases a 25% capital gain rate by 5%. Capital gain that represents the recapture of straight line depreciation is taxed at a maximum rate of 25% instead of 20%. Code § 1(h)(1)(D).

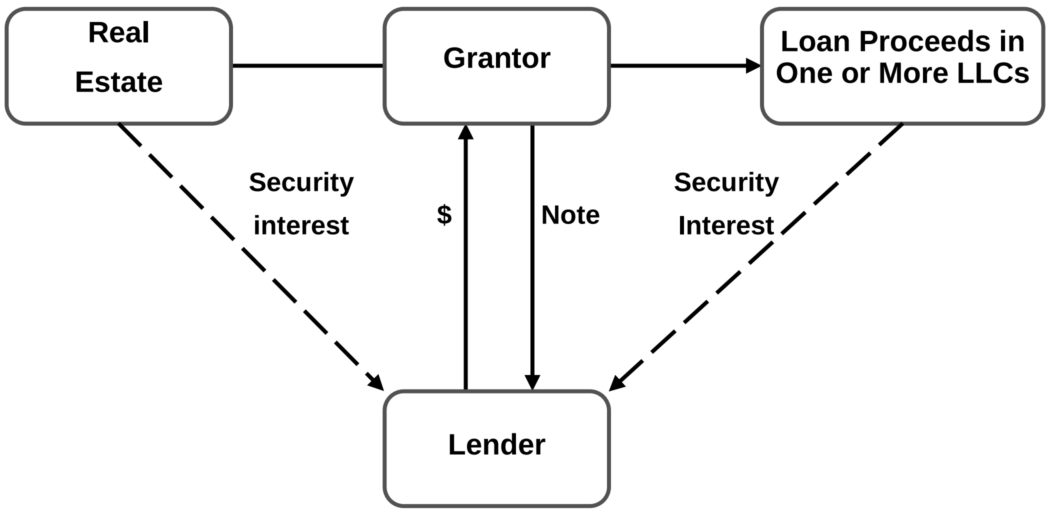
[1820] This is called a rolling, asset-splitting GRAT strategy and is described in part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 5539.

the security interest is imposed on the LLC's account and interests in the LLC can be freely transferred among trusts to implement the strategy.[1821] Also note that an account with multiple owners might be deemed a partnership in certain situations.[1822]

II.H.10.e. Illustration of Equity Strip and Gift

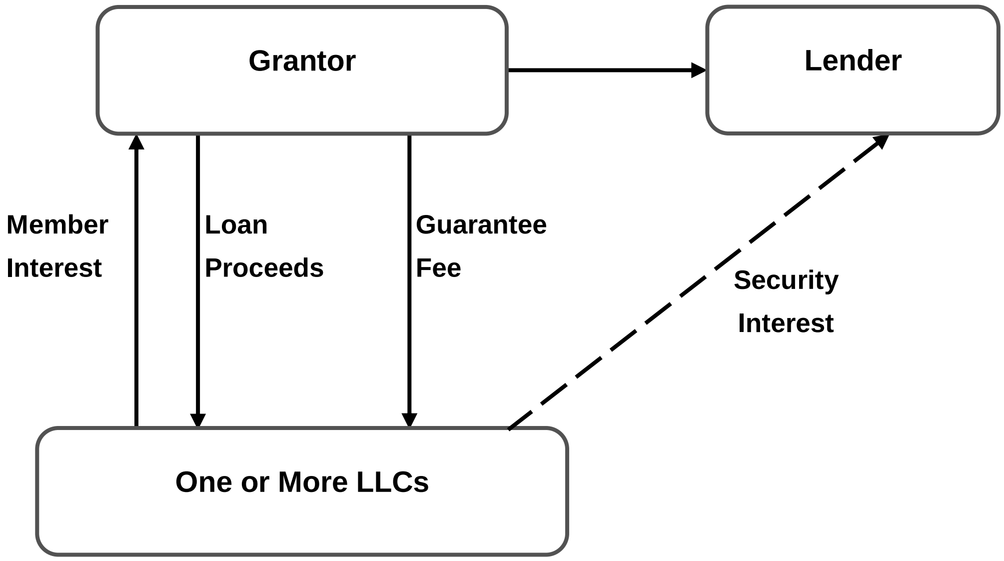
See parts II.H.10.e.i Flowchart of Equity Strip, II.H.10.e.ii Flowchart of Placing Loan Proceeds into Entity, and II.H.10.e.iii Flowchart of Transfer of Loan Proceeds.

II.H.10.e.i. Flowchart of Equity Strip

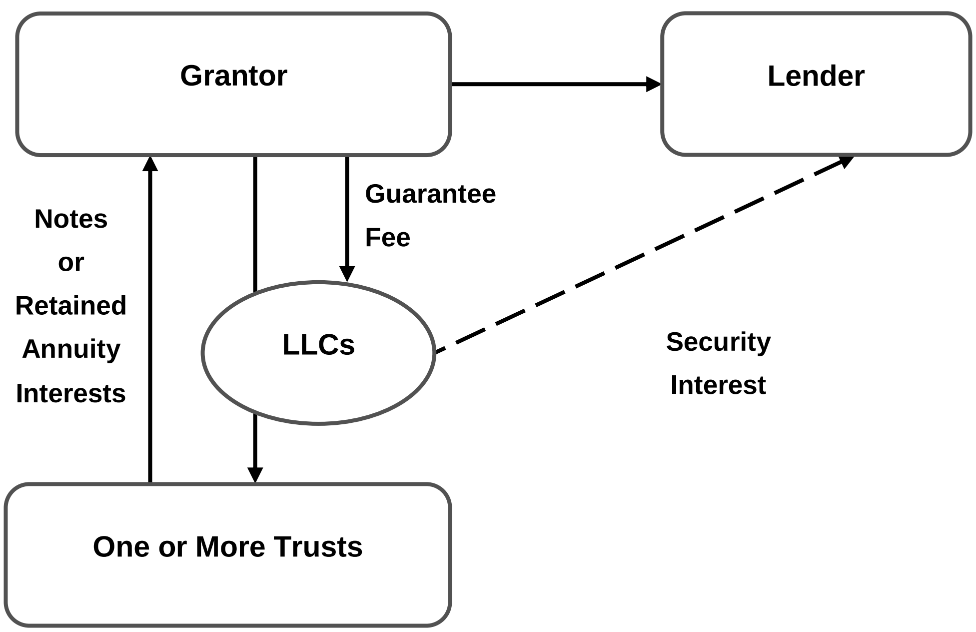


[1821] See part II.Q.8.a Partnership as a Master Entity, especially fns. 4430-4432 and the accompanying text.
[1822] See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common.

II.H.10.e.ii. Flowchart of Placing Loan Proceeds into Entity



II.H.10.e.iii. Flowchart of Transfer of Loan Proceeds



II.H.11. Preferred Partnership to Obtain Basis Step-Up on Retained Portion

If all of the equity has been extracted, the future growth is still an estate planning issue. Furthermore, the client might not be comfortable with extracting the equity. In either case, consider contributing the real estate to a preferred partnership, in which the client receives a preferred distribution of profits as a fixed percentage of the fair market value of the contributed property, as well as receiving a capital account equal to the fair market value of the contributed property, plus perhaps a straight 1% of the residual profits; the client then transfers the remaining residual profits – the so-called “common interest.”

If the partnership has a Code § 754 election in place, a partner's allocable share of the partnership's non-IRD assets will receive a new basis when the partner dies.[1823] Thus, a preferred partnership can be an excellent vehicle for transferring future growth while obtaining a basis step-up on the portion retained. This is particularly useful for a person whose taxable estate and adjusted taxable gifts would be less than the estate tax exemption with the current value included but would exceed the estate tax exemption if the property grows in value or generates income in excess of the preferred return.

II.H.11.a. Basics of Preferred Partnerships

In a preferred partnership, one or more partners has a preferred interest and one or more partners has a common interest. The preferred interest includes a capital account that receives a percentage return on that capital account, which preferred return is paid generally before making distributions to the partners owning the common interest. A common interest is a capital account plus a flat percentage of the profits distributed after the preferred interest receives its distributions. As described further below, the goal is to maximize the initial value of the preferred partnership interest and to minimize the initial value of the common interest.

The preferred interests receive operating distributions before the common interests and receive a return of their capital accounts before the common interests receive their capital accounts. The preferred returns are not guaranteed; rather they are preferred distributions of cash from operations. Because they are contingent on cash flow, they are more risky than mere loans and therefore require a higher return. See part II.H.11.c Payment of Preferred Return.

Maximizing the value of the preferred interests reduces the payment required on the capital account, reducing the pressure on the partnership to generate operating cash and leaving more cash available for the common interests.[1824] Usually the partnership is a limited partnership, and the preferred interest is accompanied by a 1% common interest as the controlling general partner;[1825] providing the preferred interest owner with this controlling common interest increases the likelihood of actually receiving the preferred distributions and therefore reduces risk and the required return. The remaining 99% common interest generally is comprised of interests as limited partners, although it might include interests as general partners that aggregate to less than 1%. If and to the extent that operating cash flow beyond the preferred return is used to repay the preferred partner's capital account, beware of tax issues. This excess operating cash flow is taxed to the common interests, because the income is allocated to them, becomes capital and only then is used to pay the preferred partner; this is an inherent part of partnership accounting. In many cases, the partnership agreement should require distributions to the common interests to pay these taxes before the excess operating cash flow is used to pay the preferred partners' capital accounts.

Forming the partnership usually does not trigger income tax.[1826] Because the right to receive preferred payments depends on cash flow and is not guaranteed, forming the partnership is

---

[1823] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[1824] See part II.H.11.d Valuing Preferred Partnership Interests.

[1825] There is nothing wrong with stapling a common interest as a general partner that exceeds 1%, aside from the desire to allocate growth (the common interest) to the next generation.

[1826] See part II.M.3 Buying into or Forming a Partnership.

presumed not to constitute a disguised sale.[1827] Although a guaranteed payment within certain limits is also presumed not be a disguised sale,[1828] using property to satisfy the obligation (because cash flow is inadequate) would probably constitute a sale and trigger income tax.[1829] The tax laws strongly encourage the preferred payment to be cumulative, meaning that make-up distributions are made in future years if current cash flow is insufficient;[1830] these rules strongly encourage payments no later than four years after the due date,[1831] and payments using property should constitute tax-free distributions.[1832]

When one creates an entity with preferred distributions and receives preferred distributions equal to the value of what one contributed, Code § 2036 does not include in one's estate the right to the common interest.[1833] However, if one does everything wrong, Code § 2036 will apply to a preferred partnership.[1834]

II.H.11.b. Preferred Partnership Compared to Sale to Irrevocable Grantor Trust

The disadvantages of a preferred partnership relative to a sale for a note are the higher required return (preferred stock generally pays dividends much higher than the AFR) and the higher equity investment required by the other owners (although Code § 2701 generally requires the common interest to be worth at least 10%, in practice appraisers require it to be 15%-20% or more).

1827 See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

1828 See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

1829 Code § 707.

1830 See part III.B.7.b Code § 2701 Overview.

1831 Code § 2701(d)(2)(C).

1832 See part II.Q.8.b.i Distribution of Property by a Partnership.

1833 *Hutchens Non-Marital Trust v. Commissioner*, T.C. Memo. 1993-600 (preferred stock) (Missouri case). Also, preferential liquidation rights and the right to distributions that were greatly disproportionate to that enjoyed by another class of equity, the other class of which the decedent had transferred, did not constitute a retention of rights to the transferred shares. *Boykin v. Commissioner*, T.C. Memo. 1987-134. Presumably the IRS wanted to include the transferred shares because they were voting, whereas the retained shares were nonvoting. After *Boykin* and before *Hutchens*, Congress repealed Code § 2036(c) and enacted Chapter 14 in its place. The legislative history says:

> The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor.

Stacy Eastland's Heckerling materials suggest that, because of this favorable history and case law, preferred partnerships might be less susceptible to Code § 2036 attacks than other entities.

1834 *Estate of Liljestrand v. Commissioner*, T.C. Memo. 2011-259, applying *Bongard* (see fn 99 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders):

> As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14 percent of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000, thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property....
>
> Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime.

However, the preferred partnership interest has an advantage of basis step-up. If one sells low basis assets to an irrevocable grantor trust and dies shortly thereafter, there is no growth on which estate taxes are paid, the note is included at roughly the same value as the sold asset, and the sold property does not receive a basis step-up. On the other hand, if one uses a preferred partnership, the underlying assets attributable to the preferred partnership will receive a new basis when the preferred partner dies.[1835]

One might consider pairing the two concepts: retain the preferred interest and have an irrevocable grantor trust hold the common interest. If the senior family member gets ill, (s)he buys the common interest from the trust,[1836] so that the common interest can receive a basis step-up at death.

II.H.11.c. Payment of Preferred Return

Generally, the preferred return should be paid out of operating cash flow.[1837]

Although guaranteed payments might seem attractive from a gift tax viewpoint,[1838] they are undesirable from an income tax viewpoint.[1839]

II.H.11.d. Valuing Preferred Partnership Interests

Rev. Rul. 83-120 explains how to value preferred and common stock. Presumably its concepts would apply to partnerships. Key ideas include:

- The preferred distributions must exceed the interest paid to the entity's lenders.[1840] Because AFRs are based on government bonds that are viewed as having no credit risk, the rates charged by lenders to businesses generally exceed the AFR. In other words, preferred rates exceed lenders' rate which exceed the AFR. Thus, preferred distribution rates are significantly greater than the AFR.

[1835] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[1836] See fn. 1791, found in part II.H.5.b Moving Real Estate from Irrevocable Trust to Grantor.

[1837] See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales.

[1838] Guaranteed payments do not trigger the special rules for family partnerships described in part III.B.7.b Code § 2701 Overview. See Code § 2701(c)(1)(B)(iii).

[1839] Guaranteed payments would generally be limited to 150% of AFR (which is much lower than market now). See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales. Also, because a guaranteed payment under Code § 707(c) is not a regular partnership distribution under Code § 731, gain or loss would be triggered on the distribution of assets in kind to satisfy that pecuniary obligation. Contrast that with a partnership distribution, which generally does not trigger gain or loss, as described in part II.Q.8.b.i Distribution of Property by a Partnership. Although it might seem common sense that a distribution out of operating cash flow would be satisfied out of cash from operations so that assets do not need to be sold, the situation for family partnerships is not so simple. Family partnerships need to make their preferred payments no later than four years after they accrue. Code § 2701(d)(2)(C). This four-year requirement should not cause problems with the disguised sale rules, which are mainly concerned about payments within two years after the preferred partner has contributed assets to the partnership. See part II.M.3.e Exception: Disguised Sale. Thus, using a preferred payment out of operating cash flow instead of a guaranteed payments not only adds helpful flexibility for partnerships generally but also is very important for family partnerships.

[1840] Rev. Rul. 83-120, § 4.02.

- Preferred distribution rates also require sufficient coverage, which means the entity's ability to pay the preferred return. The entity needs plenty of income-generating assets to assure payment.[1841] Appraisers prefer to see the preferred interest holder have enough control over distributions to maximize the chance that distributions will actually be made. Although control tends to generate Code § 2036 concerns, the fact that a largely undiscounted preferred interest is included in the holder's estate should prevent Code § 2036 from causing problems.[1842]

- The entity needs to have ample equity to be able to pay the equity's stated liquidation right.[1843]

The above bullet points raise the issue of "coverage." If preferred interests are large compared tp the rest of the equity, then the likelihood of making the preferred payments decreases. A decreased likelihood of payment means that a risk premium is required; in other words, the preferred distribution rate increases. Ironically, and increased preferred distribution rate increases risk, causing rates to need to be higher. To avoid this problem, capitalize the entoty with more value in the common ownership.

If the partnership is a family entity, watch out for the complexities and uncertainty in valuation described in Code § 2701 later in these materials.[1844] Although the rules governing family entities generally require that the common interest have a value of at least 10% of the deal,[1845] typically it's at least 20% of the deal, so that the preferred profits distribution is kept at a reasonable rate. In a marketable securities partnership, the common is a much higher proportion, because the equity rates paid on the preferred stock often will significantly exceed the annual expected investment income on the marketable securities. Thus, practical coverage requirements tend to make the 10% minimum common value a moot issue.

A recapitalization can constitute a gift, whether under general principles[1846] or under these special rules for family partnerships.

[1841] Rev. Rul. 83-120, § 4.03 includes the following explanation:

> Coverage of the dividend is measured by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends. *Standard & Poor's Ratings Guide*, 58 (1979). Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock. The ratio for the preferred stock in question should be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage.

[1842] See fns 1833-1834 in part II.H.11.a Basics of Preferred Partnerships.

[1843] Rev. Rul. 83-120, § 4.04 provides:

> Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high quality preferred stock to determine adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

[1844] See part III.B.7.b Code § 2701 Overview.

[1845] See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales.

[1846] Rev. Rul. 86-39.

II.H.11.e. Using Preferred Partnership that Intentionally Violates Code § 2701

Consider making placing $5M into a preferred partnership that is a family entity, retaining a $4M preferred interest with noncumulative preferred distributions redeemable at par in the holder's discretion, and giving $1M in common to the next generation.

The preferred return is a nice income stream. If the preferred holder needs more cash for unexpected spending needs, the preferred holder can require a partial redemption of the preferred's par value.

The gift and estate tax consequences are as follows:

- If the partnership violates Code § 2701, the gift of common generates a $5M taxable gift, because the preferred is valued at zero.

- If a Code § 2701 interest in existence on the date of the initial transferor's death is held by an applicable family member and therefore is not included in the gross estate of the initial transferor, the Code § 2701 interest is deemed to be transferred at the death of the initial transferor to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor. In such case, the transfer tax value of the interest is the value that the executor can demonstrate would be determined for gift tax purposes if the interest were transferred immediately before the initial transferor's death.[1847]

Code § 2701 applies "[s]olely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift." Thus, it does not apply for GST purposes, as described in this example from a treatise:[1848]

> Grandfather gives common stock of Family Corporation to Granddaughter, while retaining preferred stock. The gift tax under Chapter 12 will be calculated by valuing the common stock under Section 2701. The GST tax under Chapter 13 will be determined by valuing the common stock without regard to Section 2701.

So, even though the noncompliant partnership freeze can use the entire gift tax exemption, it will not use a corresponding amount of GST exemption.

Although a taxable gift generally reduces the donor's lifetime gift/estate tax exemption, "adjusted taxable gifts" reported on the estate tax return do not include gifts that are includible in the donor's gross estate.[1849] Thus, adjusted taxable gifts arising from a noncompliant preferred interest are washed out when the preferred interest is included in the donor's gross estate.

If the donor splits gifts with the spouse, the order and manner in which the mitigation occurs depends on who dies first.[1850] Consider leaving the preferred interest in a trust for the surviving

[1847] Reg. § 25.2701-5(c)(3)(ii).
[1848] Zaritsky & Aucutt, ¶ 2.03[4] Scope of Section 2701, ¶ 2.03[4][a] Generation-Skipping Transfer Tax, *Structuring Estate Freezes: Analysis With Forms* (WG&L), citing the preamble to the proposed regulations, 56 Fed. Reg. § 14322 (1991).
[1849] Code § 2001(b).
[1850] See Reg. § 25.2701-5(e).

spouse and electing a QTIP marital deduction[1851] only to the extent that the mitigation provisions do not wipe out the estate inclusion.

II.H.11.f. Practical Uses of Estate Freezes

Many of the ideas discussed below are illustrated in materials put together by Stacy Eastland for 2015 Heckerling, ideas on which he has worked for many years and continues to improve.[1852] Stacy's materials contain many creative ideas not listed below, including combining leverage with preferred partnerships and GRATs; however, I am very reluctant to combine leverage with GRATs.

II.H.11.f.i. Increasing Investment Yield to Enable Owner to Transfer More Outside of Estate Tax System

The example below is for a bypass trust and the surviving spouse, but it could just as easily apply to:

- An irrevocable grantor trust created by the spouse instead of the bypass trust, or
- A partnership between a GST-exempt trust and either its beneficiary or a non-GST-exempt trust for the benefit of the GST-exempt trust's beneficiary.

A surviving spouse might engage in an estate freeze with a bypass trust created by the deceased spouse. The surviving spouse contributes assets and receives a preferred interest (with enhancements described in part II.H.11.a Basics of Preferred Partnerships), and the bypass trust contributes assets and receives a common interest. The surviving spouse receives a nice annual income flow, and the preferred interest will receive a new basis at the surviving spouse's death.

Furthermore, if the surviving spouse has some DSUE and is at risk of losing it because of remarriage, the surviving spouse might consider electing to treat the preferred interest as gifted to the bypass trust, even though the surviving spouse has not in fact gifted the interest.[1853] presumably the gifted interest would be included in the surviving spouse's estate because of actual ownership, but the amount of inclusion should be washed out, as described in part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701.

Although a QTIP trust could engage in a freeze transaction, Code § 2519 poses risks if the valuation is wrong. A QTIP trust might make distributions or loans to the surviving spouse so that the surviving spouse can later engage in the preferred partnership planning. Therefore, one might consider entering into the preferred partnership before the QTIP trust is funded, being wary, however, that Code § 2701 views transactions by a trust as transactions by its beneficiaries.[1854]

[1851] See fn. 1689, found in part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[1852] Discussions with Ellen Harrison and Stacy when preparing for our 2015 Heckerling panel have sharpened my thinking in this area. ACTEC Fellows can see some of Ellen's thoughts by looking at the Business Planning Committee materials for the 2015 Annual Meeting.
[1853] Code § 2701(c)(3)(C)(i).
[1854] Reg. § 25.2701-6(a)(4).

A portfolio of marketable securities might be a good candidate for such planning. Because the preferred return is significantly higher than general interest and dividend rates, the surviving spouse can boost the surviving spouse's annual cash return on the assets contributed. Essentially, the partnership would use the income from the bypass trust's contributed assets to make preferred payments to the surviving spouse in exchange for the growth of the surviving spouse's contributed assets. In the example below, the surviving spouse's contributed assets would need to comprise approximately 30% of the partnership to attain this result.

Suppose, for example, the surviving spouse contributed $3 million of marketable securities and the bypass trust contributed $7 million of marketable securities, each portfolio generating 2.5% cash distributions. Thus, the partnership's $10 million generates $250,000 annual cash yield. Dividing the $250,000 annual cash yield by the surviving spouse's $3 million contribution constitutes an 8.3% yield, which might be comparable to an annual cash preferred dividend. Note that the surviving spouse's income has increased from $75,000 per year to $250,000 per year. Now the surviving spouse can afford to used leveraged transfers to shift other assets outside the estate tax system. Or the surviving spouse could, in a separate transaction that was not planned until after the preferred partnership formation had seasoned sufficiently, simply sell to an irrevocable grantor trust $2 million of preferred partnership interest yielding 8.3% in exchange for a note bearing the AFR (much lower than 8.3% when this analysis was written) and retain $1 million of preferred partnership interest, earning $83,000 per year income (up from $75,000) but decreasing the amount subject to estate tax from $3 million down to $1 million (if the sale price simply goes to pay taxes on the irrevocable grantor trust). Furthermore, the $2 million capital account preferred interest would be worth less than $2 million if the surviving spouse retained the general partner interest, the control feature of which supported the value of the preferred in the surviving spouse's hands but which is not available to support the value of the $2 million preferred interest that is sold to the trust. Thus, the irrevocable grantor trust would pay less than $2 million for its preferred interest. Or, instead of doing a sale to an irrevocable grantor trust, the surviving spouse could use a GRAT, which will be guaranteed to succeed to the extent that the preferred return exceeds the Code § 7520 rate. (This example illustrates an extreme, in that the yield would likely be set at an amount lower than the partnership's annual income, to ensure coverage.)[1855]

The above strategy could be supercharged if the bypass trust contributed its partnership interest to an S corporation and the surviving spouse made a QSST election. That would cause the surviving spouse to pay the income tax on the common interest's capital gains (and other income allocable to it). If one were to use this strategy, the partnership agreement should not require distributions to pay tax on the common interests' income (contrary to the general recommendation of part II.H.11.a. Basics of Preferred Partnerships). Furthermore, one should consider how this approach affects the exit strategy – what happens to the bypass trust after the surviving spouse dies – described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

A simpler alternative with more modest results might be available. Consider dividing the trust, converting one portion to a unitrust and giving away another portion.[1856] The unitrust might be a higher rate of distribution than interest and dividends, allowing the surviving spouse to feel comfortable giving away that other portion.

[1855] See part II.H.11.d Valuing Preferred Partnership Interests.
[1856] See Letter Ruling 201426016.

Commercial real estate might not be a great candidate for directly engaging in increasing one's rate of cash flow return using the preferred partnership planning described above. First, the cash yield for privately managed commercial real estate tends to be close to preferred rates, making the type of leverage described in the example above difficult to achieve. (That doesn't mean that a preferred partnership is a bad idea; it simply does not create as much opportunity to enhance the surviving spouse's rate of return on retained assets.) Second, losing the basis step-up on the real estate would be quite painful. However, the leveraged planning described above could work <u>indirectly</u> for commercial real estate. Strip the real estate's equity, as described in part II.H.10 Extracting Equity to Fund Large Gift, then engage in this type of planning for the loan proceeds.

If one has an operating business in an S corporation, a preferred partnership is not available[1857] to replicate this result unless the transferor is the sole owner or the other owners have similar objective. The S corporation itself could contribute its assets to a preferred partnership in lieu of its shareholder(s) directly forming the preferred partnership.

Also note that preferred partnerships can be an excellent tool for getting future growth out of corporate solution, whether or not the corporation has an S election in place.[1858]

Also note that any freeze could be undone by switching from preferred/common to being all common, although the unrealized appreciation would need to be accounted for and the IRS might argue that the recapitalization constituted a gift. Accounting for unrealized appreciation would be a matter of determining the gain that would have been recognized if all assets had been sold for fair market value at the time of the change and specially allocating it to each partner; usually this is done by restating capital accounts to take these calculations into account – a process called booking up.[1859]

II.H.11.f.ii. Reverse Freeze to Guarantee Successful Sale to Irrevocable Grantor Trust

Normally one would have the transferor retain preferred and transfer common – to get the growth outside of the estate tax system. Consider doing the reverse, as described below.

Preferred partnership returns significantly exceed the AFR.[1860] The principal amount generally remains stable, because the entity needs to start with ample cushion to make sure that the stated liquidation amount will be paid.[1861] The main risk of decline in value is if interest rates increase, causing the present value of payments to decrease. However, if the holder of the preferred equity has the right to redeem for its stated value at any time, the preferred equity should hold its value.

[1857] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S corporation and Entity Classification Elections for the Same Entity.

[1858] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially II.Q.7.h.viii Value Freeze as Conservative Alternative.

[1859] For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 462. The related gain allocation is called a "reverse-Code § 704(c) allocation" and is provided by fn. 4528 of part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[1860] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 1840.

[1861] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 1843.

Thus, a grantor could sell a preferred partnership interest to an irrevocable grantor trust for a note at the AFR, and the transaction would have a very high likelihood of succeeding.

I have seen this idea promoted for life insurance policies, where the preferred return is sufficient to pay not only the interest on the note to the grantor but also the life insurance premiums.

II.H.11.f.iii. Getting Business Value Out of Corporate Solution

Holding a business in an entity taxed as a partnership has several income tax advantages over holding the business in a C or S corporation; see part II.E Recommended Structure for Entities.

Foe how to migrate to that structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

See also part II.H.5.c Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S corporation.

II.H.11.f.iv. Shifting Income or Growth from High Tax State

Suppose grantor previously created an irrevocable trust while in a high tax jurisdiction and later creates (or the grantor's spouse later creates) another one in a low- or no-income tax state.

If the trust in the high tax state has low basis assets, a preferred partnership might be a way to shift growth to the other state – perhaps even after seven years[1862] getting the low basis assets outside of the high tax state altogether.

Conversely, if the trust in the high tax state has high income but expects little or no capital gain, perhaps a preferred partnership can shift the income to the other state and leave the never-to-be-taxed unrealized appreciation in the high tax state.

However, if the trust in the high tax state has high basis assets, selling the assets and lending the money to the other trust in exchange for a long-term AFR note might do the trick more simply than engaging in a preferred partnership. If the trust in the higher tax state is a credit shelter trust and the surviving spouse does not need the income, the trustee could contribute the note to an S corporation and have the spouse make a QSST election so that all of the income is taxable to the surviving spouse, whether or not it is distributed; the S corporation then distributes only enough to pay the surviving spouse's income tax and invests the rest of the note payments.[1863]

[1862] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[1863] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure

II.J.4.j.i. Need to Provide Notices

In Missouri and many other states, a beneficiary can sue a trustee any time before five years after the first to occur of the trustee's removal, resignation, or death of the trustee, the termination of the beneficiary's interest in the trust, or the trust's termination.[2204]

However, a beneficiary may not sue a trustee more than one year after the last to occur of the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and the date the trustee informed the beneficiary of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.[2205]

A report adequately discloses the existence of a potential claim if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.[2206] The trustee may choose to disclose less than complete information; in that case, the trustee is protected only with respect to the information that is disclosed.

The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it. Given that a beneficiary's failure to bring a claim might constitute a gift,[2207] allowing any disputes to settle annually might minimize gift tax issues.

[2204] Section 1005(c) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provides:

> (c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:
> (1) the removal, resignation, or death of the trustee;
> (2) the termination of the beneficiary's interest in the trust; or
> (3) the termination of the trust.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2205] Section 1005(a) and (b) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provide:

> (a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than one year after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.
> (b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2206] Uniform Trust Code § 1005(b), found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.10-1005.2, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2207] The failure to assert a claim is a gift when the right to assert the claim becomes foreclosed, Rev. Rul. 84-105, which is described in fn. 5416, which is found in part III.B.1.b Gifts Without Consideration, Each year, after a tax return preparer's peak period ends, the preparer might consider suggesting that the trustee contact counsel and obtain help in putting together an annual notice. The tax return preparer can compile the information, especially given that many preparers keep records in PDFs and can easily burn them to a CD. Part II.J.4.j.ii provides an example of what that might look like.

Every trustee should consider following this procedure:

- Litigious Beneficiaries. Having as few years as possible open will help reduce the stakes and make it less worthwhile for them to spend money to take legal action. Annual notices require them to state their concerns now, rather the criticizing many years in the future – put up or shut up. And, if the trustee has made a mistake (nobody's perfect), the trustee is in a better position to rectify it now than after the mistake's effects have been compounded for many years.

- One Big Happy Family. Sure, everyone's happy now. But relationships can change overnight – a beneficiary gets divorced, has a business failure, becomes addicted to drugs, is struck by physical or mental illness that changes his or her outlook on life, undergoes other financial or emotional stress, or simply starts disliking the trustee. Provide notices now, while everyone is happy and unlikely to complain. Besides, the trustee generally should be keeping beneficiaries informed anyway. Notices now can prevent a big claim later if a blow-up occurs.

Generally, a trustee may use the trust's resources to provide notices, respond to questions, provide distributions to some beneficiaries to adjust for perceived unfairness in distributions to other beneficiaries, and defend lawsuits (so long as the trustee did not engage in bad faith or reckless indifference to the beneficiaries' interests).

Countervailing this recommendation are concerns about the effect of notices on the beneficiaries themselves. The trustee might be concerned that knowing that a pool of funds is available for a beneficiary might change the beneficiary's behavior – make the beneficiary more interested in draining the trust than earning a living, generate a sense of entitlement, or encourage the beneficiary to ask the grantor or the grantor's surviving spouse for money. The trustee will need to weigh those concerns against the trustee's legal exposure and general duties to provide information and might even decide that serving as trustee is too thankless a task. Better to think about these issues now and with eyes opened than to encounter a surprise.

Including Restructuring Businesses or Trusts Before Gifts or Other Transfers. Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> … the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

If somehow the consent does somehow consist of any power or right to enlarge or shift a beneficial interest, note that a principal/income allocation generally is only a few percent, and a beneficiary's failure to object to an accounting – if somehow characterized as a lapse of a general power of appointment - might very well be less than the 5% lapse of a general power of appointment that, under Code § 2514(e), does not constitute a gift. Having an annual report may keep the grievances within the 5% range. For more details on calculating the 5% lapse, see fn 5227 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

II.J.4.j.ii. Sample Notice

After this paragraph, the rest of this part II.J.4.j.ii is a shell of a notice I have used. The trustee should consult with the trustee's own legal counsel to determine the advisability and sufficiency of such a notice under the circumstances.

Re: Trustee's Notice re: [trust's name]

As you know, the [trust's name] (the "Trust") was created by the [name of trust agreement].

As a beneficiary of the Trust, and on behalf of any other current or future beneficiaries of the Trust, you have the right to request a copy of the [name of trust agreement] and to receive information about the Trust's investments and other activity.

[Disclose any related party transactions.]

The enclosed CD-ROM contains the following information for the Trust for the period of January 1, 20xx, through December 31, 20xx:

1. [any trust accounting regularly prepared]

2. [brokerage statements]: January 1, 20xx, through December 31, 20xx

3. 20xx Fiduciary Income Tax Return for the Trust

4. Investment policy for [brokerage account or for trust as a whole]

If you have any questions with respect to this letter and the information contained on the enclosed CD-ROM, or if you have any difficulty accessing the information, please contact me. If you want to make a claim that I, as trustee, have breached any duty with respect to the Trust, you have one (1) year from the last to occur of (i) the date on which you (or your representative) were sent a report that adequately disclosed the existence of potential claim for breach of trust, and (ii) the date you were informed of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.

Attached you will find an Acknowledgement confirming receipt of this information. Please sign and date the acknowledgement and return it via fax or email to my attention.

Thank you.

[closing]

[page break]

<u>ACKNOWLEDGEMENT</u>

On my behalf and on the behalf of any other current or future beneficiaries, I hereby acknowledge receipt of the Trustee's Notice to the beneficiaries of the [trust's name], which includes reports relating to the trust's activities for the period January 1, 20xx, through December 31, 20xx.

[signature line and date blank]

II.J.5. Mandatory Income Trusts

II.J.5.a. Issues Arising with Mandatory Income Trusts

For very important limitations on the use of the Code § 642(c) charitable deduction, see fns. 2135-2136 in part II.J.4.c Charitable Distributions.

Some of the interplay between entities and trusts is described in parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

Also consider what happens when a trust holds only illiquid business assets and the trust needs to pay the trustee fee. Generally, one-half of trustee fees and certain other administrative expenses is allocated to income and one-half to principal.[2208] Using the trust's income to pay trustee fees, etc. attributable to would be problematic. Consider:

- Draft into the trust agreement language flexible enough to opt out of this general rule.[2209]

- Consider exercising a power to adjust, reclassifying some of the entity's distributions from income to principal, if the income that the business generates after the adjustment fairly balances the interests of the income beneficiary and remaindermen.[2210]

- Consider that the trustee might not have any significant activities directly on behalf of the trust and might instead spend most of his or her time running the business entity. This would especially be true if the entity was formed to hold investment assets. Perhaps the business entity should pick up a large majority of the burden of compensating the trustee, so that the above two recommendations are more palatable?

- Have the entity make noncash distributions, which generally are treated as principal.[2211] The trust can then sell those assets and use the proceeds to pay trustee fees. Note that a distribution of property is a recognition event for corporations[2212] and might be a recognition event for partnerships,[2213] so consider distributing high basis assets (which the entity might need to purchase).

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[2214]

[2208] Section 501 of the Uniform Principal & Income Act.
[2209] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2311.
[2210] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2216.
[2211] Section 401(c)(1) of the Uniform Principal & Income Act.
[2212] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[2213] See part II.Q.8.b.i Distribution of Property by a Partnership.
[2214] See parts III.A.4.c.iv.(b) What the Trustee Must Do to Alter the Trust's Investments If the Trust Agreement Does Not Address the Issue and III.A.4.c.iv.(c) How to Minimize Disputes About What the Trustee Should Do.

II.J.5.b. Uniform Fiduciary Income & Principal Act (UFIPA)

II.J.5.b.i. General Ideas in UFIPA

A fiduciary determines trust accounting income by analyzing the character of the trust's receipts and disbursements, which are not necessarily tied to the trust's taxable income. This part II.J.5.b refers to trusts and trustees as a shorthand for any type of fiduciary arrangement (including an estate) or fiduciary (including a personal representative/executor; UFIPA (see below) section 103 determines the scope and section 102 provides definitions of "fiduciary" and "terms of the trust" refer to other trust-like arrangements (including life estates) to which this discussion applies.

At its July 2018 annual meeting, the Uniform Law Commission approved the Uniform Fiduciary Income & Principal Act (UFIPA). The drafting committee chair was Turney Berry; the "reporter" who drafted the results of the committee's decisions was Ron Aucutt; and, as an ACTEC observer, I had significant input into the process.

UFIPA re-wrote the Uniform Principal & Income Act ("UPIA" in this part II.J.5.b), the 2008 limited changes to which I served as the reporter.

In those states that adopt UFIPA/UPIA (the "Act" in this part II.J.5.b), the Act serves as rules that apply if and to the extent that the governing instrument does not provide different results ("default rules in this part II.J.5.b). UFIPA § 201(a) provides:[2215]

> In making an allocation or determination exercising discretion under this [act], a fiduciary shall:
>
> (1) act in good faith, based on what is fair and reasonable to all the beneficiaries;
>
> (2) administer a trust or estate impartially, except to the extent terms of the trust manifest an intent that the fiduciary shall or may favor one more beneficiaries;
>
> (3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in this [act]; and
>
> (4) administer the trust or estate in accordance with this [act], except to extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise.

Although the terms of a trust and UFIPA describe what happens under state law, the tax laws might not respect a provision that strays too far from traditional fiduciary accounting income (FAI) principles.[2216]

II.J.5.b.ii. Power to Adjust or Convert to/from a Unitrust

Mandatory income trusts can cause conflicts between the income beneficiary, who tends to want the trustee to invest to generate current income, and the remaindermen, who tend to want the trustee to invest to generate long-term growth in principal. However, investing for long-term

[2215] For UPIA's counterpart, see fn 2308 in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[2216] See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

growth may increase long-term income, so all parties may benefit from investing for growth – especially if the trustee can count some of this growth as income.

UFIPA recognizes this solution by providing a power to adjust (see part II.J.5.b.ii.(a)) or to convert to/from a unitrust (see part II.J.5.b.ii.(b) Unitrust).

II.J.5.b.ii.(a). Power to Adjust

The power to adjust authorizes the trustee to divide the trust's total realized return, meaning income and realized gains, between income and principal. For example, if a reasonable income distribution rate is 3% and the total realized return is 8%, but traditional income included in the total realized return is only 2%, then the trustee would exercise the power to adjust by allocating 3% of the total realized return, consisting of 2% traditional income distribution rate and 1% from the realized gains. In other words, capital gains comprising 1% of the total return would be reallocated from trust accounting principal to trust accounting income. If desirable, the trustee would then be able to include that reallocated 1% capital gain to distributable net income (DNI), so that the income beneficiary would pay tax at his or her rates, rather than the capital gain possibly being taxed to the trust at its perhaps higher rates. See parts II.J.8.c.i Capital Gain Allocated to Income Under State Law and II.J.3.a Who Is Best Taxed on Gross Income.

Under UPIA, a trustee may adjust between principal and income to the extent the trustee considers necessary if:[2217]

- The trustee invests and manages trust assets as a prudent investor,

- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and

- The trustee determines that the adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

The impartiality component recognizes that an income beneficiary would want the trustee to invest for income and the remaindermen want the trustee to invest for growth. A prudent investor would tend to invest for both income and growth and make fair distributions of total return to the income beneficiary. The power to adjust authorizes the trustee to invest for total return and allocate part of the growth component to the income beneficiary. If the trustee is actually distributing the capital gain to the income beneficiary as part of a fair sharing of the trust's total return, then it would seem fair to tax the income beneficiary on the capital gain that the income beneficiary receives. Depending on the overall situation, it might also be fair to include in that adjustment compensation for the taxes the income beneficiary pays on those capital gains.[2218] Often, the trustee couches the power to adjust in terms of a target percentage of the trust's value; however, the trustee might vary the target percentage as the trustee deems appropriate.

[2217] UPIA § 104(a).

[2218] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

UPIA prescribes a number of the factors the trustee should consider[2219] and circumstances that limit or prevent the exercise of this power.[2220] Illinois has a more concise power to adjust that is in some ways more flexible and in some ways less flexible than UPIA.[2221]

Under UPIA, because the adjustment must be necessary to fulfill the trustee's duty of impartiality between the beneficiaries, presumably the power to adjust would not apply when the same standards apply to the distribution of income and principal.

However, UFIPA § 203(a) requires only that the trustee determine that "the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially." Thus, UFIPA requires only that the power to adjust will be helpful, not necessary. UFIPA also clarifies that the trustee is not liable for failing to exercise the power[2222] and provides that the trustee is not liable for any decision regarding the power made in good faith.[2223] The fiduciary has wide latitude regarding the periods to which any such adjustment applies[2224] but is subject to reporting requirements.[2225]

In deciding whether and to what extent to exercise the power to adjust, a fiduciary must consider all factors the fiduciary considers relevant, including relevant factors in UFIPA § 201(e) and the application of UFIPA § 401(i),[2226] 408,[2227] or 413 (the latter being a general marital deduction savings clause).[2228]

[2219] UPIA § 104(b).

[2220] UPIA § 104(c).

[2221] 760 ILCS 15/3(b)(2) authorizes the trustee to use discretion in allocating receipts to income or principal:

> if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.

[2222] UFIPA § 203(b) provides:

> This section does not create a duty to exercise or consider the power to adjust under subsection (a) or to inform a beneficiary about the applicability of this section.

[2223] UFIPA § 203(c) provides:

> (c) A fiduciary that in good faith exercises or fails to exercise the power to adjust under subsection (a) is not liable to a person affected by the exercise or failure to exercise.

[2224] UFIPA § 203(j) provides:

> (j) The exercise of the power to adjust under subsection (a) in any accounting period may apply to the current period, the immediately preceding period, and one or more subsequent periods.

[2225] UFIPA § 203(k) requires a description of the exercise of the power to adjust to be:

> (1) included in a report, if any, sent to beneficiaries under [Uniform Trust Code Section 813(c)]; or
>
> (2) communicated at least annually to [the qualified beneficiaries determined under [Uniform Trust Code Section 103(13)], other than [the Attorney General]][all beneficiaries that receive or are entitled to receive income from the trust or would be entitled to receive a distribution of principal if the trust were terminated at the time the notice is sent, assuming no power of appointment is exercised].

[2226] UFIPA § 401(i) provides:

> If a fiduciary receives additional information about the application of this section to an entity distribution after the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under Section 203.

UFIPA 201(e) provides factors a fiduciary must consider in deciding whether to exercise the power to adjust under UFIPA § 203, convert an income trust to a unitrust under UFIPA § 303(a)(1), change the percentage or method used to calculate a unitrust amount under UFIPA § 303(a)(2), or convert a unitrust to an income trust under UFIPA § 303(a)(3), all of which are exercisable "if the fiduciary determines the exercise of the power will assist the fiduciary to administer the trust or estate impartially."[2229] UFIPA § 201(e) provides the following factors:

(1) the terms of the trust;

(2) the nature, distribution standards, and expected duration of the trust;

(3) the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7;

(4) the desirability of liquidity and regularity of income;

(5) the desirability of the preservation and appreciation of principal;

(6) the extent to which an asset is used or may be used by a beneficiary;

(7) the increase or decrease in the value of principal assets, reasonably determined by the fiduciary;

(8) whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal;

(9) the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods;

(10) the effect of current and reasonably expected economic conditions; and

---

[2227] UFIPA § 408 authorizes an independent fiduciary to ignore various insubstantial allocations to income (and allocate all to principal). Subsection (b) authorizes a fiduciary to presume an allocation is insubstantial if:

(1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; and

(2) the asset producing the receipt to be allocated has a fair market value less than 10 percent of the total fair market value of the assets owned or held by the fiduciary at the beginning of the accounting period.

In addition to restrictions on exercising this power found within UFIPA § 408, UFIPA § 203(e) restricts the exercise of the UFIPA § 408 power; see fn 2229 and accompanying text.

[2228] UFIPA § 413, "Marital Deduction Property Not Productive of Income," provides:

> If a trust received property for which a gift or estate tax marital deduction was allowed and the settlor's spouse holds a mandatory income interest in the trust, the spouse may require the trustee to make property productive of income, convert property to property productive of income within a reasonable time, or exercise the power to adjust under Section 203, to the extent the trust assets otherwise do not provide the spouse with sufficient income from or use of the trust assets to qualify for the deduction. The trustee may decide which action or combination of actions to take.

[2229] UFIPA § 201(d).

(11) the reasonably expected tax consequences of the exercise of the power.

A fiduciary may not exercise the power to adjust:[2230]

(1) if the adjustment or determination would reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries;

(2) if the adjustment or determination would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust;

(3) if the adjustment or determination would reduce an amount that is permanently set aside for a charitable purpose under the terms of the trust, unless both income and principal are set aside for the charitable purpose;

(4) if possessing or exercising the power would cause a person to be treated as the owner of all or part of the trust for federal income tax purposes;

(5) if possessing or exercising the power would cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes;

(6) if possessing or exercising the power would cause an individual to be treated as making a gift for federal gift tax purposes;

(7) if the fiduciary is not an independent person;[2231]

(8) if the trust is irrevocable and provides for income to be paid to the settlor and possessing or exercising the power would cause the adjusted principal or income to

[2230] UFIPA § 203(e), which also precludes determining that an allocation is insubstantial under UFIPA § 408.

[2231] [This footnote is not in UFIPA § 203(e)(7).] UFIPA § 102(10) defines an "independent person as a parson that is not:

(A) for a trust:
  (i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];
  (ii) a settlor of the trust; or
  (iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;
(B) for an estate, a beneficiary;
(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);
(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or
(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

be considered an available resource or available income under a public-benefit program; or

(9) if the trust is a unitrust under Article 3.

However, if (4), (5), (6), or (7) above applies to a fiduciary but do not limit a co-fiduciary, the co-fiduciary may exercise the power to adjust, unless the exercise of the power by the remaining co-fiduciary or co-fiduciaries is not permitted by the terms of a trust or applicable law.[2232] If there is no such co-fiduciary, the fiduciary may appoint such a co-fiduciary, which may be a special fiduciary with limited powers, and the appointed co-fiduciary may exercise the power to adjust, unless the appointment of a co-fiduciary or the exercise of the power by a co-fiduciary is not permitted by the terms of the trust or applicable law.[2233]

Furthermore, a fiduciary may release or delegate to a co-fiduciary[2234] the power to adjust if the fiduciary determines that possessing or exercising the power to adjust will or may cause a result described in (1) through (6) or (8) above; or deprive the trust of a tax benefit or impose a tax burden not described in (1) through (6) above.[2235]

For tax issues regarding the power to adjust, see part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

Terms of a trust which deny or limit the power to adjust between income and principal do not affect the application of UFIPA § 203, unless the terms of the trust expressly deny or limit the power to adjust.[2236]

II.J.5.b.ii.(b). Unitrust

UFIPA Article 3 provides for unitrusts. Part II.J.8.c.i.(c) Unitrust describes various tax issues relating to using unitrusts.

A "unitrust" is a trust for which net income is a unitrust amount.[2237] A "unitrust amount" means an amount computed by multiplying the trust's value by a determined percentage,[2238] the percentage being referred to as the "unitrust rate."[2239] Some tax laws prevent

[2232] UFIPA § 203(f)(1).
[2233] UFIPA § 203(f)(2).
[2234] UFIPA § 203(h) provides that such a release or delegation to a co-fiduciary of the power to adjust:
(1) must be in a record;
(2) applies to the entire power to adjust under subsection (a), unless the release or delegation in the record provides a limitation, which may be a limitation to the power to adjust:
(A) from income to principal;
(B) from principal to income;
(C) for specified property; or
(D) in specified circumstances;
(3) for a delegation, may be modified by a re-delegation under this subsection by the co-fiduciary to which the delegation is made; and
(4) subject to paragraph (3), is permanent, unless the release or delegation in the record provides a specified period, including a period measured by the life of an individual or the lives of more than one individual.
[2235] UFIPA § 203(g).
[2236] UFIPA § 203(i).

The terms of a trust may provide that income must or may be calculated as a unitrust amount, in which case the trust is an "express unitrust."[2240] Otherwise, a fiduciary may convert an income trust to a unitrust if the fiduciary adopts a unitrust policy.[2241] A fiduciary may modify a unitrust policy[2242] or even convert a unitrust back to a trust that is not unitrust.[2243] In changing to or from or modifying a unitrust, a fiduciary must follow certain procedures and determine "that the action will assist the fiduciary to administer a trust impartially."[2244]

A fiduciary has no duty to take or consider any of these actions or to inform a beneficiary about the possibility of taking any of these actions.[2245] Furthermore, a fiduciary that in good faith takes or fails to take an action described above is not liable to a person affected by the action or inaction.[2246]

Of course,[2247] the terms of the trust may regulate or prohibit any of the above actions.[2248]

A unitrust policy must provide:

(1) the unitrust rate or the method for determining the unitrust rate,[2249]

(2) the method for determining the applicable value,[2250] and

(3) the application of certain mandatory or permissive rules.[2251]

A unitrust policy may:[2252]

[2237] UFIPA § 301(5).
[2238] UFIPA § 301(6).
[2239] UFIPA § 301(8).
[2240] UFIPA § 301(2).
[2241] UFIPA § 303(a)(1).
[2242] UFIPA § 303(a)(2).
[2243] UFIPA § 303(a)(3), which refers to an "income trust," which UFIPA § 301(3) defines as "a trust that is not a unitrust."
[2244] UFIPA § 303(b).
[2245] UFIPA § 302(e).
[2246] UFIPA § 302(f).
[2247] UFIPA § 201(a)(3) provides that a fiduciary shall "(3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in [UFIPA]." Furthermore, UFIPA § 201(a)(4) requires a fiduciary to "administer the trust or estate in accordance with [UFIPA], except to the extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise."
[2248] UFIPA § 302(a) provides that, except as provided in subsection (b), UFIPA Article 3 applies to:

(1) an income trust, unless the terms of the trust expressly prohibit use of this [article] by a specific reference to this [article] or an explicit expression of intent that net income not be calculated as a unitrust amount; and
(2) an express unitrust, except to the extent the terms of the trust explicitly:
    (A) prohibit use of this [article] by a specific reference to this [article];
    (B) prohibit conversion to an income trust; or
    (C) limit changes to the method of calculating the unitrust amount.

[2249] UFIPA § 305(b)(1), referring to UFIPA § 306.
[2250] UFIPA § 305(b)(1), referring to UFIPA § 307.
[2251] UFIPA § 305(b)(3), referring to UFIPA §§ 306-309, including mandatory rules under UFIPA §§ 307(a) and 308(a) and optional rules to the extent the fiduciary adopts them, referring to UFIPA §§ 306, 307(b), 308(b), and 309(a).

(1) provide methods and standards for:

   (A) determining the timing of distributions;

   (B) making distributions in cash or in kind or partly in cash and partly in kind; or

   (C) correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;

(2) specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or

(3) provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

UFIPA Article 3 does not apply to a trust described in Code § 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3)(A)(ii) or (iii), or 2702(b).[2253] Also, if a trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%, as well as other requirements.[2254] A "special tax benefit" includes the gift tax annual exclusion because the trust's income interest qualifies as a present interest in property;[2255] the trust is or was a QSST;[2256] a marital deduction trust;[2257] or a trust grandfathered from GST or a trust with an inclusion ratio less than one, in either case if needed to avoid possible GST tax.[2258] Whether a fiduciary in independent generally is based on whether that person is a settlor or a beneficiary or is related to either.[2259]

[2252] UFIPA § 309(a).
[2253] UFIPA § 302(b).
[2254] UFIPA § 309(b).
[2255] UFIPA § 102(18)(A), referring to Code § 2503(b).
[2256] UFIPA § 102(18)(B). See part III.A.3.e.i QSSTs.
[2257] UFIPA § 102(18)(C), referring to an estate or gift tax marital deduction under Code § 2056 or 2523 for a transfer to a trust, which deduction depends or depended in whole or in part on the right of the settlor's spouse to receive the trust's net income.
[2258] UFIPA § 102(18)(D), (E).
[2259] UFIPA § 102(10) provides that an "independent person" is a person who is not:
(A) for a trust:
   (i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];
   (ii) a settlor of the trust; or
   (iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;
(B) for an estate, a beneficiary;
(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);
(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or
(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

II.J.5.b.ii.(c). Comparing Power to Adjust to a Unitrust

Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally. Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries.

However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate.

Computing this average adds to the trustee's recordkeeping burden, although the calculation itself might or might not be simple. For a trust holding marketable securities, the calculation might not take very long. On the other hand, for a trust with closely-held business interests or real estate, the calculation might impose additional costs on the trust; in such a case, one might draft a trust applying the unitrust only to easy-to-value assets and using either more traditional principal and income concepts or the power to adjust for difficult-to-value assets.

Providing a fixed unitrust percentage allows the trustee to avoid fights with the income beneficiary and remaindermen over what percentage to use. However, it also can cause the trust to sell assets in a down year. For example, if the trust provides a 3% unitrust and interest and dividends are 2%, the trustee needs to raise the 1% difference by selling assets. That's fine when asset values increase, but it can cause the trust to be depleted if trust values have not increased, especially if the trust has several down years. Using a power to adjust, the trustee might distribute only interest and dividends in down years and distribute capital gains in up years, perhaps making extra distributions in up years to make up for decreased distributions in down years. The problem is that the income beneficiary might rely on a particular level of distributions, and distributing less in a down year might not be acceptable. Using a unitrust based on an average of the past few years' value would help smooth fluctuations, giving the beneficiary time to adjust spending habits when notified that values are down but that the decrease will be spread over time. When assets appreciate, the trustee might consider taking some of those gains and reserving them for down years, so that a unitrust will not have to sell assets in a down market.

Satisfying a unitrust with appreciated assets appears to be a deemed sale of those assets.[2260]

The first time a unitrust payment includes amounts in excess of trust accounting income, whether or not satisfied with appreciated assets, the trustee must make an irrevocable election to treat that excess (to the extent required to satisfy the unitrust obligation) - in the current and all future years - as included in or excluded from DNI.[2261]

However, the trustee may each year separately elect to treat any distribution of capital gain pursuant to a power to adjust as included in or excluded from DNI.[2262]

Thus, to maximize income tax flexibility, I tend to prefer the power to adjust over a unitrust.

[2260] See part II.J.8.d.i Distribution in Kind - Generally, especially fns 2331-2332.

[2261] See part II.J.8.c.i.(c) Unitrust, found in part II.J.8.c.i Capital Gain Allocated to Income Under State Law.

[2262] See part II.J.8.c.i.(a) Power to Adjust, found in part II.J.8.c.i Capital Gain Allocated to Income Under State Law.

II.J.6. Income Allocation on Death of a Beneficiary

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for the beneficiary's last taxable year or in the gross income of the beneficiary's estate is determined by the computations under Code § 652 for the taxable year of the trust in which his last taxable year ends.[2263] Consider whether income should be expressly payable or not payable to the beneficiary's estate.

If an amount is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under Code § 662 for the taxable year of the estate or trust in which his last taxable year ends.[2264]

Both of these rules are subject to part II.J.9.a Separate Share Rule.

II.J.7. Code § 645 Election to Treat a Revocable Trust as an Estate

An election under Code § 645, filing IRS Form 8855, causes a qualified revocable trust[2265] to be taxed as part of an estate. The form is due by the time of the first income tax return filed for the

---

[2263] Reg. § 1.652(c)-2, which further provides:

> Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

[2264] Reg. § 1.662(c)-2, which further provides:

> Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

[2265] "Qualified revocable trust" means any trust treated under Code § 676 as owned by the decedent by reason of a power in the grantor, determined without regard to Code § 672(e). Code § 645(b)(1).

grantor's estate (or grantor's revocable trust, if no probate estate exists);[2266] there appears to be no relief for failing to meet that deadline, because the deadline is statutory.[2267]

An estate may elect to use a fiscal year,[2268] which can help shift income to the most suitable year, if the additional work in reconciling calendar year Forms 1099 can be justified. It appears that an estate may elect a fiscal year on a late-filed return,[2269] an estate with a Code § 645 election requires a timely filing.[2270]

[2266] Code § 645(c) provides a deadline of "not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions)."

[2267] Letter Ruling 201314011 granted relief for late filing of Form 8939, which was due with the estate's first income tax return. The ruling noted:

> Estate did not make an effective election under § 645 to treat Trust as part of the estate However, Estate's first Form 1041, US Income Tax Return for Estates and Trusts, reported all of the income of Estate and Trust as if Estate had made an effective election under § 645, and set a fiscal tax year ending Date.

In granting the relief for late filing of Form 8939, the ruling held:

> This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645. This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645.

[2268] Code § 441 generally allows the taxpayer to choose its taxable year, subject to certain limitations. Code § 644 requires trusts to use the calendar year, but estates are not so required.

[2269] Reg. § 1.441-1(c)(1) provides:

> *In general*. Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (*e.g.*, Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return"), the filing of an application for an employer identification number (*i.e.*, Form SS-4, "Application for Employer Identification Number"), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

Although Reg. § 1.441-1(c)(2) provides exceptions, the only one of concern is that the taxpayer must keep books. Reg. § 1.441-1(c)(2)(ii) provides:

> *Taxpayers without books*. A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

[2270] Reg. § 1.645-1(c)(2)(i) provides:

> *Time and manner for filing the election*. If there is no executor for a related estate, an election to treat one or more QRTs of the decedent as an estate for purposes of subtitle A of the Internal Revenue Code is made by the trustees of each QRT joining in the election, by filing a properly completed election form, or in any other manner prescribed after December 24, 2002 by forms provided by the IRS, or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the trust, taking into account the trustee's election to treat the trust as an estate under section 645 (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time

Among benefits are an unlimited charitable set-aside (which is not always beneficial)[2271] and UBTI not reducing the charitable deduction,[2272] deducting losses on funding pecuniary bequests, more favorable time deadlines for holding or making elections with respect to stock in an S corporation, and being able to deduct losses from certain active real estate rental.[2273] However, beware state income results – it might be easier for a state to claim jurisdiction over an estate than a trust, so making the Code § 645 election might convert a nonresident trust to a resident estate;[2274] note that this result might be better if the trust would be taxed in a high-tax state and the estate taxed in a low-or-no-tax state. Also, if the trust owns stock in an S corporation that makes material charitable contributions, an ESBT election may facilitate deducting the charitable contribution deduction.[2275]

This treatment expires on the "applicable date." If no estate tax return is required to be filed, the "applicable date" is two years after the date of the decedent's death;[2276] otherwise, it is six months after the date of the final determination of estate tax liability.[2277] Final determination of estate tax liability is the earliest of the following:[2278]

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

---

prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041.

[2271] Code § 642(c)(1) and the regulations thereunder allow trusts to deduct gross income paid to charity during the taxable year and the following taxable year. Code § 642(c)(2) and the regulations thereunder (as well as Reg. § 1.645-1(e)(2)(i) and(e)(3)(i)) authorize estates to deduct gross income permanently set aside; however, contingent claims, regardless of size, might disallow the entire set-aside deduction. *Belmont v. Commissioner*, 144 T.C. No. 6 (2015). Reg. § 1.642(c)-2(d) provides, "No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." *Estate of John D. DiMarco v. Commissioner*, T.C. Memo. 2015-184, citing *Belmont*, concerned with the uncertainty of administrative expenses in light of litigation, disallowed the charitable set-aside, holding, "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

[2272] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 4122.

[2273] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 2656.

[2274] See part II.J.3.e.i Residence Generally. For example, RSMo § 143.331 (http://www.moga.mo.gov/mostatutes/stathtml/14300003311.html) treats an estate as a resident merely if the decedent was domiciled in Missouri, whereas a trust is not a resident unless not only was the settlor a resident but also the trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

[2275] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, fn 4102 and the text preceding it.

[2276] Code § 645(b)(2)(A).

[2277] Code § 645(b)(2)(B).

[2278] Reg. § 1.645-1(f)(2)(ii).

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

The IRS might not issue a closing letter until the estate requests one, thereby extending the time that a Code § 645 might continue to apply under (A) above.[2279]

After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the Code § 6166 election.[2280]

Reg. § 601.6109-1(a)(4), "Taxpayer identification number to be used by a trust upon termination of a section 645 election," provides:[2281]

[2279] See fn. 6109, found in part III.B.5.d.iv.(g).

[2280] Reg. § 1.645-1(f)(2)(ii). Jonathan Blattmachr suggested this idea. Note that Rev. Rul. 76-23 held that, "where the sole purpose for retaining stock of a small business corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under section 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged for purposes of section 641(a)(3), and thus the estate will continue to be an eligible shareholder within the meaning of section 1371(a) for the period during which the estate complies with the provisions of section 6166." Contrast this to an estate, for which Reg. § 1.641(b)-3(a) discusses whether administration is unduly prolonged:

> The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

[2281] Reg. § 301.6109-1(a)(5), "Persons treated as payors," provides:

> For purposes of paragraphs (a)(2), (3), and (4) of this section, a payor is a person described in § 1.671-4(b)(4) of this chapter.

(i) *If there is an executor*. Upon the termination of the section 645 election period, if there is an executor, the trustee of the former electing trust may need to obtain a taxpayer identification number. If § 1.645-1(g) of this chapter regarding the appointment of an executor after a section 645 election is made applies to the electing trust, the electing trust must obtain a new TIN upon termination of the election period. See the instructions to the Form 1041 for whether a new taxpayer identification number is required for other former electing trusts.

(ii) *If there is no executor*. Upon termination of the section 645 election period, if there is no executor, the trustee of the former electing trust must obtain a new taxpayer identification number.

(iii) *Requirement to provide taxpayer identification number to payors*. If the trustee is required to obtain a new taxpayer identification number for a former electing trust pursuant to this paragraph (a)(4), or pursuant to the instructions to the Form 1041, the trustee must furnish all payors of the trust with a completed Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury by the trustee providing each payor with the name of the trust, the new taxpayer identification number, and the address of the trustee.

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[2282]

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[2283]

Code § 643(a)(3) provides:[2284]

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust,[2285] the gains must:

Reg. § 1.671-4(b)(4) is found in part III.B.2.e.i Grantor Trust Treatment During the Grantor's Life.

[2282] Reg. § 1.643(a)-3(e), Example (14).

[2283] Code § 643(a) provides:

> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[2284] Code § 643(a)(3) further provides:

> Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[2286]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset.[2287] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[2288] Whether other real estate is a capital asset depends on various facts.[2289]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[2290] to the extent it does not constitute certain depreciation recapture.[2291] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[2292] Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

[2285] Code § 643(a)(6)(C) provides:

> Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

[2286] Code § 643(a)(3); Reg. § 1.643(a)-3(a).

[2287] Code § 1221(2).

[2288] Section 401(c)(1) of the Uniform Principal & Income Act.

[2289] See part II.G.13 Future Development of Real Estate, especially fn. 1320.

[2290] Code § 1231(a)(3)(A)(i). See part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.

[2291] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 1243. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 1244. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015). In October 2016, the IRS made major revisions to its Cost Segregation Audit Techniques Guide, found at https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents.

[2292] Letter Ruling 200243002. For more discussion of goodwill, see fns. 1665, 3476, and 3515 (especially the latter).

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal.[2293] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[2294]

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

[2293] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.

[2294] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading would be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[2295] are excluded from distributable net income (DNI).[2296]

[2295] Reg. § 1.643(a)-3(d) provides:

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[2296] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note that (b)(1) relates to determining whether capital gain has been allocated to income for state law purposes, and (b)(2) and (b)(3) relate to distributing capital gains that have been allocated to corpus.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[2297]

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act,[2298] which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b

---

Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

[2297] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:
>
> (1) Allocated to income under the terms of the governing instrument or local law by the generates fiduciary on its books or by notice to the beneficiary,
>
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
>
> (3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.
>
> However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2298] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[2299]

Generally, the Act allocates capital gains to principal.[2300] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[2301] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See part II.J.5.b.ii.(a) Power to Adjust.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[2302] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "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 … 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." This specific provision supplements any power to adjust that might generally apply.[2303]

---

amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.c.i Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[2299] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

[2300] Act § 401.

[2301] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).

[2302] See part III.A.4 Trust Accounting Income Regarding Business Interests.

[2303] See part II.J.8.c.i.(a) Power to Adjust.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets for important tactical issues in implementing these ideas.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[2304] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[2305] The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.c.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

[2304] Part II.J.8.c.i.(a) Power to Adjust.

[2305] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[2306]

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[2307]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[2308] The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.[2309]

[2306] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

> State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

[2307] Act § 103(a).

[2308] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing

However, Reg. § 1.643(b)-1[2310] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

The regulation respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to

---

> 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 allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[2309] Section 103(a) of UPIA provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

For UFIPA's counterpart, UFIPA § 201(a), see text preceding the text accompanying fn 2216 in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

[2310] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

> administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[2311]

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[2312] That language comes from

---

[2311] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

[2312] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 2451.

the marital deduction regulations.[2313] Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status,[2314] does not constitute a power of appointment,[2315] and does not have generation-skipping transfer tax implications.[2316] The

---

[2313] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income*. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

[2314] Code § 674(b)(8); Reg. § 1.674(a)-1(b)(1)(iv).

[2315] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

See fn. 2115 for additional authority on ascertainable standards.

Letter Ruling 8908032 recognized that Reg. §§ 20.2041-1(b)(1) generally prevents administrative powers from creating a general power of appointment:

> …. Although the amount of income that A may receive each year is generally limited, the trust provides that any income from real estate must be distributed first and that all the income from real estate be distributed to A even if such distribution exceeds the annual limitation. Thus, if the trust had substantial income from real estate, it is possible for A to receive distributions in excess of the annual limitation imposed by the trust.

trustee might want to consider providing accountings or other notices to the beneficiaries that

---

Where the holder of a power is not completely free from legal control or restraint in the disposition of property, a power held by the holder would not be a general power of appointment. Such legal control or restraint exists when the holder is legally accountable for its exercise. fiduciary duties imposed by local law are always subject to the control of the courts and the holder is always under a legal duty to account. See *Security-Peoples Trust Company v. United States*, 238 F.Supp. 40 (W.D. Pa. 1965). The initial step in determining whether a decedent has a general power of appointment is to determine, in light of local law, the interest conveyed to the decedent under trust; *i.e.*, the extent to which consonant with testamentary trust provisions, the decedent could invade and consume the principal. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).

It is necessary to look to the law of State X to determine whether A has the power to alter the beneficial interest under the trust. If A appointed herself trustee, A, as the trustee, would have the authority under the trust to sell trust assets and to invest the proceeds in real estate. Thus, A could cause trust income from real estate to exceed the limitation set forth in the trust for income distributions from other sources and, consequently, increase the total income distributions to A. Such investment policy and actions by A as the trustee would result in a shift of the beneficial interest of the trust. However, A would not have complete freedom to set investment policy for the trust. The statutory law of State X requires that a trustee consider the relative interests of both income and remainder beneficiaries in determining the prudence of any investment and imposes a duty on the trustee to administer the trust with due regard to the respective interests of income beneficiaries and remainderpersons in accordance with the terms of the trust. In addition, the highest court in State X has addressed the responsibilities of the trustee and stated that:

> It is the duty of the trustees to preserve the corpus of the trust for the remaindermen and to secure the usual rate of income upon safe investments for the life tenant, and to use a sound discretion in reference to each of those objectives. They cannot postpone the yielding of income for the increase of capital, nor select a wasting or hazardous investment for the sake of greater present income.

Congdon v. Congdon, 160 Minn. 343, 200 N.W. 76 (1924).

Moreover, *In re Clarke's Will*, 204 Minn. 574, 284 N.W. 876 (1939), addressed a situation where the trustee, who was also the income beneficiary, treated trust property incorrectly as "income" rather than "capital" and made erroneous distributions to herself. The court held that the trustee-income beneficiary had a duty to distinguish between the rights of the life tenant and those of the remaindermen with meticulous care. The court found that, although there had been no intentional wrong, there was an invasion of the rights of the remaindermen by the trustee-income beneficiary that amounted to fraud, irrespective of intention.

The law of State X clearly imposes a strong fiduciary duty on a trustee to protect the interests of all beneficiaries of the trust. While A, as the trustee, may invest trust assets in real estate that may produce sufficient income resulting in an increase in distributions to A, A cannot adopt an investment policy that would be detrimental to the interests of the remaindermen. Neither Trust 1 nor Trust 2 gives A, as the income beneficiary, any control over investment policy or income withdrawal. Due to the restrictions imposed by both the law of State X and the trust instruments, A does not have an unfettered right to change the interests of the beneficiaries.

Accordingly, A's power to remove the current trustee and appoint anyone, including A, as the trustee is not a general power of appointment as described in section 2041 of the Code.

[2316] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

> … administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[2317]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[2318]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

II.J.8.c.ii. Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year.

[2317] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.
[2318] See fn. 2345.

During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example (3). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. <u>The beneficiary's need for distributions in excess of income is sporadic</u>. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[2319] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[2320] For example, any distribution made on or before March 6, 2018 can be treated as a 2017 or 2018 distribution.[2321] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under

---

[2319] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

[2320] Code § 663(b).

[2321] In a leap year, the deadline is March 5; in other years, the deadline in March 6.

Reg. §§ 1.643(a)-1 through 1.643(a)-7.[2322] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[2323]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus.[2324] The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(3), Reg. § 1.643(a)-3(b)(2) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[2325]

[2322] Reg. § 1.663(b)-1(a)(2)(i).

[2323] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).

[2324] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 5708. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

[2325] Code § 643(e)(2).

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

II.J.8.c.iv. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.v. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.v. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind; Specific Bequests

II.J.8.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI[2326] or constitutes a bequest of income,[2327] a distribution is a nontaxable gift[2328] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[2329]

When a trust distributes property to satisfy a pecuniary obligation, the trust recognizes gain on the deemed sale,[2330] even if the trust's residue is less than the pecuniary obligation.[2331] This

---

[2326] Reg. § 1.102-1(d).

[2327] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).

[2328] Reg. § 1.102-1(a), (d).

[2329] See part III.B.1.c Gifts with Consideration – Bargain Sales.

[2330] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Reg. § 1.651(a)-2(d) provides:

> If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

[2331] Rev. Rul. 66-207 included the following facts and conclusion:

> By the terms of the decedent's will he made a bequest of a specific sum of money in the amount of 250x dollars to be used to create a trust for the benefit of a designated beneficiary. After

rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary,[2332] and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied.[2333]

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received

---

> payment of all debts, costs of administration, claims, and specific bequests, other than the sum of 250x dollars, the executor finds that all he has left in the estate are assets now having a fair market value of 200x dollars and an aggregate basis to the estate of 150x dollars. Included among these assets is cash in the amount of 10x dollars. All of these assets will be transferred in trust to the designated trustee in accordance with the terms of the will….
>
> Section 1.661(a)-2(f) of the regulations provides, in part, that no gain or loss is realized by the trust or estate by reason of the distribution of property in kind unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount. Under this provision of the regulations whenever property other than money is distributed by an estate to any beneficiary, including a trust, in satisfaction of a cash bequest the estate realizes gain or loss measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property so distributed. See *William R. Kenan, Jr., et al. v. Commissioner*, 114 F.2d 217 (1940); and *Sarah P. Suisman v. Eaton*, 15 F.Supp. 113 (1935), *affirmed per curiam*, 83 F.2d 1019, *certiorari denied*, 299 U.S 573.
>
> When the executor of this estate distributes the property remaining in the estate to the designated trustee in creation of the trust the estate will realize a gain of 50x dollars. This is the difference between the amount of the bequest satisfied by distribution of property other than cash (200x dollars less 10x dollars cash, or 190x dollars) and the basis (150x dollars less 10x dollars cash or 140x dollars) to the estate of the assets other than cash distributed in satisfaction of the bequest of a specific sum of money. The effect of the distribution will be the same as if the executor sold the remaining assets of the estate and distributed the proceeds to the trustee in trust.
>
> No amount is deductible by the estate under section 661 of the Code or includible in gross income of the trust under section 662 of the Code since the distribution will be in satisfaction of a bequest of a specific sum of money, as defined by section 1.663(a)-1(b) of the regulations.
>
> Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest.

[2332] Rev. Rul. 83-75, citing *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940), reasoned:

> The trustee was obligated to pay a fixed annuity to qualified charitable organizations. Under the principles of section 1.661(a)-2(f)(1) of the regulations and the case law cited, the distribution of appreciated securities causes the trust to realize gain or loss if the distribution satisfies a right to receive a distribution in a specific dollar amount. Although the trustee has authority to pay the annuity to qualified charities of the trustee's choice, the distribution satisfies a right to receive a specified dollar amount. It is not necessary or practical to identify a particular qualified charity with the right to receive a specified dollar amount. In *Kenan*, the court stated that the word "exchange" does not necessarily have the connotation of a bilateral agreement which may be said to attach to the word "sale". Thus, the distribution in this case is an exchange even though the trustee consulted with no one before satisfying the obligation to pay the annuity by using the appreciated securities.

Rev. Rul. 83-75 held:

> The distribution by the trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable organization is a sale or exchange of the securities that results in taxable gain to the trust.

[2333] Rev. Rul. 68-392, which went through the rules that existed at that time regarding including capital gain in DNI and concluded that they did not apply. However, since then, the regulations have changed, so a different result may occur; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

a pro rata distribution and exchanged it with the other beneficiaries.[2334] Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; [2335] for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales,[2336] but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate)[2337] satisfying a pecuniary bequest.[2338] The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value,[2339] unless gain was recognized, in which case it is the property's value.[2340]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.[2341]

[2334] Rev. Rul. 69-486. See Zaritsky, Lane & Danforth, ¶2.19. Gain on the Division, Termination, or Reformation of a Trust, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2335] Rev. Rul. 69-486. Reg. § 1.1015-2(a) provides:

> (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.
>
> (2) The principles stated in paragraph (b) of §1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

[2336] Code § 643(e)(3).

[2337] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[2338] Code § 267, especially subsections (a)(1), (b)(6) and (b)(13).

[2339] Code § 643(e)(2).

[2340] Code § 643(e)(3).

[2341] Reg. § 1.663(a)-1(a), which provides further:

> Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for

II.J.8.e. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time.[2342] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[2343]

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act,[2344] consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[2345]

> its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

[2342] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation.

[2343] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

[2344] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[2346] Only the following distributions from an entity are not considered trust accounting income:[2347]

- property other than money;
- 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;
- money received in total or partial liquidation of the entity; and
- 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.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[2348] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division.[2349] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[2350]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[2351] Furthermore, interrelated calculations might be required for a mandatory income

amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

2345 In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.

2346 Act § 401(b).

2347 Act § 401(c).

2348 See part II.M.3.b Exception: Diversification of Investment Risk.

2349 See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.

2350 Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 4471.

2351 See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.

trust.[2352] Generally, we should look to see whether planning under part II.J.8.c.i Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[2353] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[2354]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[2355] Such indirect

---

[2352] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.D.2 Trust Accounting and Taxation.
[2353] Reg. § 1.652(b)-3(a).
[2354] Reg. § 1.652(b)-3(d).
[2355] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[2356] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income.[2357] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 1912-1913).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[2358]

An expense allocated to tax-exempt income and therefore disallowed for income tax purposes may be deductible for estate tax purposes. Rev. Rul. 59-32, which Rev. Rul. 63-27 clarifies as showing just one among the acceptable methods of such a calculation.

[2356] Reg. § 1.652(b)-3(c).

[2357] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2358] Reg. § 1.642(c)-3(b)(2) provides:

> *Determination of the character of an amount deductible under section 642(c)*. In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:
>
> Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.
>
> Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

- Special rules apply to depreciation deductions.[2359]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[2360]

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[2361] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[2362]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[2363] it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and

---

Reg. § 1.643(a)-5(b) provides:

> If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of § 1.662(b)-2 and § 1.662(c)-4(e).

[2359] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2360] Code § 661(b).

[2361] Reg. § 1.661(b)-1.

[2362] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[2363] See fn. 2358.

which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[2364]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands[2365] (which, among other things, is important for net investment income tax purposes).[2366]

[2364] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 2358, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

[2365] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[2367]

When allocating among beneficiaries:[2368]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

> determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[2366] See fn. 1932, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[2367] Reg. § 1.662(b)-1, which is quoted in fully in fn. 2365. Furthermore, Reg. § 1.652(b)-2(a) provides:

> The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

[2368] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

> (1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.
>
> (2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.
>
> (3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.