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Please Address Reply to:

September 27, 2018

CC:PA:LPD:PR (REG-107892-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044

Submitted electronically at www.regulations.gov (indicate)

Re: IRS and REG-107892-18: Comments on Proposed Regulations under Sections 199A and 643(f)

Dear Ladies and Gentlemen,

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit comments pursuant to IRS and REG-107892-18, published in the Federal Register on August 16, 2018. The preamble requests comments on proposed regulations under sections 199A, dealing with the 20% deduction for qualified business income, and 643(f), authorizing the treatment of trusts created for tax avoidance as if they were one trust.

ACTEC is a professional organization of approximately 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

ACTEC's comments and recommendations are set forth in the attached memorandum.

If you or your staff would like to discuss the comments, please contact Steven B. Gorin, who led the task force that put together the comments, at (314) 552-6151 or sgorin@thompsoncoburn.com, Beth Shapiro Kaufman, Chair of the ACTEC Washington Affairs Committee, at (202) 862-5062 or bkaufman@capdale.com, or Deborah McKinnon, ACTEC Executive Director, at (202) 684-8460 or domckinnon@actec.org.

Respectfully submitted,

Charles D. Fox IV, President

Attachments

Comments of The American College of Trust and Estate Counsel ("ACTEC")

on Proposed Regulations under Sections 199A and 643(f)

Treasury Notice 83 Fed. Reg. 40884 (08/16/18) requested comments on proposed regulations issued under sections 199A and 643(f) of the Internal Revenue Code[1]. ACTEC commends Treasury and the IRS for their efforts in quickly putting together such a well-organized package of proposed regulations, and we appreciate the opportunity to comment on the proposed regulations.

Below is an executive summary, followed by detailed comments. Although ACTEC raises various concerns, these should not detract from ACTEC's overall appreciation for Treasury and the IRS's tremendous effort.

Executive Summary

1. Reporting Burdens (page 3).

ACTEC responds to Treasury and the IRS's request for comments on providing a special rule for a relevant passthrough entity ("RPE") with no owners having taxable income above the threshold amount that would exempt the RPE from determining and reporting W-2 wages, unadjusted basis immediately after acquisition ("UBIA") of qualified property, and whether the trade or business is a specified service trade or business ("SSTB").

2. Sections 707(a) and 707(c) (page 3).

As the Preamble states, section 199A(c)(4) provides that qualified business income ("QBI") does not include reasonable compensation paid to a taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business, any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and 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. Although the legislative history for section 199A does not explain why these items were excluded, ACTEC suggests that the intent was to prevent a taxpayer who provides services to a single trade or business from having QBI with respect to payments it receives for those services. ACTEC does not believe that this exclusion was intended to apply to payments described in section 707(a) or (c) earned by a taxpayer that conducts its own trade or business, so long as that trade or business is not focused primarily on providing services to only one qualified trade or business. Therefore, ACTEC recommends proposed § 1.199A-3(b)(2)(ii)(I) and (J) provide an exception when payments are made to a service provider conducting its own trade or business.

[1] Unless otherwise stated, references herein to "section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended. References herein to "§" are to relevant sections of the Treasury regulations. References herein to the "Preamble" are references to the preamble to the proposed regulations (REG-107892-18).

3. Aggregation under Proposed § 1.199A-4 (page 4).

ACTEC appreciates the helpful rules of proposed § 1.199A-4. However, ACTEC suggests that the rules be expanded to include attribution used in other areas of the proposed regulations and the tax laws, such as expanding the persons included as a family member and providing for an alternative ownership test focused on voting rights. ACTEC would also appreciate clarification regarding the manner in which beneficial interests in trusts are considered for purposes of aggregation.

4. Nongrantor Trusts and Estates (page 11).

ACTEC has concerns regarding the threshold amount generally and also how it applies to electing small business trusts (ESBTs). Proposed § 1.199A-6(d)(3)(iii) would require trusts and estates to determine their taxable income before any income distribution deduction in order to determine whether taxable income exceeds the threshold amount, thereby counting twice (at the trust level and at the beneficiary level) any taxable income reported to a beneficiary on a Schedule K-1. ACTEC believes this violates section 199A(e)(1), which takes into account all taxable income, modified by disregarding only the section 199A deduction. ACTEC also would appreciate confirmation that the taxable income threshold would apply separately for the S portion and the non-S portion.

ACTEC believes that proposed § 1.199A-6(d)(3)(v), "Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount," is overbroad and should focus on what would be considered abusive and describe appropriate consequences.

ACTEC is concerned with § 1.199A-6(d)(3)(vi), Example (1), which seems to overlook section 167(d).

5. Section 643(f) Multiple Trust Rule (page 15).

Section 643(f) contains at least one undefined term, "primary beneficiary," and the legislative history does not clarify its definition but rather injects uncertainty. Proposed § 1.643(f)-1 seems to redefine "principal purpose." ACTEC would appreciate clarification of the terms "primary beneficiary" and "principal purpose" and guidance on when "primary beneficiaries" and "grantors" are each considered to be substantially the same.

6. "Unadjusted Basis Immediately after Acquisition" ("UBIA") and "Depreciable Period" of "Qualified Property" under Section 199A(b)(6)(B) (page 28).

ACTEC suggests clarification be made to the definitions of "unadjusted basis immediately after acquisition" ("UBIA") of "qualified property" of a taxpayer, and the "depreciable period" with respect to such qualified property, under section 199A(b)(6)(B). The comments include the effect of a taxpayer's death or the contribution of property to partnerships by partners and to S corporations by shareholders.

7. Charitable Remainder Trusts (page 33).

ACTEC responds to the request for comments on how section 199A interacts with the tier rules under section 664.

Detailed Comments

1. Reporting Burdens.

Treasury and the IRS requested comments on whether it is administrable to provide a special rule for RPEs with no owners having taxable income above the threshold amount that would exempt the RPEs from determining and reporting W-2 wages, UBIA of qualified property, and whether the trade or business is an SSTB.

ACTEC believes that having this special rule would avoid unnecessary compliance costs for RPEs, would reduce potential confusion on the part of owners who do not need this additional information, and would reduce the amount of unnecessary information provided to the IRS. If a special rule is adopted, ACTEC requests that detailed information be provided on how a qualifying RPE can elect to take advantage of the rule and what information the RPE will be required to report to its owners in connection with the rule. It would also be helpful to indicate what documentation an RPE would need to provide to the IRS (or otherwise collect) and retain for its records in connection with an election of this special rule.

2. Sections 707(a) and 707(c).

As the Preamble states, section 199A(c)(4) provides that qualified business income ("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, any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and 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. Although the legislative history for section 199A does not explain why those items were excluded, ACTEC suggests that the intent was to prevent a taxpayer who provides services to a single trade or business from having QBI with respect to payments it receives for those services. ACTEC does not believe that this exclusion was intended to apply to payments described in section 707(a) or (c) earned by a taxpayer that conducts its own trade or business, so long as that trade or business is not focused primarily on providing services to only one qualified trade or business. Therefore, ACTEC recommends that proposed § 1.199A-3(b)(2)(ii)(I) and (J) provide an exception when the payments are made to a service provider conducting its own trade or business.

For example, suppose a company is in the trade or business of managing rental real estate for many properties throughout the metropolitan area, and the properties are owned in separate partnerships. Generally, its management fees would constitute QBI. However, the company is a partner in one or more of the real estate partnerships; and, as written, proposed § 1.199A-2(b)(ii)(I) and (J) would not allow the management fees to be part of the company's QBI, because such fees would be treated as section 707(a) or (c) payments. ACTEC does not believe that the company should lose the section 199A deduction merely because it owns an interest in the partnerships. ACTEC suggests that, if the company qualifies its management fees as QBI

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independent of the trade or business activities of the partnerships, those fees should be included in the company's QBI.

In contrast, if the company provides its services to only one partnership in which it is a partner, section 707(a) or (c) payments would be disallowed, even if the company's level of activity constituted a trade or business. To determine whether a taxpayer, such as the company, is providing services to more than one trade or business or is providing services to only one trade or business, ACTEC recommends using tests similar to those in proposed § 1.199A-5(c)(2), "Services or property provided to an SSTB." These tests would be applied to determine whether, for example, more than one partnership would be treated as one partnership to whom the company is providing services. The company would have the ownership information of each partnership to apply these tests, because as a partner it is entitled to that information (see introduction to Aggregation under Proposed § 1.199A-4 (page 4)).

3. Aggregation under Proposed § 1.199A-4.

ACTEC appreciates the helpful rules of proposed § 1.199A-4 and recognizes the concern stated in the Preamble that, if "aggregation were not permitted, certain taxpayers would restructure solely for tax purposes, with the resulting structures leading to less efficient economic decision-making." ACTEC suggests that the rules need to be adjusted in order to reduce the need for business owners to rearrange their ownership structure to qualify under section 199A when functionally related businesses are conducted through more than one entity by the same core ownership group.

Before discussing these suggestions, ACTEC notes that, under the current proposed regulations and under ACTEC's suggestions, each owner of an RPE needs to know who the other owners of the RPE are in order to determine whether common ownership exists. Accordingly, in response to the request for comments on whether a reporting or other information sharing requirement should be required, ACTEC recommends that each Schedule K-1 from an RPE be required to list all of the RPE's owners and their respective ownership percentage.

A. Optional Aggregation of Trades or Business to Combine QBI, UBIA and W-2 Amounts if Entities are Commonly Controlled and the Percentage of Common Ownership is at Least 20%.

The opportunity included in proposed § 1.199A-4 to aggregate functionally related trades or businesses conducted through separate entities is an important step toward addressing the concerns raised in the Preamble. ACTEC believes, however, that the requirements for aggregation should take into account common control as well as common ownership: In many functionally related business entities, a control group manages the entities and the equity ownership also overlaps significantly, without satisfying the proposed minimum 50% common ownership requirement. If there is common control, ACTEC believes that a minimum of 20% common ownership should be sufficient to allow aggregation.

As proposed, other aspects of the aggregation process screen out separate trades or businesses that are not joined together in a related business. In addition to the common ownership requirement, proposed § 1.199A-4(b) requires a certain level of functional business connection among the businesses, *i.e.*, the businesses to be aggregated must exhibit at least two of three

possible types of functional connections (the same or related product offerings, the sharing of resources, and an operational interdependency such as conducting business as part of the same supply chain).

Furthermore, as a practical matter, the trades or businesses that an individual elects to aggregate would be closely-related; otherwise they would not be willing to share the commercially sensitive financial information required for aggregation. Individuals must receive enough information from each aggregated trade or business to be able to combine the QBI, W-2 wages, and UBIA of qualified property and compute the limitations relating to W-2 wages and UBIA. The information will include net business revenues and wage costs and may indicate depreciation and financing. Business owners may request additional information in order to be assured of the accuracy of what they are provided. Because the election is irrevocable, each subsequent year of aggregation inherently requires sharing of confidential information on business operations and capital investment. This itself shows a strong economic and management alliance. Unrelated entities in the same supply chain or offering complementary products, for example, generally would not be willing to share such information for fear of its impact on their business.

In formulating the aggregation rules, ACTEC suggests that, if there is a level of common control among trades or business, it would be appropriate to be more flexible as to what constitutes common ownership of the trades or businesses to be aggregated. In particular, if the trades or businesses are commonly controlled through voting stock, a controlling general partner, or other equivalent, the rule could allow a lesser degree of common ownership, such as 20% rather than 50% in order to aggregate.

Example 1. Smith, a successful real estate entrepreneur, operates three apartment buildings which are held in separate LLCs, each of which is wholly owned by Smith. To expand the business more rapidly and achieve management economies, Smith forms a new single member LLC, Smith LLC, to hire employees and solicit outside investors to fund the purchase and rehab of more properties. The investors are willing to fund 90% of the acquisition and rehab cost of new properties in exchange for a return of capital and 70% of the profits, if Smith in turn commits that Smith LLC will manage the new projects and contribute the remaining 10% of the costs in exchange for a return of capital and 30% of the profits. Smith seeks to aggregate his interest in the three original LLCs and his interest in the new properties, but Smith does not meet the 50% minimum common ownership required for aggregation.

Example 2. Jones is an established owner of a trucking business operated in an S corporation. As part of Jones's succession plan, Jones recently formed a new S corporation to operate a functionally related service business (i.e., temporary warehousing). The new S corporation is owned by Jones, an adult child of Jones, and three key employees. All five owners are equal owners in the new corporation, except that Jones owns the only voting stock for the first five years. Jones owns 20% of the new company directly and 20% by attribution from the adult child; therefore, Jones cannot aggregate under proposed § 1.199A-4, even though Jones has 100% of the voting control.

ACTEC believes that permitting aggregation based on common control with a lesser ownership threshold will reduce the occasions where businesses are connected by common control but would periodically qualify or fail to qualify for aggregation because of changes in ownership (*e.g.*, rising from 30% to 50% common ownership for a given year by meeting a performance milestone

in a partnership with shifting allocations or dropping from 50% to 45% common ownership due to obtaining a new equity investor in one entity but not another).

If ACTEC's suggestion is adopted, common control could be measured in a manner comparable to the definition of control under sections 2701 and 2704. While these sections deal with estate and gift taxes rather than income taxes, they address many of the control questions that arise across the spectrum of modern trades or businesses. With these changes, the aggregation rule will accommodate different types of common ownership and control that are often used in structuring related trades or businesses.

B. <u>Attribution of Ownership for Determining Common Control or Ownership should have a Broader Definition of "Family" to include Sibling Relationships</u>.

For family attribution purposes, proposed § 1.199A-4 does not include sibling relationships. ACTEC believes that failing to include sibling relationships to determine family attribution under the aggregation rules would impose a material limitation on the opportunity to aggregate family businesses owned by siblings and is inconsistent with many other situations where siblings are treated as economically linked.

Specifically, the SSTB rule under proposed § 1.199A-5(c)(2)(ii) that precludes disaggregation to create affiliated non-SSTB businesses relies on relationships described in section 267(b) or 707(b) to identify related parties. Those sections attribute ownership from one sibling to another.

In addition, many rules under the Code treat siblings as being economically connected so as to treat taxable sales and exchanges between them as occasions for abuse, require adverse treatment by deferring losses under section 267 and denying capital gains treatment under section 1239, and apply restrictive rules to like-kind exchanges and installment sales to curb joint efforts to reduce their aggregate gain or to defer taxes. The overall concept is that siblings are so closely related as to be considered the same economic unit or at least to be conclusively presumed to be acting in concert. Sibling attribution is also used in Chapter 14 of the Code in applying adverse results to family-controlled transactions by defining "family" as involving siblings (see section 2704(c)(2), which also includes spouses of siblings).

The following examples illustrate the effect of not treating siblings as "family."

<u>Example 3</u>. Assume in Example 1 above that the "outside investors" are siblings of Smith who inherited their ownership interests in the new properties from their father, or alternatively are investing their own funds. Even if the aggregation rule is not expanded as suggested above to count common control as a qualifying factor, ACTEC believes that common ownership by siblings should apply for purposes of family attribution. Similarly, in Example 2 above, if the key employees are siblings of Jones, their interests should apply for purposes of family attribution.

<u>Example 4</u>. Successful real estate developer White dies and leaves his interests in his business entities to a combined trust for his three adult children until his estate is settled. Each entity owns individual developed and undeveloped properties. Working with the children, the trustee divides the entities in the combined trust into three different groupings of equal value. One grouping contains entities primarily holding established rental apartment properties of interest to child D,

the second contains entities primarily holding finished and unfinished mixed use projects consisting of apartments and retail properties of interest to child E, and the third entities primarily holding mostly mixed use office and retail properties of interest to child F. All of the entities will continue to be managed by the established entity that was managing and developing the properties in the various entities during White's life, and that management entity will now be owned equally by his adult children. Unless sibling attribution applies, however, dividing the entities holding the properties in this manner precludes aggregation with the service entity if the three groupings are distributed outright, one for each child in sole ownership.

C. Trust or Estate Ownership should be Attributed to Beneficiaries and then Reattributed within the Family.

Proposed § 1.199A-4 addresses attribution among family members but not attribution for ownership held in a trust or an estate. Business interests are often held in nongrantor trusts for succession and estate planning reasons; therefore, the trust attribution question is unavoidable. Also, although the discussion below focuses on trusts, similar concerns apply to estates. To what extent is an interest held in a trust for family members treated the same as direct ownership by family members, particularly where the beneficial interests in the trust will change over time?

Example 5. Brown owns 51% of an LLC that conducts a business, and a trust for Brown's spouse and children owns 49% of the LLC. The trust also owns 100% of another capital-intensive entity that could be aggregated with the LLC under the proposed regulations if 50% common ownership could be established.

Without a workable rule for trust attribution, ACTEC believes the aggregation rule under proposed § 1.199A-4 will present an obstacle to the orderly succession of family businesses and to estate planning transfers in trust during life and at death. ACTEC acknowledges that fashioning a workable trust attribution rule is inherently difficult because interests shift over time with changes in the beneficiary class (*e.g.*, due to births, deaths, distributions, passage of time, and exercises of powers of appointment).

In addition, the obstacles are greater if the minimum of common ownership required for aggregation is always set at 50% and siblings are not included for family attribution purposes. If "family" is narrowly defined and the minimum percentage is high, the attribution of beneficial trust interests becomes much more critical because siblings often have some variation of shared interests in trusts established for them.

Attribution must also address those beneficial interests in the trust that not only shift over time but are never actually fixed, that is, because those interests that depend on the trustee's discretion to make distributions based on need or "best interests" of persons within a group of beneficiaries. These "flexible interests" are now quite commonly used in estate planning, such as in a trust when current returns can be accumulated and pass to other beneficiaries or when current distributions may be "sprinkled" disproportionately among a class of beneficiaries based on the trustee's discretion.

The tax law has no generally applicable established standard or rule for identifying a primary beneficiary or beneficiaries of a trust or for making meaningful beneficiary allocations of trust ownership under the attribution rules in other contexts, in part because of the difficulty of

developing such a standard and in part because different contexts call for different rules. *See Steuben Securities Corp. v. Commissioner*, 1 T.C. 395, 399 (1943) (attributing stock from a trust to its beneficiaries under the personal holding company rules in proportion to current distributions, disregarding the actuarial interests in the remainder because, given the statutory purposes, beneficiaries should be those with a "direct present interest in the shares and income in the taxable year"); FSA 199952014 (September 23, 1999) (rejecting actuarial test, reviewing case law in detail, distinguishing Rev. Rul. 62-155, 1962-2 C.B. 132, and noting that the issue was to determine indirect ownership of CFC stock by a trust beneficiary under section 958(a) and that the actuarial test, according to § 1.958-2(c)(1)(ii)(a), is used for determining constructive ownership under section 958(b).

Fortunately, however, aggregation for purposes of section 199A could provide the opportunity to adopt a relatively simple set of rules. Unlike other contexts, there is no risk of severe consequences such as allocating deemed taxable income to beneficiaries who might never receive the income. Vetter, "ACTEC Proposals Integrate Subch. J, PFIC Regime for Foreign Trusts," *Tax Notes* 222, 225 (October 11, 2010); ACTEC Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J, 4,6 (June 23, 2010). The rule here could apply for all purposes of section 199A so that the same rule would be favorable to some taxpayers by allowing aggregation under proposed § 1.199A-4 and adverse to other taxpayers by requiring aggregation of activities to an affiliated SSTB under proposed § 1.199A-5(c)(2)(ii). Furthermore, the difficult attribution questions will arise only in those trusts that have a mixed class of beneficiaries; if all of the beneficiaries are family members, it will be simple to determine whether the trust is part of the potential majority by simply attributing all of the trust's ownership to the other family members without having to determine how much should be attributed to any one beneficiary. In most cases it will be obvious that the trust's beneficial interests will be all or substantially all for the benefit of family members, such as a trust for the benefit of spouse and children, or for the benefit of children and grandchildren.

Experience with attribution in other contexts suggests that the standard applied for section 199A purposes should fall between two different approaches. On one end of the spectrum of possibilities, attribution could be based on determining the primary beneficiary by a "facts and circumstances" test for each trust, such as examining the distribution history, trust records of goals and expected distributions, and the needs and life expectancy of the individual beneficiaries. While flexible and adaptive to different types of trusts, this analysis is subjective and the conclusions open to debate. The approach may seem the most appropriate because it could emphasize the tracing of current income from business-related sources, and allow the trust to be attributed to the primary beneficiary at the current time. However, deciding what years should be in "the current time" is an arbitrary process; and the process could easily break down when distributions shift among different beneficiaries over a few years or when meaningful distributions from the business are not made to the trust and to the beneficiaries for long periods of time because net cash flow is being reinvested. *See* TAM 200733024 (August 17, 2007) and PLR 9024076 (March 21, 1990).[2]

[2] TAM 200733024 applied a "facts and circumstances" test under the PFIC regime to trust distributions made in successive years to or for the benefit of two different groups of beneficiaries; first the non-US beneficiaries and then in the next year the US beneficiaries, resulting in US tax savings, and analysis relying on records showing the trust was understood to be equally owned by the two groups despite its discretionary

At the opposite end of the spectrum, attribution could follow a purely actuarial calculation. The formulae under section 7520 for determining beneficial interests for a term of years or for the life of a person likely to live more than one year could be used to determine the percentage interest in the trust for different beneficiaries, and then the trust's business interests could be attributed to the beneficiaries in the same proportion. This approach seems precise and objective if a trust provides for mandatory periodic distribution of current income and the trust principal passes to the remainder beneficiary when the income beneficiary dies. The actuarial formula, however, does not take into account the flexibility commonly used in writing and managing trusts today. For example, beneficial interests can be subject to the following powers:

1. Trustee discretion to accumulate current income during the life of a beneficiary and add it to the principal that ultimately passes to the remainder beneficiary, or discretion to distribute principal to the life beneficiary or make current distributions to the remainder beneficiary.

2. Trustee discretion to adjust the return to the income interest, or powers in the trustee to decant into a new trust with different beneficial interests.

3. Trustee discretion to "sprinkle" distributions to benefit one or more persons among an entire class of beneficiaries such that it cannot be assumed that each member of the class will receive equal or any distributions.

These powers are common in modern trusts that would hold a business interest for estate planning and succession purposes. Accordingly, unless an adjustment can be made for these powers, the actuarial approach is not useful.

As a starting point, the actuarial approach is preferable to a "facts and circumstances" approach. The apparent precision and objectivity of the actuarial method of attribution is appealing for use in determining whether entities in a business structure can be aggregated because the test employed here should be relatively simple and beyond debate in application. The aggregation question does not justify the potentially complex and inevitably subjective analysis that would be needed to apply a "facts and circumstances" approach to attribution (see, for example, the analysis in PLR 9024076 referenced above), but some additional element must be added beyond pure mathematics in order to accommodate the flexible powers in modern trusts.

Accordingly, ACTEC recommends an approach to trust attribution under section 199A that starts with the actuarial formula and then adjusts for trust interests that cannot be measured by such a pure mathematical calculation. In other contexts this is done by ignoring remote interests and by assuming trustee discretion is exercised to maximize the value of certain beneficial interests. As applied here, ACTEC recommends the following adjustments:

1. Ignore as too remote all interests that are less than 5% of the trust by actuarial calculation.

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terms. PLR 9024076, in determining the control group under the personal holding company rules using a "facts and circumstances" test, abandoned the actuarial test in view of the discretionary powers in the trust, and used a seven-step analysis that included a review of trustee duties, actual distributions, family relationships, presumed exercise of a parent's power of appointment in favor of children, actuarial values, and valuation premiums associated with control blocks of stock, but the recognized key starting point was an established five-year pattern of distributions.

2. Identify the group of individuals who are potential holders of a majority interest in the entities that already meet the other criteria for aggregation; and, from among the remaining beneficiaries, identify those who as individuals are members of, or related to members of, that group.

3. If trustee powers would affect the actuarial value of beneficiaries identified in step 2, assume that the trustee's discretion will be exercised to the maximum extent to support the identified beneficiary or beneficiaries. Then, calculate the separate actuarial interests of the beneficiaries and attribute the trust's ownership of the trades or businesses to the beneficiaries accordingly.

The first step is used to screen out remote interests as in, for example, attribution under sections 958 and 1563. This simplifies the process and reduces the occasions where there would be resulting reattribution under the family attribution rule. Here, however, the 5% interests are ignored without first applying the maximum discretion rule of step 3, so that the number of remote interests that can be disregarded is more easily determined and the screen is likely to be more meaningful.

The second and third steps are critical to avoiding the "facts and circumstances" approach that required complex analysis in PLR 9024076 (referenced above). To keep the process manageable, the adjustment for discretionary powers must make certain assumptions as to how those powers would be exercised. In other contexts where this method is used, most commonly, the tilt is in favor of finding common ownership or control; for example, see sections 267(e)(3)(B) and 1563(e)(3)(A), as well as § 25.2701-6(a)(4)(i) (applicable to determining control under section 2701 and 2704). For purposes of section 199A, ACTEC suggests the tilt should be in favor of attribution and thus in favor of the majority group likely qualifying for aggregation. As noted above, the trades or businesses to be aggregated must also be functionally related and the taxpayer group will be inclined to elect aggregation and thereby share financial information only if there is in fact a close relationship. Favoring attribution will facilitate the election opportunities, and we do not see a harm in more rather than less aggregation.

ACTEC's recommendations can be illustrated by an example based on the regulations under section 2701:

<u>Example 6</u>: An irrevocable trust holds a partnership interest in partnership P. One-half of the trust income is to be paid to D for D's life. The remaining income may, in the trustee's discretion, be accumulated or paid to or for the benefit of a class that includes D's child F, in such amounts as the trustee determines. On the death of the survivor of D and F, the trust corpus is required to be distributed to Charity. Assume that D's actuarial interest in the trust exceeds 5% based on D's life expectancy, and the actuarial interest of the class of which F is a member exceeds 5%. Also assume D's life interest in half the income is valued at 60% (the actuarial value of D's life interest if D were entitled all of the income) times ½ (D's share of the income), or 30%. Accordingly, D holds 30% of the trust's interest in P, which is the 50% actuarial value times half of the trust's income. The actuarial value of the life interest of the class of which F is a member would be 50% if that class were entitled to all of the income. O that class, only F is a member of the "family." Thus, the class holds 25% of the trust's interest in P. F is attributed the entire value of the class interest, rather than just an equal share, because F is a member of the class eligible to benefit from the maximum discretion in favor of D's family and thus is deemed to receive the entire trust

income for such time as F survives D. Thus, D is attributed more than 50%, which is 30% directly and more than 25% by attribution from F. Compare Example 4, § 25.2701-6(b).

If the above steps are too complex to be applied each time a trust is an owner of a trade or business, ACTEC requests that taxpayers be allowed to elect an alternate "short-cut" method. The shortcut method would be applicable to substantially all "family" trusts, and would be implemented by collapsing the steps as follows.

1. All of the trust's ownership in the trade or business would be attributed to those beneficiaries as a group who are in the same "family" (as defined under proposed § 1.199A-4(b)(3), and as modified as described above to include siblings) and whose total interest in the trust as a family group represents more than 50% of the trust, measured by the actuarial calculation described above.

2. In a typical trust created for children and/or other descendants, the trust's ownership could be attributed to that class of family members as a group, because the actuarial value would exceed the 50% minimum. As a result, all trust ownership would be attributed to the family, and there would be no need to ascertain the interest of each beneficiary because, as discussed immediately below, family attribution would aggregate their individual interests in any event.

After stock is attributed to the beneficiaries in either of the methods described above, the stock should be reattributed to other family members under section 267 as Example 6 above illustrates. Stock constructively owned by a person by reason of ownership of a corporation, partnership, estate or trust pursuant to section 267(c)(1) is treated as actually owned by the person, which then allows that stock to be attributed to that person's family members through family attribution. See, *e.g.*, *Pomeranz v. Commissioner*, T.C. Memo. 1980-36 (ownership of corporation attributed from trust to its beneficiaries and then ultimately to taxpayer to deny deductibility of loss under section 267 on transaction between taxpayer and corporation). As in section 267(c)(5), the stock then owned by another family member (D in the above example) pursuant to section 267(c)(2) is not treated as owned by that other individual family member for purposes of re-applying section 267(c)(2) in order to make yet a third family member the owner of the stock.

4. <u>Nongrantor Trusts and Estates</u>.

Proposed § 1.199A-6(d)(3)(iii) would require trusts and estates to determine their taxable income before any income distribution deduction in order to determine whether taxable income exceeds the threshold amount, thereby counting twice (at the trust level and at the beneficiary level) any taxable income reported to a beneficiary on a Schedule K-1. ACTEC believes this violates section 199A(e)(1), which takes into account all taxable income, modified by disregarding only the section 199A deduction.

ACTEC believes that proposed § 1.199A-6(d)(3)(v), "Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount," is overbroad and should focus on what would be considered abusive and describe appropriate consequences.

ACTEC is concerned with § 1.199A-6(d)(3)(vi), Example (1), which seems to overlook section 167(d).

A. Determination of Threshold Amount for Nongrantor Trusts and Estates.

ACTEC has concerns regarding the threshold amount generally and also how it applies to electing small business trusts (ESBTs).

(1) Nongrantor Trusts and Estates.

Proposed § 1.199A-6(d)(3)(iii) provides, "[f]or 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 section 651 or 661 (emphasis added)." This section appears to provide that, in connection with calculations under section 199A, a nongrantor trust or estate will be required to include income that is not taxable to it, resulting in a double counting of trust or estate income for section 199A purposes. It is unclear if this was an intended or unintended result.

It is possible that, because a nongrantor trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries under proposed § 1.199A-6(d)(1), such a rule was included to avoid the double counting of a deduction at the trust or estate level. This would occur if the trust or estate calculated its threshold amount only with respect to the amount of income retained by it after allocations to beneficiaries under the general rules of proposed § 1.199A-6(d)(1). If that is the case, then ACTEC requests the proposed regulations be revised to provide clarification in this regard so that the income allocated to the trust or estate for section 199A purposes is based only on the income that the trust or estate retains.

However, if Treasury and the IRS intended to eliminate a trust or estate's deduction, an explanation of the statutory authority for requiring nongrantor trusts and estates to "double count" income at the trust or estate level, even though they are otherwise treated as an RPE with respect to amounts distributed to beneficiaries, is needed.

Congress understands well that estates and trusts are entitled to distribution deductions that cause the taxable income earned by those entities to be allocated instead to their beneficiaries. Sections 651 and 661 are the very underpinnings of the method by which the taxable income of trusts and estates are measured. If the taxable income of trusts and estates were to be computed for purposes of section 199A without regard to the distribution deduction available to those taxpayers, Congress clearly could have made provision for such an adjustment. Congress neither did so nor appears to have authorized the Secretary to do so. Therefore, proposed § 1.199A-6(d)(3) appears to exceed Treasury and the IRS's authority with regard to the computation of taxable income for computing the threshold amount for trusts and estates.

One might argue that the manner in which estates, trusts, and their beneficiaries compute taxable income could allow QBI to be shared among multiple taxpayers, each of whom are entitled to their own threshold amount. But of course, this same argument applies to all pass-through entities, whose owners are each entitled to compute their threshold amounts separately (as discussed above in connection with proposed § 1.199A-6(d)(1)). Likewise, this argument could be used to say that the shifting of taxable income between a trust or an estate and its beneficiaries should not be allowed, because doing so allows multiple taxpayers to take advantage of the progressive tax rates applied to that income under section 1. Those arguments are unavailing. Congress' concern about the improper multiplication of threshold amounts is more properly dealt with under

the multiple trust rules of section 643(f), which was enacted for the very purpose of aggregating multiple trusts where a principal purpose of such trusts is the avoidance of federal income tax.

The income from nongrantor trusts and estates has always been divided between the trust or estate and its beneficiaries under the fundamental principles of subchapter J. Adding a rule that requires a trust or estate to be treated differently solely for purposes of section 199A could be viewed as punitive in nature and treats similarly situated taxpayers differently. Therefore, the distribution deduction should be taken into account in determining a nongrantor trust or an estate's taxable income for purposes of computing the section 199A threshold amount.

If proposed § 1.199A-6(d)(3)(iii) requires nongrantor trusts and estates to ignore the distribution deduction for calculation of the threshold amount, the following disparate results could occur:

Example 7. Assume that Trust A is a grantor trust established for the benefit of its grantor's daughter D and has $300,000 of income in Year 1. If Trust A remains a grantor trust for all of Year 1, all income will be reported on grantor's income tax return, and any section 199A calculations will be made by grantor. Assuming grantor is married and has no other income, the threshold amount will not be exceeded.

Example 8. Assume that Trust B is created on its grantor's death on January 1 of Year 1 for the benefit of its grantor's daughter D. Also assume that the trust has $300,000 of dividend and interest income in Year 1 and that the trust makes a distribution to D from the trust of $180,000 of its income in Year 1. The $300,000 of income will, for all income tax purposes other than the section 199A threshold calculation, be allocated $120,000 to the trust to be taxed at the trust level and $180,000 to D to be reported on her income tax return. However, for purposes of section 199A, the threshold amount at the trust level will be $300,000 and the threshold amount for D will be $180,000, for a total of $480,000 combined taxable income counted toward the thresholds, even though only $300,000 of income actually exists. This results in the trust exceeding the threshold amount, even though the trust only retains income well below the threshold amount. If D is single, the threshold amount will be exceeded by D as well.

The disparate treatment between Example 7 and Example 8 appears punitive in nature. In Example 8, no tax avoidance purposes exist. In addition, at any time a distribution is made to a beneficiary there are real economic consequences in connection with such a distribution that should be taken into account in all tax calculations, including the section 199A threshold determination.

Paragraph I.3 of the Special Analysis section of the Preamble states that Treasury and the IRS do not anticipate any meaningful economic distortions to be induced by proposed § 1.199A-6 and requests comment on these estimated impacts. If the application of § 1.199A-6(d)(1) results in the double counting of trust and estate income for section 199A purposes (as demonstrated by Example 8 above), then ACTEC respectfully disagrees with this assessment. Any such rule could be punitive in nature because it fails to take into account the actual economic consequences of distributions from a nongrantor trust or estate to its beneficiary and the fiduciary duties exercised in connection with such distributions and is inconsistent with the longstanding fundamental principles of subchapter J.

As an alternative, if proposed § 1.199A-6(d)(1) is not modified to remove the prohibition of a distribution deduction for purposes of computing the threshold amount, ACTEC suggests that the regulation should stipulate that any beneficiary who receives a distribution of taxable income from a trust or an estate will be allowed to disregard that taxable income in determining whether the beneficiary's income exceeds the threshold amount. While this approach requires a seemingly unauthorized modification to the taxable income of both trusts and estates and their beneficiaries, it avoids the double counting problem outlined above by having the trust or estate's taxable income counted only once, at the trust or estate level.

(2) Electing Small Business Trusts.

Proposed § 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 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.

ACTEC agrees that proposed § 1.199A-6(d)(3)(iv) appropriately describes the interaction between sections 199A and 641(c), as well as § 1.641(c)-1. However, ACTEC would appreciate clarification regarding how the section 199A threshold will apply to the taxable income of the S portion and the non-S portion of the ESBT.

Section 641(c)(1)(A) provides that, for purposes of chapter 1, "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." Section 1.641(c)-1(a) elaborates:

> *In general*. An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See § 1.1361-1(m).

Consistently with the above, ACTEC believes that the S portion and the non-S portion of an ESBT should be treated as separate trusts when applying the section 199A threshold so that each portion will be entitled to its own threshold amount under proposed § 1.199A-1(b)(11).

If Treasury and the IRS are concerned that taxpayers may form S corporations to take advantage of the separate trust treatment to apply multiple thresholds to avoid Federal income tax, ACTEC suggests that anti-abuse rules similar to those outlined in section 643(f) could be established.

B. <u>Clarification of Example under § 1.199A-6(d)(3)(vi)</u>.

The example in proposed § 1.199A-6(d)(3)(vi) provides a detailed calculation of how to calculate the section 199A deduction for each beneficiary and the trust, including allocations of deductions that include depreciation. The example could be misleading to taxpayers in connection with the depreciation allocations because of the netting of depreciation in the section 199A deduction calculations. For income tax reporting from a trust or estate, section 167(d) provides that depreciation is an item that may be reported separately and is not taken as a deduction against income that passes through to a beneficiary of a nongrantor trust or an estate. (This rule applies only if the trust does not create a reserve for depreciation, but usually any reserve would be maintained at the RPE level for the business as a whole.) If the example is intended to show only the section 199A deduction calculation (in accordance with proposed § 1.199A-6(d)(3)(i)) and not imply that there will be a change to the actual reporting of income and pass-through expenses like depreciation to the beneficiary, along with the relevant information needed to make the section 199A deduction calculation, clarification in this regard would be helpful to taxpayers and would avoid improper reporting at the trust level. Alternatively, if this example is intended to demonstrate changes to how these items are reported to beneficiaries of nongrantor trusts and estates for all purposes, then clarification of how section 199A affects those calculations is needed.

5. <u>Section 643(f) Multiple Trust Rule</u>.

Section 643(f) contains at least one undefined term, "primary beneficiary," and the legislative history does not clarify its definition but rather injects uncertainty. Proposed § 1.643(f)-1 seems to redefine "principal purpose." ACTEC would appreciate clarification of the term "primary beneficiary" and "principal purpose" and guidance on when "primary beneficiaries" and "grantors" are each considered to be substantially the same.

Section 643(f) provides that, for purposes of subchapter J, two or more trusts will be treated as a single trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1. Section 643(f) also provides that, for purposes of applying section 643(f), a husband and wife will be treated as one person.

The Preamble discusses the effective date of proposed § 1.643(f)-1, as well as the determination of whether an arrangement involving multiple trusts that existed prior to the effective date is subject to treatment under Section 643(f).

The Preamble states (emphasis added):

> The rule in proposed § 1.643(f)-1 would apply to any *arrangement involving multiple trusts* entered into or modified on or after August 16, 2018. In the case of any *arrangement involving multiple trusts* entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under Section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f).

The Preamble also states:

> Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed § 1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).

The Preamble thus appears to indicate that the position of Treasury and the IRS is that proposed § 1.643(f)-1 will apply to arrangements involving multiple trusts entered into or modified after March 1, 1984.[3] ACTEC believes it would be helpful if proposed § 1.643(f)-1 clarified how section 643(f) applies to arrangements involving multiple trusts created between March 1, 1984 and August 16, 2018 on the basis of the statute and legislative history by means of examples and further explanation. We refer to such trusts as "pre-effective date trusts." ACTEC also requests further guidance and clarification regarding the application of section 643(f) to pre-effective date trusts and to trusts established on or before March 1, 1984.

In addition, ACTEC requests that proposed § 1.643(f)-1 address the application of the effective date rules to irrevocable trusts that were treated as grantor trusts or grantor-type trusts prior to August 16, 2018 and became nongrantor trusts on or after August 16, 2018. Specifically, will an irrevocable trust that is treated as a grantor trust or grantor-type trust be treated as having been established or modified at the time of its conversion to a nongrantor trust? ACTEC recommends that, if a grantor trust or grantor-type trust becomes a nongrantor trust for any reason other than an intentional act by the grantor with no independent significance, then these unintentional acts will not be treated as the establishment or modification of a trust. Examples of acts of independent significance include the grantor's or a trust beneficiary's death or divorce,[4] or the actions of a third party.

A. <u>Arrangement Involving Multiple Trusts</u>.

The Preamble uses the term "arrangement involving multiple trusts" or a similar phrase four times in discussing the effective date provisions for proposed § 1.643(f)-1. The meaning of this term is not clear especially because it does not appear in section 643 or the proposed regulation. The application of proposed § 1.643(f)-1 requires that there be two or more trusts established or funded on or after August 16, 2018 (or perhaps March 1, 1984), and that a principal purpose for establishing or contributing additional cash or other property to such trusts be the avoidance of Federal income tax.

ACTEC requests the effective date provisions and proposed § 1.643(f)-1 clarify what is meant by the term "arrangement involving multiple trusts." The proposed regulation should further clarify that the term does not modify the substantive requirements for application of Section 643(f) that

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[3] March 1, 1984 is the effective date for section 643(f) under the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369).

[4] Section 675(3) treats the grantor as the owner of the borrowed portion of a trust if the grantor has directly or indirectly borrowed the trust's principal or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. If the grantor's spouse has borrowed trust funds, section 675(3) will treat the grantor as the deemed borrower and hence the owner for any year in which that loan is outstanding. However, the third sentence of section 675(3) expressly provides that section 675(3) does not apply after the grantor and the spouse are divorced or legally separated as provided in section 672(e)(2).

a principal purpose of such trusts (*i.e.*, all of the trusts to be aggregated) be avoidance of Federal income tax.

<u>Example 9</u>: G establishes a trust for his daughter D after March 1, 1984 for estate planning purposes. G establishes a second trust for D after August 16, 2018. A principal purpose of the second trust is avoidance of Federal income tax, but no principal purpose of the first trust is the avoidance of Federal income tax. The application of section 643(f) requires that a principal purpose of such trusts (*i.e.*, both of the trusts) be avoidance of Federal income tax. Accordingly, there is no "arrangement involving multiple trusts," and the trusts will not be treated as a single trust under section 643(f).

B. <u>Legislative History</u>.

The House Ways and Means Committee Report and the Senate Finance Committee Report[5] ("Committee Reports") made in connection with the Deficit Reduction Act of 1984 state:

> Trusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries. Similarly, trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.

The Committee Reports each have two examples, both of which focus on whether multiple trusts have substantially the same primary beneficiary or beneficiaries. One example simply assumes that the, not a, principal purpose for the creation of multiple trusts is the avoidance of Federal income tax. The example describes four trusts established by the same grantor, each of which has three of four siblings as its beneficiaries. Therefore, each sibling is a co-beneficiary of three of the four trusts. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries. The Committee Reports state that the respective committee expects that the Treasury regulations would treat the trusts as one trust. It appears that the purpose of this example may be to demonstrate that multiple trusts established for different siblings over which the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries can be treated as trusts for the same beneficiaries even though not all of the trusts have identical beneficiaries.

The second example involves two trusts established by the same grantor and involves a situation in which one person is the income beneficiary of one trust and may receive distributions of income or principal from a second trust solely for medical expenses. In the paragraph prior to the second example, the Committee Reports state, "[w]here there are substantial independent purposes, and tax purposes are not a principal purpose of the existence of separate trusts, the trusts will not be aggregated." The Committee Reports then provide the second example as an example of two trusts that would not be aggregated.

Proposed § 1.643(f)-1(c) also provides two examples illustrating the application of the multiple trust rule. The two examples seem modeled after the two examples in the Committee Reports. Each example involves multiple trusts established by the same grantor and assumes facts regarding the grantor's subjective intent in establishing multiple trusts. As discussed below, these

[5] H. Rept. 98-432, Part 2, 98th Congress (1983-1984), and S. Rept. 98-169, 98th Congress (1983-1984).

examples do not specify or describe what factors were determinative of the conclusion that the multiple trusts had substantially the same primary beneficiary or beneficiaries.

C. Additional Guidance Needed.

As noted above, section 643(f) provides that, for purposes of subchapter J, two or more trusts will be treated as a single trust if (1) such trusts have substantially the same grantor or grantors, and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. Section 643(f) also provides that for purposes of its application, a husband and wife will be treated as one person. In the case of a trust which was irrevocable on March 1, 1984, section 643(f) applies only to that portion of the trust which is attributable to contributions to corpus after March 1, 1984. P.L. 99-514 § 1806(b).

Although section 643(f) enumerates two elements for its application, it is clear from the statutory language that three elements must co-exist for it to apply:

1. The trusts must have substantially the same grantor or grantors;

2. The trusts must have substantially the same "primary" beneficiary or beneficiaries; and

3. A principal purpose of such trusts is the avoidance of federal income tax.

ACTEC recommends that proposed § 1.643(f)-1 be expanded to separately discuss each of these elements and to provide examples and/or contra-examples for each.

In addition, proposed § 1.643(f)-1 does not define the term primary beneficiary or beneficiaries, and does not delineate what is meant by the terms "substantially the same grantor or grantors," or "substantially the same primary beneficiary or beneficiaries." The only guidance is in the Committee Reports and case law. The Committee Reports state:

> [T]rusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries. Similarly, trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.

Accordingly, ACTEC requests that proposed § 1.643(f)-1 provide clarification in the following areas:

(1) Primary Beneficiary or Beneficiaries.

Section 643(f) applies only to trusts that have the same "primary" beneficiary or beneficiaries; therefore, a simple overlap in the identity of trust beneficiaries is insufficient unless the same person or persons are "primary" beneficiaries of each trust. The Code does not define the phrase "primary beneficiary or beneficiaries." Likewise, neither the Uniform Trust Code[6] nor the Restatement (3d) of Trusts offer a definition.

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[6] The Uniform Trust Code defines a trust beneficiary as a person who either has a present or future beneficial interest in a trust (UTC § 103(3)). The Uniform Trust Code also defines a qualified beneficiary as

Grantors sometimes expressly identify certain beneficiaries as "primary" beneficiaries and others as "secondary" beneficiaries, typically in the context of permitting a trustee to vary its duty of loyalty and impartiality to favor one beneficiary or class of beneficiaries over others. When the trust instrument clearly establishes that a beneficiary's right to distributions are secondary or incidental to the rights of another beneficiary or beneficiaries, those beneficiaries whose rights are subordinate cannot fairly be classified as primary beneficiaries. In addition, in the context of subchapter J, it is more likely that a "primary" beneficiary would be limited to a person or persons who are entitled to, or permitted to receive, current distributions of trust income. It is those beneficiaries whom proposed § 1.643(f)-1 should define as a "primary" beneficiary or beneficiaries. In that regard, ACTEC suggests that a definition could be modeled in part after the definition in section 1361(e)(2). Specifically, proposed § 1.643(f)-1 could limit the definition of a "primary beneficiary or beneficiaries" to include only "with respect to any period, a person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the distributable net income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period)."

Moreover, ACTEC recommends that the definition provide that persons who, at the discretion of any person, may receive a distribution of distributable net income will not be considered a "primary beneficiary or beneficiary" if their entitlement to distributions is clearly secondary or incidental to the right of other persons entitled or permitted to receive current distributions of distributable net income.

Example 10: F establishes Trust 1 after March 1, 1984 for the benefit of his daughter S. The trust permits distributions to S for her health, maintenance, support, and education. The terms of Trust 1 permit the trustee to make distributions of income or principal to F's parents X and Y if, after considering all of their other resources, such a distribution is required for a medical emergency or exigency, and only if doing so will not jeopardize S's financial security. Two years later, F's spouse creates Trust 2, which requires that distributions be made to X and Y for their health, maintenance, and support. No current distributions are permitted from Trust 2 to any other persons during the lifetimes of X and Y. Upon the death of X and Y, the remaining property of Trust 2 passes to F's children, one of whom is S. S is a primary beneficiary of Trust 1 since she is permitted to receive current distributions of Trust 1's distributable net income. Although X and Y are permitted distributees of Trust 1's distributable net income, they are not primary beneficiaries because their right to receive distributions from Trust 1 are clearly secondary or incidental to the rights of S. X and Y are primary beneficiaries of Trust 2 since they are entitled to receive distributions of distributable net income from Trust 2. Although S is a remainder beneficiary of Trust 2, she is not a primary beneficiary during the lifetimes of X and Y since she is not entitled or permitted to receive current distributions of Trust 2's distributable net income. Therefore, during the lifetimes of X and Y, Trust 1 and Trust 2 do not have the same primary beneficiary or beneficiaries and will not be treated as a single trust under section 643(f).

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a beneficiary who, on the date the beneficiary's qualification is determined, is a distributee or permissible distributee of trust income or principal (UTC § 103(13)).

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(2) Substantially the Same Primary Beneficiaries.

ACTEC requests proposed § 1.643(f)-1 clarify the amount of overlap of beneficial interests among multiple trusts that would cause the trusts to be treated as having substantially the same primary beneficiary or beneficiaries, one of the fundamental tests for application of section 643(f).

Proposed § 1.643(f)-1, Example 1 (which is similar to the second example in the Committee Reports) involves the following facts:

A establishes three irrevocable, nongrantor trusts. Trust 1 is for the benefit of A's sister, B, and A's brothers, C and D; Trust 2 is for the benefit of A's second sister, E, and for C and D; and Trust 3 is for the benefit of E.

Proposed § 1.643(f)-1, Example 1 concludes that Trust 1, Trust 2, and Trust 3 would be aggregated and treated as a single trust. However, proposed § 1.643(f)-1, Example 1 provides no discussion behind the conclusion that the three trusts have substantially the same primary beneficiary or beneficiaries. The example seems to address only that a principal purpose of the creation and funding of the trusts was section 199A. Absent a clear explanation of how the three trusts have the same primary beneficiaries to cause the trusts to be aggregated, considerable uncertainty will exist regarding the application of section 643(f).

Proposed § 1.643(f)-1, Example 2 (which is virtually identical to the second example in the Committee Reports) has the following facts:

X establishes two irrevocable, trusts. Trust 1 is for the benefit of X's son, G; and Trust 2 is for the benefit of X's daughter, H, and for G for his medical expenses.

Proposed § 1.643(f)-1, Example 2 does not indicate if the trusts are grantor or nongrantor trusts. ACTEC recommends that the example be clarified to describe the trusts as nongrantor trusts.

Proposed § 1.643(f)-1, Example 2 appears to assume that the trusts have the same primary beneficiary or beneficiaries, but it does not provide any analysis in this regard. From the facts, we know that the remainder beneficiary of both trusts is the same person, *i.e.*, H. G is the current income beneficiary of Trust 1 and is a beneficiary of Trust 2 solely with respect to distributions of income or principal for G's medical expenses. One explanation may be that the trusts have the same primary beneficiaries because G is entitled to receive current income distributions from Trust 1 and may potentially receive distributions from Trust 2 for his medical expenses. Another explanation may be that, because both trusts have the same remainder beneficiary, the trusts will be deemed to have the same primary beneficiary for purposes of section 643(f).

ACTEC suggests that further guidance is needed to determine when multiple trusts will be treated as having the "same primary beneficiary or beneficiaries." The analysis should focus on the amount of overlap required for trusts to be treated as having "substantially the same primary beneficiary or beneficiaries." Using the definition recommended above, G is the only person entitled to current distributions from Trust 1. Therefore, G is the primary beneficiary of Trust 1. The identity of the remainder beneficiary of the trusts is irrelevant. In addition, G's right to receive distributions from Trust 2 solely for medical expenses clearly demonstrates that H is the primary

beneficiary of Trust 2. Therefore, proposed § 1.643(f)-1, Example 2 should state that the two trusts do not have substantially the same primary beneficiary or beneficiaries.

Proposed § 1.643(f)-1, Example 2 also states there are significant non-tax differences between the substantive terms of the two trusts but fails to specify those differences. Presumably, we can assume that one difference is the ability of the trustee of Trust 2 to distribute income or principal for G's medical needs, but the example fails to state that this constitutes one or all of the significant non-tax differences.

Proposed § 1.643(f)-1, Example 2 also may create confusion because it concludes that tax avoidance will not be presumed to be a principal purpose because of the "significant non-tax differences." ACTEC believes it would be helpful to clarify that there is no tax benefit to the trusts and provide specific examples of what constitutes a significant tax benefit.

(3) <u>Substantially the Same Grantor or Grantors</u>.

(a) Identifying the Grantor. ACTEC recommends that for purposes of proposed § 1.643(f)-1, reference be made to § 1.671-2(e), which describes who will be treated as a grantor for purposes of part I of subchapter J of chapter 1 of the Code. Existing general principles used for determining the identity of a grantor under subchapter J provide a useful analogy for administrable rules that are appropriate for the purposes of section 643(f). Their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them.

<u>Example 11</u>: F establishes a trust after March 1, 1984 for the benefit of his daughter S. The trust permits distributions to S for her health, maintenance, support, and education. A year later, F's mother G establishes trusts for each of her grandchildren, including S. G utilizes the same law firm to prepare these trusts, and all of the substantive terms of the trusts are identical. Nevertheless, since F and G are not the same grantors, the trusts created by F and G for the benefit of S will not be treated as a single trust under section 643(f).

(b) Additional Questions Regarding the Identity of the Grantor. ACTEC requests proposed § 1.643(f)-1 clarify the following areas of ambiguity:

1) Similar to ACTEC's request for clarification of the term "substantially the same primary beneficiary or beneficiaries," what is meant by the term "substantially the same grantor or grantors"?

2) If a trust has more than one grantor, how will section 643(f) be applied?

3) If a person holding a general power of appointment over a trust exercises that power in favor of another trust, will the person who exercised the general power of appointment be treated as the grantor of the transferee trust?[7]

(4) <u>Tax Avoidance Purpose</u>.

Section 643(f)(2) provides that two or more trusts may be treated as one if, "a principal purpose of such trusts is the avoidance of the tax imposed by this chapter," with "this chapter" being a

[7] See Treas. Reg. §1.671-2(e)(5).

reference to chapter 1 of the Code. Proposed § 1.643(f)-1(b) attempts to define the term "a principal purpose" and creates a presumption by providing, "[a] principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."

The definition of "a principal purpose" in proposed § 1.643(f)-1(b) generally refers to an income tax without specifying that it be a Federal income tax benefit. This may create confusion in connection with trusts that are created in a manner that is tax efficient for state income tax purposes.

The presumption described in proposed § 1.643(f)-1(b) appears to improperly shift the focus away from avoidance of Federal income tax, as required by section 643(f), to a requirement that there be non-tax purposes for the creation of multiple trusts, which is not supported by the statute. In order to rebut the presumption, only significant non-tax purposes are to be considered. By imposing this requirement, proposed § 1.643(f)-1 improperly disregards the consideration of taxes that are not federal income taxes, such as estate, gift, and generation-skipping transfer taxes, as purposes that may exist for the creation of multiple trusts.

The presumption is not whether non-Federal income tax reasons exist or whether alternative ways of achieving the grantor's purposes could have been utilized, but rather whether avoidance of Federal income tax is a principal purpose for the creation of multiple trusts. Non-Federal income tax purposes for the use of multiple trusts may reflect that the avoidance of Federal income tax is not a principal purpose for the creation of multiple trusts, but the suggestion that such non-Federal income tax purposes are required is simply not consistent with section 643(f). Furthermore, proposed § 1.643(f)-1 seems to require the taxpayer to prove that the non-income tax purposes could not have been achieved without the creation of the separate trusts. Taken literally, this imposes a burden on taxpayers to prove that there was no other way of achieving those purposes.

Proposed § 1.643(f)-1 creates a presumption that a principal purpose for establishing or funding two or more trusts is the avoidance of Federal income tax if a significant income tax benefit results from the use of separate trusts. The language appears to alter the section 643(f) test from a principal purpose test to a significant purpose test. Clarification is needed in connection with the application of this provision in light of the unambiguous statutory language.[8]

ACTEC respectfully submits that the presumption contained in proposed § 1.643(f)-1 is overbroad and is an impermissible interpretation of the statute. This fact can be demonstrated by an example:

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[8] "Significant purpose" is too high of a burden. Any time a taxpayer creates any structure, the taxpayer needs to consider tax consequences. See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."); *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394, 398, fn. 4 (1972) ("Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring … to minimize taxes"). Proposed § 1.199A-6(d)(3)(v) would overturn decades of jurisprudence by imposing a subjective standard that would make planning impossible to do.

Example 12: Q creates trusts after March 1, 1984 for each of his four children. The trusts permit distributions to each child for his or her health, maintenance, support, and education. Two years later, Q's wife R creates trusts for each of their four children to provide for the post-secondary education of the children and their descendants. Before a recent change in income tax laws, the multiple trusts achieve no significant income tax savings. As a result of changes to the income tax rules after the trusts were formed, the fact that the trusts are administered separately results in a significant tax savings. This tax savings was impossible to foresee at the time the trusts were created. Nevertheless (assuming that the trusts have substantially the same beneficiaries), under proposed § 1.1643(f)-1, a principal purpose for establishing or funding a trust will be presumed to be the avoidance of Federal income tax unless it can be established that Q and R could not have achieved their non-tax purposes without creating separate trusts. This result cannot have been contemplated by the statute.

ACTEC believes that proposed § 1.643(f)-1 should follow case law interpretations of "principal purpose" instead of creating new standards. A principal purpose for a transaction is a question of fact and is determined from the entire circumstances in which the transaction occurred. In *Pitcher v. Commissioner*[9], the Tax Court found that "the proper test for whether tax avoidance was a principal purpose is not, as respondent urges, whether a tax avoidance purpose figures prominently as a reason for the plan, or whether business reasons are so overwhelming as to make tax avoidance a negligible concern, but rather whether the transaction had as one of its 'first-in-importance' purposes the avoidance of Federal income taxes." The principal purpose test is used in other provisions of the Code. It has been interpreted to mean the purpose to evade tax exceeds any other purpose.[10] Relying on *Malat v. Riddell*,[11] courts have held in the context of sections 269, 367, 1248, and 877 that a principal purpose of tax avoidance standard is satisfied only when the avoidance of tax outranks any other purpose. For example, in *Dittler Bros. Inc. v. Commissioner*, the Tax Court stated, "the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its "first-in-importance" purposes the avoidance of Federal income taxes."[12]

The first example provided by proposed § 1.643(f)-1 recites facts that would rarely be evident in the actual administration of the statute (*i.e.*, that the grantor created multiple trusts after reading "an article in a magazine that suggests that taxpayers can avoid the W-2 wage limitation of section 199A by contributing portions of their family businesses to multiple identical trusts established for family members").

The second example states there are significant non-tax differences between the substantive terms of the two trusts but fails to specify those differences. Presumably, we can assume that one difference is the ability of the trustee of Trust 2 to distribute income or principal for G's medical needs, but the example fails to state that this constitutes one or all of the significant non-tax differences. The example also creates confusion by concluding that tax avoidance will not be

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[9] 84 T.C. 85 (1985).

[10] Benjamin M. Willis, "A Principal Purpose: There Can Be Only One," *Tax Notes*, June 10, 2013, page 1318.

[11] 383 U.S. 569 (1966).

[12] 72 T.C. 896, 915 (1979).

presumed to be a principal purpose because of the "significant non-tax differences." ACTEC believes it would be helpful to clarify if there is no tax benefit to the trusts and provide specific examples of what constitutes a significant tax benefit.

In addition, the second example fails to disclose whether federal income tax savings are provided by the trusts, or whether the taxpayer could achieve the trusts' significant non-tax purposes only by creating separate trusts (which is the basis of the presumption in proposed § 1.643(f)-1). Instead, the example simply notes that there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the two trusts. While the result in the second example is welcomed, neither example proves helpful in identifying a principal tax avoidance purpose. ACTEC believes that the result in the second example can better be explained by the fact that the two trusts do not have the same primary beneficiary or beneficiaries, using the definition of that phrase, as recommended above.

In fact, it is hard to envision any circumstance with regard to trusts created or funded between 1986 (when income tax brackets for trusts and estates were significantly compressed) and 2018, where the formation of separate trusts could be said to have had as a principal purpose the avoidance of federal income tax. This fact is further addressed in ACTEC's request for consideration of the effective date provisions of the proposed regulations below.

In lieu of the presumption contained in proposed § 1.643(f)-1, ACTEC recommends that a principal purpose for establishing two or more trusts will be the avoidance of Federal income tax only when, but for Federal income tax savings known to be available to the grantor or grantors at the time of the trusts' formation or funding, a single trust would have been created.

(5) Modification of Pre-Effective Date Trusts.

The Preamble provides the "rule in proposed § 1.643(f)-1 would apply to any arrangement involving multiple trusts entered into *or modified* on or after" August 16, 2018 (emphasis added). Proposed § 1.643(f)-1 does not provide rules for determining when a modification will cause a trust to be treated as subject to proposed § 1.643(f)-1. ACTEC suggests that rules similar to the effective date rules that apply for purposes of the generation-skipping transfer tax be used as the model for the effective date rules for proposed § 1.643(f)-1. Specifically, § 26.2601-1(b)(4) deals with modifications of existing trusts. ACTEC also believes that only a modification to a pre-existing trust that implicates the multiple trust rule should cause a trust to be treated as subject to proposed § 1.643(f)-1. For example, if the modification involves a change to the "primary beneficiary" of the trust then proposed § 1.643(f)-1 would apply. In contrast, a modification that only involves the administrative provisions of a trust should not cause a trust to be treated as subject to proposed § 1.643(f)-1.

(6) Contribution of Additional Assets to a Trust or Funding a Trust.

Proposed § 1.643(f)-1 provides that two or more trusts having substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries will be aggregated and treated as a single trust if a principal purpose "for contributing additional cash or other property to such trusts" is the avoidance of Federal income tax. Proposed § 1.643(f)-1 does not provide rules for determining what will be treated as an addition that will cause a trust to be subject to proposed

§ 1.643(f)-1. ACTEC recommends that rules similar to the effective date rules that apply for purposes of the generation-skipping transfer tax be used as the model for the effective date rules for proposed § 1.643(f). Specifically, § 26.2601-1(b)(1), which deals with additions to existing trusts, could be applied to proposed § 1.643(f)-1. Section 26.2601-1(b)(1)(b)(iv) treats an addition to an existing trust as a separate portion of the trust.

For example, ACTEC recommends that proposed § 1.643(f)-1 should provide that assets transferred from one pre-effective date trust to a second pre-effective date trust are not treated as additional contributions. Moreover, if a pre-effective date trust borrows funds to invest those funds in a business, the transaction should not be treated as a contribution of additional assets to the trust.

D. Proposed § 1.199A-6(d)(3)(v): Anti-abuse Rule for Creation of Multiple Trusts to Avoid Exceeding the Threshold Amount.

In discussing proposed § 1.199A-6(d)(3)(v), the Preamble states that "[u]nder 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 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."[13]

Proposed § 1.199A-6(d)(3)(v) states (emphasis added):

> *Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount*. 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.

First, ACTEC suggests that this provision is not needed and will cause unnecessary confusion and inconsistency in light of proposed § 1.643(f)-1, which should be sufficient to combat abuse involving multiple trusts.

Second, ACTEC suggests that if Treasury and the IRS still find this provision necessary, then it use a similar "principal purpose" standard as proposed § 1.643(f)-1 rather than the "significant purpose" language noted above, which is much more uncertain in application and an unwarranted interpretation of the statute. The significant purpose standard under proposed § 1.199A-6(d)(3)(v) is a lesser standard than the principal purpose standard in section 643(f). One commentator has stated that "a distinction is drawn between a significant purpose and a principal purpose (or purpose of first importance). The former is clearly a lesser standard."[14]

Existing general principles used for determining whether a "principal purpose" is the avoidance of federal income tax provide a useful analogy for administrable rules that are appropriate for the

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[13] Section 199A(f)(4) provides that "[t]he Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section."
[14] Benjamin M. Willis, "A Principal Purpose: There Can Be Only One." *Tax Notes*, June 10, 2013, page 1317.

purposes of proposed § 1.199A-6(d)(3)(v). The use of the "principal purpose" test in this setting will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying it. In addition, the use of this familiar test will result in a more accurate and uniform application of the statute and regulations relative to how taxpayers will interpret which trusts fall within the rule.

Third, it is not clear whether proposed § 1.199A-6(d)(3)(v) applies in situations not involving multiple trusts. Proposed § 1.199A-6(d)(3)(v) should clarify whether it may apply to situations where a grantor creates only one trust with a significant purpose of receiving a deduction under section 199A. The proposed regulations should provide examples of how proposed §§ 1.199A-6(d)(3)(v) and 1.643(f)-1 interact. Additionally, proposed § 1.199A-6(d)(3)(v) should include examples of situations in which it will not apply. Following are suggested examples:

Example 13: Before the proposed regulations were issued, A establishes an irrevocable nongrantor trust for daughter, D, who is the sole beneficiary currently eligible to receive trust distributions. The trust is funded with cash and marketable securities and the trustee and/or trust investment advisors (who are neither the grantor nor a related or subordinate party as defined under section 672(c)) thereafter decide to have the trust purchase assets that will generate substantial QBI. Because the grantor had no intention of avoiding the section 199A threshold at the time of forming or funding the trust, proposed § 1.199A-6(d)(3)(v) will not apply.

Example 14: Same facts as Example 13 except that the trust was a grantor trust at the time of its formation. After the effective date of the proposed regulations, the trust becomes a nongrantor trust. Because the grantor had no intention of avoiding the section 199A threshold at the time of forming or funding the trust, proposed § 1.199A-6(d)(3)(v) will not apply.

Example 15: Grantor dies after the effective date of the proposed regulations. Her estate plan divides her estate into three separate trusts, A, B, and C, one for the benefit of each of her three children. Each trust thereafter owns 1/3 of a business interest that generates QBI. Proposed § 1.199A-6(d)(3)(v) will not apply to any of the three trusts because funding at death is presumed not to be for the purpose of receiving a deduction under section 199A.

Fourth, ACTEC recommends that, if Treasury and the IRS still find proposed § 1.199A-6(d)(3)(v) necessary, the regulation clarify that it applies only to multiple trusts with substantially similar grantors and beneficiaries and that any intent be measured on an annual basis. ACTEC also recommends and that proposed § 1.199A-6 provide examples of what is "significant."

Example 16: A establishes an irrevocable grantor trust and an irrevocable nongrantor trust for daughter, D, who is the sole beneficiary currently eligible for distributions. Because the irrevocable grantor trust is treated as owned by A for income tax purposes, it is ignored for purposes of section 199A. Because only one irrevocable nongrantor trust is involved, proposed § 1.199A-6(d)(3)(v) does not apply.

Example 17: Same facts as Example 16, but A's spouse B also establishes an irrevocable nongrantor trust for D. Because there are multiple nongrantor trusts funded by similar grantors for similar beneficiaries, proposed § 1.199A-6(d)(3)(v) may apply.

Example 18: Same facts as Example 17, but during the taxable year, the total combined taxable income of the two trusts is $140,000, less than the $157,500 threshold. Because the purpose of proposed § 1.199A-6(d)(3)(v) is to combat the use of multiple trusts established to avoid exceeding the $157,500 threshold, and because the multiple trusts provide no additional section 199A benefit in the taxable year in question, proposed § 1.199A-6(d)(3)(v) does not apply. However, proposed § 1.643(f)-1 may apply if a principal purpose of forming or funding the two trusts is to avoid Federal income tax.

Example 19: Same facts as Example 17, except that, during the taxable year, the total combined taxable income of the two trusts combined is $300,000, a majority of which is QBI. In this situation, proposed § 1.199A-6(d)(3)(v) applies to require that each of the trusts be treated as having taxable income in excess of the threshold and the phase-out amount. In addition, proposed § 1.643(f)-1 may apply if the principal purpose of forming or funding the two trusts is to avoid Federal income tax.

Example 20: Same facts as Example 19, but only $30,000 of the $300,000 of taxable income (10%) is QBI, with the remainder being ordinary interest, dividends, and capital gains. Because such a small amount and small percentage of the trust's income is QBI, avoidance of the $157,500 threshold could not have been a significant purpose of establishing the trust and proposed § 1.199A-6(d)(3)(v) will not apply. However, proposed § 1.643(f)-1 may apply if a principal purpose of forming or funding the two trusts is to avoid Federal income tax.

Example 21: Same facts as Example 20, except that the grantor had read about section 199A in a magazine, established the trust, and had planned to fund the trust with business interests, but she then read about the proposed regulations in a magazine prior to funding, and decided to fund the trust with 90% non-business interests. The grantor's intention at the time the trust was formed is irrelevant because the intention changed by the time of funding and therefore proposed § 1.199A-6(d)(3)(v) will not apply.

Example 22: Same facts as Example 17, except that the grantors of both trusts had initially funded the trust - before the proposed regulations were issued - with cash and marketable securities, and the trustees and/or trust investment advisors (who are neither the settlors nor a related or subordinate party as defined under section 672(c)) thereafter decide to have the trust purchase assets that generate substantial QBI. Because the grantors clearly had no intention at the time of forming or funding the trusts of avoiding the section 199A threshold, proposed § 1.199A-6(d)(3)(v) will not apply.

Example 23: Same facts as Example 22, except that the first grantor had funded the trust before the proposed regulations were issued with business interests generating over $157,500 of QBI, and the second grantor had funded the trust after the issuance of the proposed regulations with similar assets. Proposed § 1.199A-6(d)(3)(v) will apply to the second trust but not to the first trust.

Finally, ACTEC recommends that proposed § 1.199A-6(d)(3)(v) should describe the consequences of violating the anti-abuse rule. First, ACTEC recommends that the anti-abuse rule be applied on a year-by-year basis. For example, if a trust violated the applicable purpose rule when established but later engaged in a trade or business that was not an SSTB and had sufficient W-2 wages or UBIA to satisfy the relevant tests even if its taxable income exceeded the threshold, the trust should be able to obtain the full section 199A deduction.

Second, proposed § 1.199A-6(d)(3)(v) should clarify consequences if a trust "will not be respected for purposes of section 199A." The Preamble notes that the purpose of the anti-abuse rule is to prevent taxpayers from circumventing the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. Nevertheless, such trusts may be treated as separate taxpayers and will not be ignored for federal income tax purposes other than section 199A. Since the perceived abuse is avoidance of the threshold, ACTEC suggests that the regulations should specify that trusts described in proposed § 1.199A-6(d)(3)(v) will be allowed a deduction under section 199A if they otherwise satisfy the requirements of the statute and regulations, but the taxable income of the trusts will be deemed to exceed the threshold by the phase-out amount. As a result, the trusts will be fully subject to the limitations imposed by sections 199A(b)(2)(B) and 199A(d)(1), regardless of the amount of their taxable income and without regard to the exceptions set forth in sections 199A(b)(3) and 199A(d)(3).

6. "Unadjusted Basis Immediately after Acquisition" ("UBIA") and "Depreciable Period" of "Qualified Property" under Section 199A(b)(6)(B).

The following comments relate to the definitions of "unadjusted basis immediately after acquisition" ("UBIA") of "qualified property" of a taxpayer, and the "depreciable period" with respect to such qualified property, under section 199A(b)(6)(B).

A. Effect of Death of a Taxpayer on the UBIA and the Depreciable Period of Qualified Property.

The Preamble states that the proposed regulations intend to set forth the following rule with respect to property inherited from a decedent and immediately placed in service by the heir:

> 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.

The actual text of the proposed regulations, however, does not contain any such provision. We therefore recommend that the proposed regulations be modified to expressly provide such a rule for property inherited from a decedent and placed in service by the heir (including, for this purpose, an executor of the decedent's estate, or any other successor-in-interest to the qualified property following a person's death) in order to implement Treasury and the IRS's clear statement of intent in the Preamble.

It further follows that if the UBIA of qualified property is generally the fair market value at the time of the decedent's death under section 1014, then the date of the decedent's death should also commence a new depreciable period for such qualified property. ACTEC recommends that the proposed regulations expressly clarify that point as well.

B. UBIA of Qualified Property Concepts that Apply to Property that is Initially Acquired by a Partnership or S Corporation Should also Apply to Property Contributed to Partnerships and S Corporations by Partners and Shareholders.

In determining the UBIA of qualified property that is placed in service by partnerships and S corporations (as well as sole proprietorships), proposed § 1.199A-2 looks to the unadjusted

basis of property immediately after acquisition. In contrast to this general principle, however, proposed § 1.199A-2(c)(3), in conjunction with the additional explanation in the Preamble, applies a different set of rules for determining the UBIA of qualified property that is contributed by a partner to a partnership or by a shareholder to an S corporation ("contribution contexts"). These different rules do not take into account the unadjusted basis of the contributed property in the hands of the contributing partner or shareholder.

Specifically, the Preamble provides:

> 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.

In addition, proposed § 1.199A-2(c)(4), Ex. 3, provides as follows:

> Example 3. (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.

ACTEC questions the reasoning for the disparate UBIA treatment conferred upon (1) qualified property that is placed in service by a partnership or an S corporation (or sole proprietorship) and

(2) qualified property that is contributed by a partner to a partnership, or by a shareholder to an S corporation. The rationale for changing the UBIA of qualified property merely because it has been contributed to an entity by an owner of such entity is unclear, and it seems that "tacking principles" to reflect the unadjusted basis and depreciable period in the hands of the contributing partner or shareholder should instead apply. ACTEC believes that the current disparate treatment will only serve to encourage taxpayers who form new entities or otherwise combine their business interests to retain depreciable property and lease it to the new or combined business as a "work-around." It seems undesirable to encourage such added complexity by taxpayers in structuring their business affairs.

Accordingly, ACTEC recommends that proposed § 1.199A-2 be revised to provide that the UBIA of qualified property contributed to a partnership or an S corporation shall be determined without regard to section 723 in the case of a partnership and section 362 in the case of an S corporation so that the UBIA of the qualified property in the hands of the contributing partner or shareholder will carry over to the RPE.

C. Disparate Treatment Concerning the UBIA of Qualified Property Should Not Be Accorded to Partnership Special Basis Adjustments under Sections 734(b) and 743(b).

Proposed § 1.199A-2(c)(1)(iii) provides that partnership special basis adjustments under sections 734(b) and 743(b) are not treated as separate qualified property. The Preamble provides the following rationale for this treatment:

> 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.

ACTEC urges Treasury and the IRS to reconsider its position and conform proposed § 1.199A-2(c)(1)(iii) to the well-established basis adjustment principles under Subchapter K of the Code, by treating special basis adjustments under sections 734(b) and 743(b) as qualified property for purposes of section 199A.

Except in the case of a partnership with substantial built-in loss, basis adjustments under sections 734(b) and 743(b) are optional and are triggered by making a timely section 754 election. A section 734(b) basis adjustment applies to partnership distributions – that is, it applies only when a partnership distributes property to a partner and that distributee partner either recognizes gain or loss on the distribution or takes a basis in the distributed property that differs from the basis that the partnership had in that property. Adjustments under section 734(b) are recorded on the books and records of the partnership and reflect an actual adjustment to the basis of partnership property.

A section 743(b) basis adjustment, on the other hand, applies only when a partnership interest is transferred (including transfers by sale, exchange, or death). Unlike an adjustment under

section 734(b), a section 743(b) basis adjustment is not recorded on the books and records of the partnership and does not affect the basis of property in the hands of the partnership. Instead, a section 743(b) basis adjustment affects only the transferee partner.

Even though both provisions operate differently, they have a common purpose: attempting to eliminate the disparities between inside and outside basis in a partnership. For purposes of brevity, these comments will focus on transfers of partnership interests subject to section 743(b) basis adjustments. However, ACTEC believes the principles described below apply equally to section 734(b) basis adjustments.

Absent a section 754 election (and assuming the partnership does not have substantial built-in loss), when a partnership interest is transferred, the transferee partner's share of inside basis usually differs from its outside basis. Consequently, when no section 754 election is in place (and assuming the partnership does not have substantial built-in loss), the partnership is viewed and treated under an entity theory for tax purposes – that is, the partnership is viewed as an entity separate and apart from its owners, much like a corporation, so that the partnership (and not its partners) is treated as the owner of partnership property. When the partnership is viewed under the entity theory, we agree that the disparity between a transferee partner's share of inside basis and its outside basis should not constitute qualified property for purposes of section 199A. That is not the case, however, when the partnership is viewed under the aggregate theory for tax purposes.

Under the aggregate theory, partners are viewed as co-owners of undivided interests in all partnership property. When the partnership makes (or previously made) a section 754 election (or, if the partnership has substantial built-in loss), the transferee partner is considered to have acquired an undivided interest in all partnership property. The disparity between the transferee partner's outside basis in its partnership interest and its share of inside basis (i.e., the amount of the basis adjustment) is determined under section 743(b) (and the regulations thereunder). The amount of the basis adjustment is then allocated among partnership assets under the rules of section 755 (and the regulations thereunder). Under § 1.743-1(j)(4)(i)(B)(1), the transferee partner (and only the transferee partner) takes into account the increased portion of the basis for purposes of depreciation under section 168 as if it were newly-purchased recovery property placed in service when the transfer occurs.

ACTEC believes that the principles of sections 734(b), 743(b), 754, and 755 have been well thought-out and are understood and accepted by the government and tax practitioners alike. Moreover, these sections have been refined over the years to avoid duplication of basis and duplication of losses. Consequently, ACTEC urges Treasury and the IRS to incorporate the existing principles of sections 734(b), 743(b), 754, and 755 into section 199A under one of two approaches.

Under the first approach, the principles of these sections would be applied to determine the UBIA of separate qualified property by reference to the difference between the transferee partner's outside basis and its share of UBIA. Following are examples clarifying the application and operation of ACTEC's suggested first approach. For each example, assume that Partnership XYZ has a single asset, which is qualified property for purposes of section 199A. Partner X is a one-third partner in the partnership. The partnership bought the asset for $300,000, and depreciation deductions have reduced its basis to $180,000. Partnership XYZ's UBIA is

$300,000. Partner X's share of UBIA is $100,000, and X's share of the asset's adjusted basis is $60,000. Partner X dies and devises X's entire interest in Partnership XYZ to A. Partnership XYZ has in effect a valid section 754 election.

<u>Example 24</u>: The fair market value of X's partnership interest on the date of X's death is $100,000, which is equal to X's share of UBIA. A's section 743(b) basis adjustment is $40,000 ($100,000 (A's outside basis) minus $60,000 (A's share of inside basis)). Nevertheless, because A's outside basis is equal to A's share of UBIA ($100,000 (A's outside basis) - $100,000 (A's share of UBIA)), there is no UBIA adjustment.

<u>Example 25</u>: The fair market value of X's partnership interest on the date of X's death is $120,000, which is $20,000 more than X's share of UBIA. A's section 743(b) basis adjustment is $60,000 ($120,000 (A's outside basis) - $60,000 (A's share of inside basis)). Moreover, because A's outside basis exceeds A's share of UBIA by $20,000 ($120,000 (A's outside basis) minus $100,000 (A's share of UBIA)), the $20,000 adjustment is treated as qualified property placed in service on the date of X's death for purposes of section 199A.

<u>Example 26</u>: The fair market value of X's partnership interest on the date of X's death is $80,000, which is $20,000 less than X's share of UBIA. A's section 743(b) basis adjustment is $20,000 ($80,000 (A's outside basis) minus $60,000 (A's share of inside basis)). Moreover, because A's outside basis is less than A's share of UBIA by $20,000 ($80,000 (A's outside basis) minus $100,000 (A's share of UBIA)), the $20,000 adjustment reduces A's share of UBIA.

The first approach, as illustrated by the above examples, is conceptually the same as the way in which the special basis adjustments under sections 734(b) and 743(b) work to maintain a separate computation of basis for partnership property solely with respect to the transferee partner. The only difference here is that UBIA is used instead of basis. The ability to take into account the UBIA of qualified property that constitutes the partnership's assets would therefore seem to fit seamlessly into the partnership tax regime, without duplicating UBIA.

The second approach fully incorporates the aggregate theory in determining UBIA and is more consistent with § 1.743-1(j)(4)(i)(B)(1), but it is more administratively burdensome. As mentioned above, under § 1.743-1(j)(4)(i)(B)(1), the transferee partner takes into account the increased portion of the basis as if it were newly-purchased recovery property placed in service when the transfer occurs. Under the second approach, the entire amount of the section 743(b) adjustment is treated as separate qualified property to preserve in its entirety the beginning of a new depreciation period, with adjustments to the partner's share of the partnership's UBIA to avoid duplicating UBIA. Below are three examples clarifying the operation of the second approach. The examples below rely on the same fact pattern set forth above.

<u>Example 27</u>: The fair market value of X's partnership interest on the date of X's death is $100,000, which is equal to X's share of UBIA. A's section 743(b) basis adjustment is $40,000 ($100,000 (A's outside basis) minus $60,000 (A's share of inside basis)). Even though A's share of the partnership's UBIA is $100,000, two UBIA adjustments will be tracked with regard to A. First, A's share of the partnership's original UBIA will be reduced by $40,000 ($100,000 (A's share of UBIA) minus $60,000 (A's share of inside basis)). Second, A's $40,000 section 743(b) basis adjustment will be treated as separate qualified property placed in service on the date of X's death for purposes of section 199A, following the principles of § 1.743-1(j)(4)(i)(B)(1).

Example 28: The fair market value of X's partnership interest on the date of X's death is $120,000, which is $20,000 more than X's share of UBIA. A's section 743(b) basis adjustment is $60,000 ($120,000 (A's outside basis) minus $60,000 (A's share of inside basis)). Even though A's share of the partnership's UBIA is $100,000, two UBIA adjustments will be tracked with regard to A. First, A's share of the partnership's original UBIA will be reduced by $40,000 ($100,000 (A's share of UBIA) minus $60,000 (A's share of inside basis)). Second, A's $60,000 section 743(b) basis adjustment will be treated as separate qualified property placed in service on the date of X's death for purposes of section 199A, following the principles of § 1.743-1(j)(4)(i)(B)(1).

Example 29: The fair market value of X's partnership interest on the date of X's death is $80,000, which is $20,000 less than X's share of UBIA. A's section 743(b) basis adjustment is $20,000 ($80,000 (A's outside basis) minus $60,000 (A's share of inside basis)). Even though A's share of the partnership's UBIA is $100,000, two UBIA adjustments will be tracked with regard to A. First, A's share of the partnership's original UBIA will be reduced by $40,000 ($100,000 (A's share of UBIA) minus $60,000 (A's share of inside basis)). Second, A's $20,000 section 743(b) basis adjustment will be treated as separate qualified property placed in service on the date of X's death for purposes of section 199A, following the principles of § 1.743-1(j)(4)(i)(B)(1).

The second approach illustrated by the above examples is conceptually the same as the way in which the special basis adjustments under sections 734(b) and 743(b) work to maintain a separate computation of basis for partnership property solely with respect to the transferee partner. The only difference here is that UBIA is used instead of basis. The ability to take into account the UBIA of qualified property that constitutes the partnership's assets would therefore seem to fit seamlessly into the partnership tax regime, without duplicating UBIA.

Although ACTEC believes that transfers of partnership interests by reason of death and transfers by purchase should be treated the same, ACTEC notes that generally a purchaser is making a new investment, and under the modified aggregate approach of section 743, any new investment should give rise to UBIA.

7. Charitable Remainder Trusts.

Section 199A does not specifically address the proper treatment of the deduction by charitable remainder trusts ("CRTs"). The Preamble requested 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 a section 199A deduction. Although CRTs are trusts for tax purposes, they are governed by section 664, rather than the rules that apply to taxable trusts. Further complicating the application of section 199A to CRTs is the fact that CRTs are hybrids because a CRT is not subject to income tax unless it has unrelated business taxable income ("UBTI"), but beneficiaries of CRTs are taxed on CRT distributions under a "worst in-first out" tier system designed to tax the most highly taxed types of income first, whether earned in the current year or earned and accumulated in any prior year.

ACTEC notes at the outset that this is not an issue that often arises. Since UBTI is subject to a 100% excise tax under section 664(c), well-advised trustees will avoid holding any assets that may generate UBTI. The only types of income that would qualify as QBI but not be UBTI would be real estate rentals, REIT dividends, royalty income, and possibly a few other narrow categories of income. The section 199A deduction cannot be used against the section 664(c) tax; although

section 664(c) is in chapter 1, section 664(c)(2)(B) provides that the tax "shall be treated as imposed by chapter 42 for purposes of this title other than subchapter E of chapter 42." Because the section 664(c) excise tax imposed on UBTI is charged to principal and is not deductible in determining taxable income distributed to beneficiaries, it should also not affect QBI.

ACTEC also notes that QBI cannot be a separate tier in the section 664 tier classification system. The tiers described in section 664 are separated by a difference in tax rate. The section 199A deduction is a deduction, not a rate difference.

Because a CRT does not have taxable income, its section 199A items would be treated as an RPE in the same manner as a trust to the extent of the beneficiaries' share of distributable net income. However, given a CRT's tier level, ACTEC believes that QBI should be at the bottom of tier 1 (meaning that it is the last income item from tier 1 to be distributed), and the section 199A items would be reported to a beneficiary on a Schedule K-1 when the associated QBI is considered to have been distributed.

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