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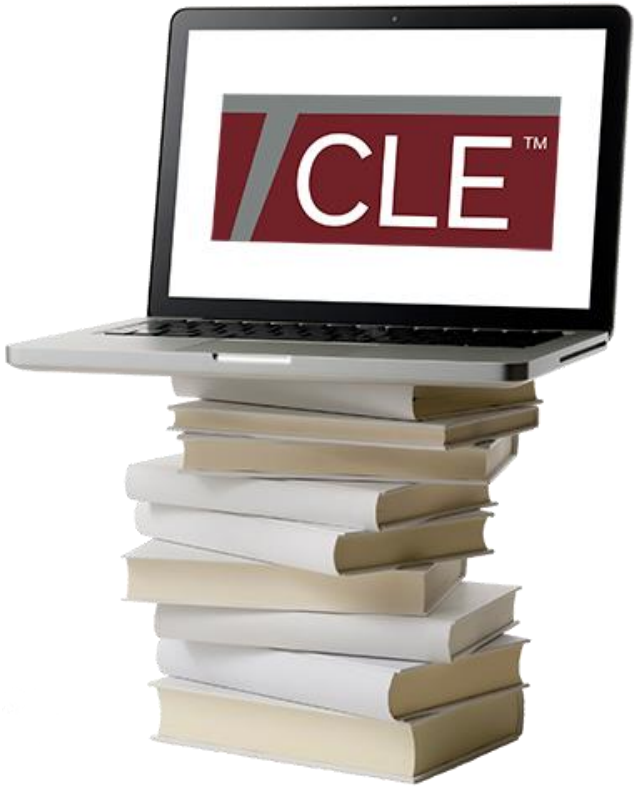
Final Regulations and Other Recent Guidance under Code § 199A; Life Insurance Income Tax Developments

Steve Gorin
sgorin@thompsoncoburn.com
314.552.6151
http://thompsoncoburn.com/people/steve-gorin
http://thompsoncoburn.com/insights/blogs/business-succession-solutions



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Overview

- Life insurance income tax issues, including proposed regulations under the transfer-for-value rules and a case involving the treatment of compensatory split-dollar arrangements
- 2019 final regulations (changing and finalizing 2018 proposed regulations), 2019 proposed regulations, and other official guidance regarding the 20% deduction for qualified business income from pass-through entities, as well as regulations attacking multiple trusts created to avoid federal income tax

Proposed Regulations Under the Transfer-for-Value Rules (II.Q.4.b.ii.)

Reportable Policy Sale - Definition

- "The acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract"
- "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."
- Proposed regulations describe substantial family, business, or financial relationships

Proposed Regulations Under the Transfer-for-Value Rules (II.Q.4.b.ii.)

Reportable Policy Sale - Consequences

- The exceptions to the transfer for value rule under Code § 101(a)(2)(A) or (B) do not apply
- Thus, the death benefit may be taxable, in that the amount excluded from gross income cannot exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee
- Various reporting requirements apply when the death benefit is paid

Impact Beyond Reportable Policy Sales (II.Q.4.b.ii.)

- Proposed regulations seemed to make the substituted basis rule not suffice when not a reportable policy sale, but an example in the proposed regulations seems to clarify that a policy that is not already tainted by the transfer-for-value rules will continue to receive favorable treatment when transferred in a substituted basis transaction (II.Q.4.b.ii.(c))
- Proposed regulations will fully cleanse only a policy that has not been transferred in a reportable sale and that cleansing applies only if the insured buys the policy for its fair market value (II.Q.4.b.ii.(e))

Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22 (II.Q.4.f.ii.(b))

- Sixth Circuit: economic benefits under even compensatory split-dollar agreements to be treated as distributions and not compensation income to an employee-shareholder
- For an S corporation, should not violate second class of stock rules, but should clean up (II.A.2.i)

Code § 199A Deduction for Qualified Business Income (II.E.1.c.)

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- Repealed Code § 199 deduction for domestic production activities
- Taxable years beginning after December 31, 2017 but not beginning after December 31, 2025
- Applies to an individual or trust that owns a partnership interest, S corporation stock, or a sole proprietorship (passthrough entity)
- Deduction up to 20% of qualified business income (QBI)
- Deduction limited to 20% of taxable income that is taxed as ordinary income
- Income tax but not NII tax or SE Tax (II.E.1.c.i.(a))
- Causes underpayment penalty to apply at 5% instead of 10% understatement

Code § 199A Deduction for Qualified Business Income (II.E.1.c.)

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- 2018 proposed regulations, preamble, and public comments are at https://www.federalregister.gov/documents/2018/08/16/2018-17276/qualified-business-income-deduction.
- The Final Regulations and preamble are found at https://www.federalregister.gov/documents/2019/02/08/2019-01025/qualified-business-income-deduction.
- 2019 proposed regulations, preamble, and public comments are at https://www.federalregister.gov/documents/2019/02/08/2019-01023/qualified-business-income-deduction. Comments are due April 9, 2019.
- Rev. Proc. 2019-11, Determination of W-2 Wages
- Notice 2019-07, Section 199A Trade or Business Safe Harbor: Rental Real Estate
- ACTEC comments on proposed regulations under Sections 199A and 643(f) (September 27, 2018)

Calculation of Deduction Generally

(II.E.1.c.v.)

- (A) the sum of certain qualified business income (QBI)-related amounts for each qualified trade or business the taxpayer carries on, plus
- (B) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.
- Focus on (A)
- May be reduced (perhaps to zero) when taxable income includes capital gains

QBI-related amount (II.E.1.c.v.)

For each separate trade or business, the lesser of:

- 20% of the taxpayer's QBI with respect to the qualified trade or business, or
- the wage and UBIA limitations

The wage and UBIA limitations do not apply when taxable income (before the Code § 199A deduction) is below certain thresholds (II.E.1.c.v.(b).).

Losses from a qualified trade or business carry to the following year to reduce the deduction

Taxable Income Thresholds

(II.E.1.c.v.(a))

- $315,000-$415,000 for married filing jointly 2018 ($321,400 bottom of $100,000 range for 2019)
- $157,500-$207,500 for all other taxpayers, including trusts for 2018 ($160,725 for married filing separately and $160,700 for others for 2019, both being bottom of $50,000 range)
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply (both concepts described below)
- Benefits phase out over that range
- Phase-outs apply cumulatively

Wage Limitation (II.E.1.c.vi.)

For each separate trade or business, the greater of:

- 50% of the W–2 wages with respect to the qualified trade or business, or
- the sum of:
  - 25% of the W–2 wages with respect to the qualified trade or business, plus
  - 2.5 percent of the unadjusted basis immediately after acquisition (UBIA) of all qualified property

Wage Limitation (II.E.1.c.vi.(a))

W-2 wages:

- Wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans
- Must relate to qualified business income
- 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

Regulations provide relief for leasing employees; however, using an independent contractor still does not help

Rev. Proc. 2019-11 implements the regulations

Qualified Property (II.E.1.c.vi.(b))

Depreciable property:

- held by, and available for use in, the qualified trade or business at the close of the taxable year
- used at any point during the taxable year in the production of qualified business income
- the depreciable period for which has not ended before the close of the taxable year

Depreciable period is greater of 10 years or class life

Land would not count (except for depreciable improvements)

Qualified Property – UBIA

(II.E.1.c.vi.(b))

- Unadjusted basis immediately after acquisition (UBIA)
- Regulations clarified that Code § 179 expensing is ignored
- Bonus depreciation capitalizes and depreciates part immediately (II.G.5.b.)
- Using bonus depreciation, most property placed in service after September 27, 2017, and before January 1, 2023 receives an immediate deduction for the entire purchase price. This is simpler and more favorable than Code § 179 (but not because of Code § 199A).

UBIA (II.E.1.c.vi.(b))

- Proposed regulations would have changed UBIA to adjusted basis when moving property to a new taxable entity in a nontaxable exchange
- Final regulations eliminated that change

UBIA (II.E.1.c.vi.(b))

Code § 754 election - inside basis change with respect to relevant partner(s) under Code § 743(b):

- For most income tax purposes, automatically applies for property owned directly by individual, is available to partnerships, and does not apply to S corporations (II.H.8., II.Q.8.e.iii)
- UBIA change applies when inside basis change applies to partnerships, but only to the extent that basis changes from UBIA, rather than adjusted basis
- Gorin example why UBIA change differs: Original purchase price and current value $100,000; accumulated depreciation $40,000; adjusted basis $60,000. Transfer occurs that triggers $40,000 basis adjustment. Old UBIA $100,000 plus $40,000 of new inside basis would equal $140,000; need to keep UBIA the same, so no UBIA adjustment. If value had increased to $125,000, then basis adjustment of $65,000 ($125,000-$60,000) and UBIA adjustment of $25,000 ($125,000-$100,000).
- Preamble to final regulations rejects Code § 734(b) changes

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii., II.E.1.c.iii.)

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- Must be a qualified trade or business
- May have multiple trades or businesses
- Each is tested separately; minimal guidance how to delineate
- Many cases describe common law principles (II.G.4.i.i.).
- QBI must be effectively connected with U.S. trade or business (II.E.1.c.ix.)

Multiple Trades or Businesses

(II.E.1.c.iii.(b))

- Within an entity, one may want to combine or separate various activities, depending on how their QBI, W-2 wages, and UBIA relate to each other and whether they can be "aggregated" or segregated
- Delineating activities as a separate trade or business may be critically important in avoiding contaminating a qualifying business with an SSTB (described later)

Multiple Trades or Businesses

(II.E.1.c.iii.(b))

Preamble to final regulations refers to Reg. § 1.446-1(d), which allows separate tax accounting methods if all of the following apply:

- Businesses are separate and distinct, and the methods used for each clearly reflect income
- To be distinct, a complete and separable set of books and records is kept for each separate trade or business (distinction between "separate" and "separable")
- If maintaining different tax accounting methods creates or shifts 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 will not be considered to be separate and distinct

Multiple Trades or Businesses

(II.E.1.c.iii.(b))

Reg. § 1.199A-3(b)(5):

> If an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The individual or RPE may use a different reasonable method with respect to different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (b)(5).

Multiple Trades or Businesses

(II.E.1.c.iii.(b))

Possible analogy to separating businesses for tax-exempt entities under Notice 2018-67 (II.E.1.f.viii):

- NAICS 6-digit codes - see Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf.
- Both Notice 2018-67 and the preamble to the final regulations under Code § 199A refer to *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987) (II.G.4.i.i.(a))

Types of Income and Activities Eligible for Deduction (II.E.1.c.)

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A relevant passthrough entity (RPE) is a partnership, an S corporation or a trust/estate that distributes its income

Each RPE must determine:

- If it is engaged in one or more trades or businesses and whether SSTB
- The QBI for each trade or business engaged in directly
- The W-2 wages and UBIA of qualified property for each trade or business engaged in directly
- The amount of any qualified REIT dividends or qualified PTP income

RPE must report to owners the above and its share of any items reported by any RPE it owns

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

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- Aggregation is completely voluntary but is irrevocable once done
- Preamble to final regulations continues to reject using passive loss grouping
- Each owner can separately aggregate the owner's own trades or businesses (perhaps with those from any RPE the owner owns), but if an RPE aggregates then that overrides its owner's ability to do so
- Aggregating allows one to combine QBI, W-2 wages, and UBIA from separate businesses (but not from SSTBs)
- Then we discuss when aggregation is permissible

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

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- Each RPE separately reports QBI, W-2 wages, and UBIA to its owners. As previously noted, each RPE separately determines whether its activities constitute a trade or business (or more than one).
- Aggregation is done at the individual, trust/estate, or RPE level. If an RPE owns another RPE, then each trade or business continues to be separated at each level until aggregated.
- Aggregation does not change the tax character of transactions between trades or businesses that are being aggregated.

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

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Consequences of RPE electing aggregation - Reg. § 1.199A-4(d)(15), Example (15)

- PRS1, a partnership, directly operates a food service trade or business and owns 60% of PRS2, which directly operates a movie theater trade or business and a food service trade or business
- PRS2's movie theater and food service businesses operate in coordination with, or reliance upon, one another and share a centralized human resources department, payroll, and accounting department
- PRS1's and PRS2's food service businesses provide products and services that are the same and share centralized purchasing and shipping to obtain volume discounts

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

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Consequences of RPE electing aggregation - Reg. § 1.199A-4(d)(15), Example (15) (continued)

- Under the above facts, PRS1's food service business cannot under any circumstances be aggregated with PRS2's movie theater business
- PRS2's aggregation of its two businesses cannot be used to bootstrap the aggregation of PRS1's food service business with PRS2's movie theater business
- PRS2's aggregation of its two businesses would prevent PRS2's food service business with PRS1's food service business. What at first seems to be a convenient aggregation at the PRS2 level in fact precludes an option that PRS1's owners may like to have

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

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Consequences of RPE electing aggregation - Reg. § 1.199A-4(d)(15), Example (15)

- Arguably, an RPE should not aggregate unless its owners cannot benefit different mixing and matching of the RPE's various businesses with their own businesses
- Instead, the RPE should provide to its owners all of the information it would have provided if it had aggregated, as well as ownership information sufficient to enable them to determine whether they can aggregate.
- Really a judgment call - the RPE itself aggregating may save its owners income tax preparers' significant time and therefore significant expense
- Aggregating horizontally (various businesses within the same RPE) is much more beneficial than aggregating vertically (the same business spread among various RPEs).

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

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Aggregation's benefits tend to be maximized when a business with lots of W-2 wages can share them with a separate but related business that does not have lots of W-2 wages. Gorin example:

- A is a group of owners that owns Parent 1 and Parent 2. Parent 1 has a manufacturing subsidiary, M1, and a real estate LLC, R1
- Similarly, Parent 2 has a manufacturing subsidiary, M2, and a real estate LLC, R2
- M1's operations are not sufficiently integrated with R2's operations to aggregate with it, and M2's operations are not sufficiently integrated with R1's operations to aggregate with it
- Each of M1 and M2 relies heavily on labor and has wages well in excess of what is needed to maximize the QBI deduction
- M1 rents from R1 the building it uses, and the R1 has very small wages and insufficient UBIA to get anywhere near needed to maximize the QBI deduction; a similar relationship exists between M2 and R2.

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

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Gorin example:

- If Parent 1 aggregates M1 with R1, M1's wages will fully support the QBI deduction from both M1 and R1
- On the other hand, that aggregation may preclude A from aggregating M1 with M2
- However, M1 doesn't need M-2's W-2 wages, because M2 also has lots of W-2 wages - due to the similarity of their businesses
- Similarly, aggregating R1 with R2 would be pointless.
- Simplest approach would be for Parent 1 to aggregate M1 with R1 and for Parent 2 to aggregate M2 with R2
- If any member of the A ownership group would be better off with vertical aggregation (aggregating all manufacturers together and all commercial rental real estate together) than with horizontal aggregation (aggregating manufacturing with real estate operations), then that member should communicate with whoever is managing Parent 1 and Parent 2 and ask them not to aggregate.

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

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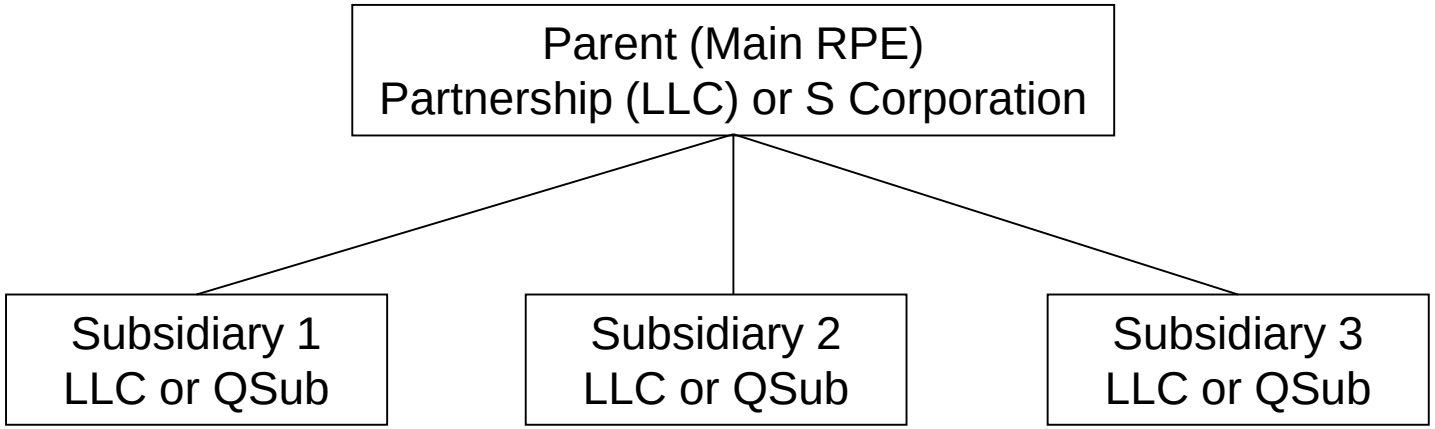
Gorin example:

- Similarly, management of Parent 1 and Parent 2 should communicate with their owners to see whether anyone objects to Parent 1 or Parent 2 aggregating
- However, just because one member of the A ownership group (X) asks management not to aggregate, that doesn't mean that management will honor that member's request
- Management needs to weigh the costs of forcing everyone to aggregate against X's benefit and may need to bring this issue to the owners to let them decide how to deal with it
- As a practical matter, management could prepare aggregation statements that each owner's tax preparers could tweak as needed and attach

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

May need to restructure to have single member LLCs under the main RPE (if main RPE is an S corporation, also might use QSub) so that all income generation is under one RPE and adds up to a trade or business that can be aggregated (II.E.1.c.):



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

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- The same person or group of persons, directly or by Code § 267(b) or 707(b) attribution, owns 50% or more of each trade or business to be aggregated
- That ownership exists for a majority of the year, including the last day
- All items aggregated are on returns same year
- The trades or businesses to be aggregated satisfy at least two of three factors
- SSTB cannot be included; different rules for those

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

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Common ownership:

- At least 50% of issued and outstanding shares
- At least 50% of capital or profits in a partnership
- Can aggregate sole proprietorship, partnership, and S corporation with each other
- Individual deemed to own interest in a trade or business owned , under section 267(b) and 707(b) attribution principles, by or for (among others)
  - The individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance)
  - The individual's children, grandchildren, parents, and siblings
  - Trusts, estates and beneficiaries

Code § 267(b) Attribution
(II.G.4.i.iv.)

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1. Members of a family, as defined in Code § 267(c)(4)
2. An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual
3. Two corporations which are members of the same controlled group (as defined in Code § 267(f))
4. A grantor and a fiduciary of any trust
5. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts
6. A fiduciary of a trust and a beneficiary of such trust
7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts

Code § 267(b) Attribution
(II.G.4.i.iv.)

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8. A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust
9. A person and certain charitable organizations controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual
10. A corporation and a partnership if the same persons own—
    (A) more than 50% in value of the outstanding stock of the corporation, and
    (B) more than 50% of the capital or profits interest in a partnership
11. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
12. An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation
13. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate

Code § 707(b) (II.Q.8.c.)

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or profits interest, in such partnership, or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interests

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

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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, property, or services that are the same or customarily offered together (broader than proposed regulations).

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).

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

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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:

- Yes - two businesses, a catering business and a restaurant, "share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting" (Example (1))
- No – only connection is 75% owner manages both businesses (Example (3))
- Yes - human resources and accounting centralized for 4 businesses (Example (4))
- Yes - 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 (Example (6))

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

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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 **(continued)**:

- No – same products and services does not mean centralized business elements (Example (7))
- Yes - common advertising and management (Example (8))
- Yes - executive chef of all of the restaurants orders food and supplies for all (Example (10))
- Yes - centralized human resources department, payroll, and accounting department (Example (14))

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.(c))

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Does not include:

- Compensation for services rendered (salary to S corporation owner-employee)
- Code § 707(c) guaranteed payment (but preferred profits interest should qualify)
- Code § 707(a) payment for services rendered

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.(c))

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Consider company that manages many properties for their owners:

- Management fee would be QBI
- But, if company becomes a partner in a landlord whose property it manages, Code § 707(a) or 707(c) would disqualify management fee from being QBI

Perhaps the prohibition against Code § 707 payments should merely not attribute landlord's trade or business status rather than prohibiting service provider from qualifying independently? Final regulations declined to provide relief.

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

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Specified service trade or business (SSTB) (II.E.1.c.iv.(a)-(n))

- Disfavored businesses include 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; investing and investment management; trading; dealing in securities; partnership interests or commodities; 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.
- Taxable income (before Code § 199A deduction) below threshold means that these businesses are not blacklisted (II.E.1.c.v.)

Specified Service Trade or Business (SSTB) Anti-Abuse Rules (II.E.1.c.iv.(o))

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Specified service trade or business (SSTB) in conjunction with other activity may disqualify the other activity partially or wholly

- "De minimis" rule - helpful in some ways but in other ways more like a snake-in-the-grass
  - If trade or business has gross receipts $25 million or less for the taxable year, it is not an SSTB if less than 10% of its gross receipts are attributable to the performance of SSTB services
  - Otherwise, it is not an SSTB if less than 5% of its gross receipts are attributable to the performance of SSTB services
  - If within safe harbor, then SSTB receipts count as regular QBI
  - If SSTB gross receipts are at least 5% or 10%, then the entire business is tainted
  - Avoid by segregating SSTB and non-SSTB businesses if allowed – confirmed by Reg. § 1.199A-5(c)(1)(iii)(B) (II.E.1.c.iii.)
- Services or property provided to an SSTB (next slide)

Anti-Abuse Rule - Services or Property Provided to an SSTB (II.E.1.c.iv.(o))

- If a trade or business has 50% or more common ownership (including Code § 267(b) or 707(b) attribution) with an SSTB, then that portion providing property or services to the commonly-owned SSTB is treated as an SSTB
- Example 1 – Law firm splits into separate entity providing services to client, owning building used only by the law firm, and providing administrative services only to the law firm. Each entity is treated as SSTB.
- Example 2 – Same as Example 1, but law firm rents only 50% of the building, and the other 50% is leased to unrelated third parties. The rental to the law firm is a separate SSTB, and the other rental is not an SSTB.

Items Included in or Excluded from QBI (II.E.1.c.ii.(a).)

- Code § 751 ordinary income from sale of partnership interest (II.Q.8.b.i.(f).) attributable to the trades or businesses conducted by the partnership is QBI
- Income from guaranteed payment for the use of capital is not QBI, but the expense reduces QBI
- Income/loss from change in accounting methods under Code § 481 is QBI
- Post-12/31/2017 previously disallowed losses or deductions (including under Code §§ 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. Nothing specifically mentions including related W-2 and UBIA amounts.
- Code § 172 net operating loss (II.G.4.i.iii.) does not reduce QBI (separate rules apply re losses from QBI activities)

Effect of Losses from Qualified Trades or Businesses On Code § 199A Deduction (II.E.1.c.vii.)

- Current year net QBI losses offset current year QBI from other activities proportionately to their respective QBI
- Excess net QBI losses are carried forward and offset next year QBI from other activities proportionately to their respective QBI. Pre-2018 losses do not reduce post-2017 QBI, and losses are used on a first-in, first-out basis.
- Wages and UBIA from trade or business with negative (or low positive) QBI do not benefit other activities unless aggregated
- Suspended passive loss may be better than net operating loss (II.K.3.), but being passive can generate net investment income (NII) tax (II.I.8.)

Items Excluded from QBI (II.E.1.c.ii.(c).)

These items are never QBI:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss
  - Preamble says Code § 1231 gains and losses are QBI to the extent not capital gain
  - Ordinary income depreciation recapture would be as well
  - Sale of business assets may convert capital gain to ordinary income; often elect to treat sale of S corporation stock as sale of assets followed by liquidation (Code § 338(h)(10) or 336(e) election – see II.Q.8.e.iii.(f).)

Items Excluded from QBI (II.E.1.c.ii.(c).)

These items are never QBI:

- Dividends, income equivalent to a dividend, etc.
- Any interest income not properly allocable to a trade or business
  - Interest on working capital is not QBI
  - Interest on accounts receivable for services or goods provided by the trade or business is QBI
- Certain Code § 954 items relating to hedging

Partnerships Compared to S Corporations (II.E.1.d.)

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Example

- $300K QBI before owner's compensation
- Reasonable compensation would be $200K
- Distribute $200K or more

Results:

- S corporation deduction based on $100K QBI after deducting wages
- Partnership deduction based on $300K QBI because no guaranteed payment to partner

However, may need S corporation to generate wages if taxable income is too high.

Consider self-employment tax on reinvested earnings if not using a limited partnership.

Real Estate as QBI (II.E.1.e.)

- Code § 199A deduction is only for a "trade or business"
- From preamble to final regulations: "In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease)."
- Consider moving expenditures and employees to landlord with tenant reimbursing costs – discussed after safe harbors

Real Estate as QBI (II.E.1.e.)

Rental is deemed to be a trade or business if:

- It is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), whether or not it is aggregated. That control means that the same person or group of persons, directly or through Code § 267(b) or 707(b) attribution, owns 50% percent or more of each trade or business to be aggregated, 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.
- Rental to a C corporation does not qualify, because a C corporation cannot be aggregated

But, treated as SSTB if and to the extent leased to commonly controlled SSTB (II.E.1.c.iv.(o) per a prior slide)

Real Estate as QBI (II.E.1.e.(a))

Notice 2019-7 safe harbor to become a Rev. Proc.:

- Separate books & records
- 250 hours
- Real estate enterprise
- Provides rental services
- Not excluded from safe harbor
- Statement on return

Details on above follow this slide

Taxpayers may rely on Notice until Rev. Proc. replaces it

Failure to meet safe harbor does not preclude being a trade or business

Real Estate Safe Harbor (II.E.1.e.(a))

250 hours:

- For taxable years beginning before January 1, 2023, 250 or more hours of "rental services" (defined later) per year with respect to the rental enterprise
- For later taxable years, any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years)
- Contemporaneous records for 2019 and later, including time reports, logs, or similar documents, regarding: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services

Real Estate Safe Harbor (II.E.1.e.(a))

Real estate enterprise:

- An interest in real property held for the production of rents
- May consist of an interest in multiple properties, directly or through an entity disregarded as an entity separate from its owner (II.E.1.c.) – see slide under Aggregation illustrating this
- Must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents as a single enterprise
- Commercial and residential real estate may not be part of the same enterprise
- Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances

Real Estate Safe Harbor (II.E.1.e.(a))

Rental services provided by owners or by employees, agents, and/or independent contractors of the owners:

- advertising to rent or lease the real estate
- negotiating and executing leases
- verifying information contained in prospective tenant applications
- collection of rent
- daily operation, maintenance, and repair of the property
- management of the real estate
- purchase of materials
- supervision of employees and independent contractors

Real Estate Safe Harbor (II.E.1.e.(a))

Possible self-employment (SE) tax consequences (II.L.2.a.ii.) of active rental :

- Services that are more than incidental to long-term rental may be subject to SE tax
- Short-term rentals do not qualify for the rental exception to SE tax

Real Estate Safe Harbor (II.E.1.e.(a))

"Rental services" do not include:

- financial or investment management activities, such as arranging financing
- procuring property
- studying and reviewing financial statements or reports on operations
- planning, managing, or constructing long-term capital improvements
- traveling to and from the real estate

Real Estate Safe Harbor (II.E.1.e.(a))

Some rental real estate arrangements are excluded:

- Real estate used by the taxpayer as a residence for any part of the year under Code § 280A
- A triple net lease, which includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This applies whether directly or allocated to the portion of the property rented by the tenant.

Real Estate Safe Harbor (II.E.1.e.(a))

Statement:

- A taxpayer or RPE attach statement to the return, on which it claims the section 199A deduction or passes through section 199A information, that the requirements of the safe harbor have been satisfied
- Penalties of perjury that taxpayer or RPE representative has examined the statement and that the statement contains all the relevant facts relating to the safe harbor and such facts are true, correct, and complete
- Signer must have personal knowledge of the facts and circumstances related to the statement
- If file electronically, attach signed statement as a PDF submitted as part of the return

Real Estate as QBI (II.E.1.e.)

Should expenditures and employees move to landlord, with tenant reimbursing landlord for costs?

- Tenant may have plenty of wages and not need them for W-2 wage limitation; employees would help landlord with W-2 wage limitation calculation
- Are landlord's owners different from tenant's owners?
- Does landlord want to devote time to this active role?
- Landlord entity becomes liable for employees' action or inaction; whoever controls landlord may be personally liable for negligent hiring
- Consider perceived adequacy of liability insurance

Real Estate Aggregation (II.E.1.e.(b))

Examples (16), (17) and (18) in aggregation regulations:

- May aggregate commercial rental in two states that share centralized accounting, legal, and human resource functions
- May not aggregate wholly owned residential condominium building and commercial rental office building that (B) share centralized accounting, legal, and human resource functions because did not (A) provide products, property, or services that are the same or customarily offered together and did not (C) operate in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies)
- May aggregate residential condominium and residential apartment building operations that share centralized back office functions and management and operate in coordination with each other in renting apartments to tenants

Trusts/Estates and QBI (II.E.1.f.)

- Grantor trusts are disregarded and their items attributed to their deemed owners.
- The trust/estate 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.
- The Code § 199A deduction is not included in calculating DNI.

Trusts/Estates and QBI (II.E.1.f.)

- Taxable income thresholds are applied separately at the trust and beneficiary levels.
- Proposed regulations asserted that the income distribution deduction is not deducted in computing a trust's taxable income for the threshold, which would double-count the beneficiary's share. Final regulations restored the income distribution deduction in computing a trust's taxable income in computing threshold.

S Corporation Trusts and QBI
(II.E.1.f.)

- Electing Small Business Trusts (ESBTs) (II.E.1.f.ii.)
  - Trapping income inside ESBT portion (general income tax rule)
  - Reg. § 1.199A-6(d)(3)(vi): "The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or 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. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust."
  - The last sentence is contrary to ESBT rules, but IRS knows that and did it anyway
- Qualified Subchapter S Trusts (QSSTs) (II.E.1.f.iii)

Trusts, QBI, and NII (II.E.1.f.Iv.)

- Shifting pass-through income to a trust may trigger the 3.8% tax on net investment income (NII) if the business income is passive (II.I.8.)
- 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 (II.K.2)
- If the trust is a QSST, then consider having the trustee sufficiently participate, to avoid NII tax in case the business is sold (II.J.15.a and II.I.8.g)

Trusts and Depreciation (II.J.3.d.; II.J.11.)

- Trusts/estates cannot use Code § 179 to expense the cost of purchases of depreciable property (which complicates tax accounting for pass-through entities with trust shareholders). However, presumably the deemed owners of any grantor trust portion can.
- Trusts/estates can use bonus depreciation, which is described in II.G.5.b.
- Beneficiaries may deduct depreciation directly, as a separate K-1 item ("directly apportioned deductions"), except to the extent that the trustee/executor maintains a reserve for depreciation

Trusts and 2017 Law (II.J.3.d.)

- Trust/estate administrative expenses – Code § 67(e) makes deductions not be itemized
- State tax deduction under Code § 164(b)(6) – separate $10,000 limitations; consider that property taxes but not income taxes are unlimited for trade or business or rental real estate
- ESBT may now have nonresident alien as permissible current beneficiary (II.A.2.f.)
- ESBT deduction for charitable contributions on K-1 from S corporation now applies Code § 170 instead of Code § 642(c) (III.A.3.e.ii.(b).)

Code § 199A Anti-Abuse Rule re Trusts (II.E.1.f.).

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Reg. § 1.199A-6(d)(3)(vii):

> A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A.

Preamble to final regulations:

> If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A.

What exactly would the effect of this be on the grantor, trust, and beneficiaries?

Code § 199A Anti-Abuse Rule re Trusts (II.E.1.f.).

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Example 1:

- Mom is married, filing jointly, with $400,000 of QBI from an SSTB and $100,000 of taxable income other than QBI
- Mom receives no Code § 199A deduction from the QBI because Mom's combined taxable income of $500,000 exceeds the upper end of the taxable income threshold
- With a principal purpose of obtaining a Code § 199A deduction, Mom gives half of her SSTB to Son, who has no other taxable income and is married filing jointly, with each of Mom and Son having $200,00 of QBI.
- As a result, Mom's taxable income before Code § 199A is $300,000, and both Mom's and Son's taxable incomes are below the taxable income threshold
- Mom and Son receive a full Code § 199A deduction

Code § 199A Anti-Abuse Rule re Trusts (II.E.1.f.).

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Example 2:

- Same as Example 1, but Mom gives half of her SSTB to Trust instead of directly to Son, which distributes half of its SSTB income to Son
- A principal purpose of the gift to Trust is to obtain a Code § 199A deduction by getting below the taxable income threshold
- Trust distributes half of its QBI to Son
- As a result, Mom's taxable income before Code § 199A is $300,000, Trust's taxable income before Code § 199A is $100,000, and Son's taxable income before Code § 199A is $100,000 (latter two ignoring exemptions/other deductions)
- How does Reg. § 1.199A-6(d)(3)(vii) affect the Code § 199A deduction for each of Mom, Trust, and Son?

Multiple Trust Rule (II.J.9.c.).

Reg. § 1.643(f)-1(a), "Treatment of Multiple Trusts," provides:

(a)General rule. For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

(b)Effective/ applicability date. The provisions of this section apply to taxable years ending after August 16, 2018.

Query its applicability outside of subchapter J (Code §§ 641-692)?

Multiple Trust Rule (II.J.9.c.).

Preamble to final regulations:

> Based on the comments received, the Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

Multiple Trust Rule (II.J.9.c.).

- Legislative history introduces significant confusion as to "substantially the same primary beneficiary or beneficiaries"
- ACTEC's comments called for not only the changes that were made but also clarification of the definitions. See ACTEC's comments for a list of issues relating to these definitions: ACTEC comments on proposed regulations under Sections 199A and 643(f) (September 27, 2018)
- No new PLRs per newly added Rev. Proc. 2019-3, section 3.01(85).

Multiple Trust Rule (II.J.9.c.).

What are the consequences of collapsing trusts?

- Suppose each of 5 children is the sole beneficiary of his or her own trust created by parents. Multiple trust rules does not apply (but query Prop. Reg. § 1.199A-6(d)(3)(v)).
- Suppose parents then create a trust for the benefit of all 5 children. Result?
  - All 6 trusts now aggregated?
  - Tax attributes of 6th trust spread among the 5 trusts?

Separate Share Rule (II.E.1.f.i.(d)).

2019 Prop. Reg. § 1.199A-6(d)(3)(iii):

> In the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.

This is completely consistent with II.J.9.a. Separate Share Rule

Charitable Remainder Trusts

(II.E.1.f.vii.)

- CRT's unrelated business income (UBI) is subject to 100% excise tax (II.Q.6.c.)
- Partnership interest may or may not generate UBI (a CRT cannot hold an S corporation) (II.Q.6.d.ii.)
- 2019 Prop. Reg. § 1.199A-6(d)(3)(v):
  - CRT does not use Code § 199A deduction
  - Beneficiary may use Code § 199A attributes when QBI is in a tier being carried out
  - W-2 and UBIA carried out only in year received

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Conclusion

- February 12 webinar Fiduciary Income Tax Refresher and Update 2019
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions
- July 23 webinar for Second Quarter Newsletter
- Leimberg collaboration