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WRNewswire: ***The 199A Deduction Series***

Final Pass-Through Deduction Regulations Clarify Family Aggregation and Trust Planning Opportunities and Limitations.

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MARKET TREND: Since new Internal Revenue Code §199A ("§199A") was enacted as part of the Tax Cuts and Jobs Act ("TCJA"), business owners and tax professionals alike have been working hard to interpret its wage limitations and service business exclusion in the context of integrated businesses and transactions. Recently finalized regulations provide much-needed clarity to this process while simultaneously erecting guardrails intended to curb abuse. As discussed in **WRNewswire 19.01.30** and **WRNewswire 19.02.07**, business owners or independent contractors principally engaged in commission-based sales of life insurance also are eligible for the deduction.

SYNOPSIS: Although the TCJA introduced a 20% deduction for qualified business income from pass-through entities, the benefits are limited for taxpayers above certain income thresholds based on wages paid or if specified services are provided. The final regulations allow taxpayers and pass-through entities to aggregate related businesses for purposes of the wage and property limitations, expanding the availability of the deduction for businesses under common control, including among certain family members. They also clarify certain planning options for grantor and non-grantor trusts. Yet several anti-abuse provisions are included that target restructuring transactions designed to circumvent the §199A limitations, particularly for trusts. Because the relative impact of the regulations depends on the facts and circumstances of each case, examples best illustrate their potential implications.

TAKE-AWAYS: Depending on their current ownership structures and wealth transfer goals, some taxpayers may achieve more significant pass-through deductions in future tax years by making relatively minor changes to ownership or operations to satisfy the aggregation rules. Trusts can be useful tools in accomplishing these goals, although the anti-abuse rules may limit planning opportunities to the use of non-grantor trusts established before the TCJA or certain grantor trusts taxed to a trust beneficiary. As §199A is scheduled to sunset in 2026, clients and advisors should balance the practical considerations and long-term ramifications of any business restructuring for §199A purposes against the potential for only short-term gains.

MAJOR REFERENCE: T.D. 9847, Treas. Regs. §§1.199A–1 through 1.199A–6.

PRIOR REPORTS: #18-04; 18-05

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§199A: THE PASS-THROUGH DEDUCTION

New §199A generally permits a deduction for up to 20% of qualified business income from pass-through entities and up to 20% of real estate investment trust ("REIT") dividends and publicly traded partnership income. For taxpayers with taxable income exceeding $210,700 in 2019 (or $421,400 for joint filers), the deduction is not available for certain specified service trades or businesses ("SSTBs"), and the deductible amount for other businesses is limited based on the greater of: (a) 50% of W-2 wages paid by the business, or (b) 25% of W-2 wages plus 2.5% of the unadjusted basis of depreciable tangible assets owned by the business at the end of the tax year. These limitations are phased in for taxpayers with taxable income exceeding $160,700 in 2019 (or $321,400 for joint filers).[1]

For purposes of §199A, SSTBs include the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners. Engineering and architecture services, however, are not SSTBs and therefore are eligible for the deduction, and, as noted in **WRNewswire 19.01.30**, and **WRNewswire 19.02.07**, business owners or independent contractors principally engaged in commission-based sales of life insurance also are eligible for the deduction.

Recently published final Treasury Regulations for §199A ("final regulations") clarify numerous issues regarding the impact of business aggregation and the use of trusts in determining the available §199A deduction.

ALLOCATING W-2 WAGES AND PROPERTY BASIS

The wage and property limitations are applied at the partner or S corporation shareholder level. A partner's share of partnership W-2 wages is determined based on the partner's allocable share of wage expenses, and the partner's share of qualified property basis is determined based upon the partner's allocable share of the partnership's depreciation expense. The same approach would apply to members of limited liability companies. Although determination of allocable shares will be fairly straightforward for partnerships which allocate in accordance with the partners' percentage interests in the partnership, the determination may be more complicated where special allocations are used.

For S corporations, the shareholder's allocable share of W-2 wages and qualified property basis is based on the shareholder's pro rata share of such item.

BUSINESSES AGGREGATION TO MAXIMIZE DEDUCTION

If the same person or group of persons owns a majority of several businesses for the majority of the tax year, the owners may (but are not required to) aggregate such businesses for purposes of calculating the deduction, regardless of the legal entity structure. The final regulations also permit aggregation at the entity level, allowing widely held private equity funds and other pass-through entities to aggregate trades or businesses operated directly or through lower-tier entities.

Attribution rules of Code §§267(b) and 707(b) are applied to determine whether businesses are commonly owned. These include familial relationships (siblings, spouse, ancestors, and descendants), as well as shareholder-corporation, partner-partnership, and trust-beneficiary relationships. A taxpayer need not be a part of the majority ownership group to take advantage of the aggregation opportunity. In fact, there is no minimum ownership threshold to participate in aggregation. However, the majority of the tax year must include the last day of the tax year.

These attribution rules may provide opportunities for businesses owned by multiple family members or trusts to aggregate to maximize the §199A deduction.

> ***Example 1 – Family Attribution/Common Ownership:*** Pat owns 50% of Corporation, an S corporation engaged in a retail business. The remaining stock of Corporation is owned equally by five qualified subchapter S trusts for each of Pat's three children (Sam, Sarah, and Sandra) and their cousins (Nick and Nora). Corporation leases its headquarters from a limited liability company, LLC. A grantor trust established by Pat's brother Chris owns 40% of LLC; the remaining interests in LLC are owned equally by each of three non-grantor trusts established for the benefit of Sam, Sarah, and Sandra.
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> Corporation and LLC are commonly owned through Pat's ownership. Ownership of 80% of Corporation is attributed to Pat: 50% directly plus 30% attributed from Sam, Sarah, and Sandra (attributed through their trusts), as Pat's children. The interests held in Nick's and Nora's trusts are not considered part of the common ownership because Nick and Nora do not have a qualifying familial relationship for this purpose (i.e., they are Pat's nephew and niece and cousins to Sam, Sarah, and Sandra). Similarly, 100% of LLC is considered owned by Pat: 40% attributed from Chris and 20% from each of Pat's children, through their trusts.
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> ***Example 2 - Loss of Common Ownership:*** Assume the same facts as Example 1, except on December 28, 2019, Pat sells her shares of Corporation to a third-party purchaser. Because there is no majority ownership on the last day of the tax year, Corporation and LLC do not satisfy the common control requirements in 2019.
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> ***Example 3 - No Common Ownership:*** Assume the same facts as Example 1, except LLC is owned 40% by Chris and 30% each by trusts established for the benefit of Nick and Nora. Although Nick and Nora together are deemed to own 100% of LLC, together they indirectly own only 20% of Corporation. Corporation and LLC are not commonly owned for purposes of §199A, because the same person or group of persons does not own 50% or more of both entities.

In addition to common ownership, aggregated businesses must satisfy at least two of three requirements:

1. They provide products, property, or services that are the same or customarily offered together.

2. They share facilities or centralized business elements such as HR, IT, purchasing, or accounting.

3. They operate in coordination with or reliance upon one or more of the businesses in the group, such as through supply chain interdependencies.

Although SSTBs may not be included in the aggregated business, the final regulations specifically provide that the rental or licensing of property to a business under common control may be aggregated, even if it would not otherwise be considered a trade or business. For planning purposes, it is not uncommon to separate the real estate or intellectual property used by an operating business into another pass-through entity which is often owned by trusts for younger generations, thereby transferring income-producing assets to heirs. This hypothetical structure provides a helpful framework for applying the final regulations.

> ***Example 4 – Aggregation Requirements:*** In addition to the facts of Example 1, Pat and Chris each own 50% of Partnership through their respective grantor trusts. Partnership operates several car wash locations in the same area Corporation and LLC are located, but it does not share facilities or centralized business elements or rely on either Corporation or LLC for its operations. Despite the common ownership, Partnership cannot be aggregated with Corporation or LLC.

If the aggregation requirements are met, the advantages of electing to aggregate will depend on whether one or more of the potentially aggregated businesses has excess W-2 wages or property basis available to increase the deduction amount for the combined business.

> ***Example 5 - Use of Excess Limitation:*** Assume the same facts as Example 1 and that each trust distributes the full amount of allocated income it receives. In addition, Corporation has \$20 million of qualified business income and \$12 million of W-2 wages. Corporation's unadjusted basis of depreciable tangible assets is minimal. LLC has \$2 million of qualified business income, no W-2 wages, and \$10 million of unadjusted basis in depreciable tangible assets. Therefore, Corporation allocates \$2 million of income and \$1.2 million of wages to Sam through his QSST (10% of Corporation's \$20 million of total qualified business income and \$12 million of total wages, because Sam's QSST is a 10% owner of Corporation), and LLC allocates Sam \$400,000 of income and \$2 million of property basis (20% of LLC's \$2 million of total qualified business income and \$10 million of unadjusted basis in depreciable tangible assets, because Sam's trust is a 20% owner of LLC).
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> If the businesses are not aggregated, Sam's pass-through deduction would be \$400,000 for Corporation (20% of \$2 million) plus \$50,000 for LLC (maximum of \$80,000 is limited to 2.5% of \$2 million), for a total of \$450,000.
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> If the businesses *are* aggregated, Sam's deduction is \$480,000 (20% of \$2.4 million total qualified business income). This is less than his W-2 limitation of \$600,000 (50% of \$1.2 million allocated wages) and therefore is not reduced.
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> Aggregation, however, has no benefit for Chris. Because he receives no allocation of W-2 wages from Corporation, his deduction will remain limited to

$100,000 (2.5% of his $4 million share of LLC property basis) rather than the maximum $160,000 (20% of $800,000 of income allocated to Chris by LLC).

If businesses are aggregated at the entity level, owners may be able to add trades or businesses to the lower tier aggregation. ***Taxpayers may not, however, break up aggregated businesses to calculate their deduction.***

Example 6 - Entity Aggregation: Amy owns 75% of the stock of Corporation, an S corporation which operates several chain restaurants. Amy is also the sole beneficiary of Trust, which owns 80% of each of LLC1, LLC2, and LLC3. All the LLCs also operate restaurants, and they share centralized business elements including human resources, accounting, and IT support, with Corporation.

Trust elects to aggregate the LLCs for purposes of §199A. As a result, any Trust distribution of the LLCs' qualifying business income to Amy will be on a combined basis, and her allocable Trust share of W-2 wages from the LLCs will be combined, as well. If Amy elects to aggregate the businesses, when calculating the amount of her pass-through deduction and the effect of any limitations, Amy would add her 75% distributive share of Corporation's income and W-2 wages to the 80% distributive share of the LLCs' income and W-2 wages aggregated by and attributed to her through Trust.

PRACTICAL APPLICATION: By permitting calculation on a combined basis, the aggregation rules may expand the availability of the deduction for commonly-controlled businesses, which otherwise would be limited based on the amount of W-2 wages and property basis. However, once businesses are aggregated, taxpayers must aggregate consistently across all subsequent tax years and disclose the particulars to the IRS (although modifications are possible to accommodate acquisitions and dispositions). Accordingly, taxpayers should carefully consider their aggregation options and analyze the projected impact in the context of future planning. Taxpayers and entities that delay the decision to aggregate will not be prohibited from doing so in a later tax year. Further, although the decision to aggregate generally may not be made based on hindsight through the filing of an amended return, this prohibition is waived for 2018.

Anti-Abuse Rule - SSTBs Under Common Control. Immediately after enactment of §199A, many tax practitioners began to suggest restructuring transactions designed to maximize the deduction's availability. The final regulations contain several anti-abuse provisions specifically targeted to these strategies, in particular those that attempt to place an SSTB into a separate entity from a business generating income that otherwise may qualify for the deduction.

While the proposed regulations initially included three limitations for businesses under common control with an SSTB, the final regulations only retain one: where the SSTB entity and the other business are under common control (i.e. 50% or more common ownership), the portion of the business providing property or services to the commonly-controlled SSTB will be treated as an SSTB. In determining common control, the same attribution rules apply as for aggregation purposes.

Example 7 - Disqualifying Income of SSTB: A grantor trust established by Phil in 2016 owns 100% of Corporation, an S corporation that provides dentistry services and thus qualifies as a medical SSTB. Trusts for Phil's four children (also created in 2016) each own 25% of Limited Partnership, a real estate rental business that satisfies the safe harbor requirements under Notice 2019-07.[2] Limited Partnership leases 50% of its property to Corporation; the remainder is leased to third parties. Therefore, 50% of Limited Partnership's otherwise qualifying business income is treated as an SSTB.

PRACTICAL APPLICATION: This restriction eliminates the "crack and pack" structures that were suggested shortly after the TCJA was passed, which were designed to scrape out a deduction by separating administrative functions or other qualifying activities from an SSTB. However, SSTB and non-SSTB businesses may be considered separately, and a taxpayer may apply the §199A deduction to the qualifying non-SSTB income, even if the businesses are operated within the same entity. Whether businesses are separate for this purpose will depend on the facts and circumstances of each case, but they must maintain separate books and records.

TREATMENT OF TRUSTS

Grantor Trusts. For income tax purposes, a grantor trust is treated as owned by the "grantor" -- typically the trust creator or, in some cases, another individual, such as a beneficiary taxed as a grantor under Code §678 ("678 trust").[3] The grantor reports and is taxed on the trust income at his or her individual income tax brackets. Consistent with this treatment, §199A provides that the grantor of a grantor trust will calculate the §199A threshold and deduction as if the grantor personally conducted the trust's activities and received its income. Accordingly, grantor trusts with different grantors determine their thresholds separately, as part of each grantor's personal calculations.

Example 8 – Multiple Grantors: John is married to Jane and has two young adult children, Alice and Brian. John created J&J LLC in 2012. It has no employees and no tangible assets. Since 2015, J&J LLC has been owned 50% by John, 25% by a trust for Alice, and 25% by a trust for Brian. In 2019, J&J LLC has $500,000 of qualifying business income. Apart from J&J LLC, John and Jane have taxable income of $500,000; Alice has taxable income of $25,000; and Brian has taxable income of $10,000. The trusts have no other income.

John and Jane have total taxable income of $750,000 ($250,000 from J&J LLC + $500,000), exceeding the joint filer maximum threshold of $421,400, so their §199A deduction is fully limited because J&J LLC pays no wages and has no depreciable tangible assets. If Alice's and Brian's trusts are treated as grantor trusts with respect to John, John and Jane's taxable income for §199A purposes increases to $1 million; again, no deduction. If, however, Alice's and Brian's trusts are 678 trusts, Alice and Brian each could each take a full §199A deduction of $25,000 on his or her trust's share of qualifying business income (20% of $125,000) because the total taxable income for each, including from the trusts, is $150,000 for Alice and $135,000 for Brian, both below the minimum taxable income threshold for single filers of $160,700.

PRACTICAL APPLICATION: In certain family or closely-held business settings, forming and using multiple 678 trusts could theoretically produce §199A deductions for qualified business income that otherwise would not be allowed if that income was attributable to a single taxpayer.

However, there are numerous practical considerations that must be balanced against the availability of any potential §199A deductions, including:

- The 678 trust beneficiary must remain under the applicable taxable income threshold for the §199A deduction, which may be difficult to maintain over time.

- The 678 trust beneficiary may have issues dealing with phantom income if he or she is being taxed on the trust income but the trustee is not making any distributions.

- Restructuring of the underlying business entity may be necessary to allow transfers of business interests or to ensure control remains with the original owners.

- As the trusts are irrevocable, it may be difficult to unwind the structure if the owner wants to reacquire the business interests or to modify the terms of the trust, particularly as the trustee will have a fiduciary duty to protect the interests of the trust beneficiary.

- Costs will be incurred not only in the initial restructuring of the ownership and/or operations of the business and creation of the trusts, but also for the on-going administration of each trust.

Non-Grantor Trusts. Non-grantor trusts are treated as separate entities for income tax purposes and taxed at their own income tax brackets on their accumulated income. The trust beneficiaries are taxed on any distributable net income that is distributed or required to be distributed by the trust, for which the trust receives a corresponding distribution deduction.

Complex Trusts. The §199A deduction generally will only be an issue for "complex" (as opposed to "simple") non-grantor trusts, since they are permitted to accumulate income.[4] To calculate a complex trust's §199A deduction, the income thresholds and limitations are generally the same as for a single filer (i.e., $160,700 - $210,700 for 2019) but apply to trust income ***after accounting for any distribution deduction***.

> ***Example 9 - Distributions Below Threshold:*** IP LLC has no employees, no tangible property, and qualifying business income of $600,000. NG Trust is a complex non-grantor trust that owns 100% of IP LLC and has four beneficiaries. If NG Trust distributes $125,000 to each beneficiary, it reduces its taxable income to $100,000, placing it below the $160,700 income threshold (in 2019) and allowing the full §199A deduction of $20,000 (20% of $100,000). If NG Trust's beneficiaries also are below the taxable income threshold, each beneficiary would receive a full deduction of $25,000 (20% of $125,000), for a total §199A deduction of $125,000. If NG Trust did not distribute the IP LLC income, its deduction would be fully limited.

PRACTICAL APPLICATION: As the SSTB and W-2 wage limitation do not apply to a taxpayer if the total taxable income does not exceed the minimum income threshold ($160,700 for single filers in 2019), a complex trust that distributes income to lower-income beneficiaries may be able to take advantage of an otherwise unavailable §199A deduction. In theory, this may be a useful strategy for trusts receiving qualifying business income within a certain range. Practically speaking, however, the decision to distribute trust income is rarely so straightforward.

For example, some beneficiaries may have other sources of income that exceed the threshold. Further, if a beneficiary is eligible to aggregate the distributed income with other qualifying business income and W-2 wages, this approach may yield disparate results. Finally, there may be non-tax reasons for limiting distributions to a beneficiary, including creditor protection, substance abuse or other personal concerns, or a desire to keep the trust confidential etc.

Anti-Abuse Rule – Principal Purpose. For non-grantor trusts, the final regulations specify that "a trust formed or funded with a ***principal purpose*** of avoiding, or of using more than one, threshold amount" to calculate the §199A deduction will not be respected as a separate trust and will be aggregated with the grantor or other trusts from which it was funded to determine the §199A threshold amounts.[5]

The Treasury and IRS, however, removed the definition of "principal purpose" and related examples from the final regulations, deciding to deal with the issues, if at all, in future guidance. This lack of guidance raises several issues. For example, what factors impact the determination of "principal purpose?" Is the determination avoided if there is substantial time between the trust's formation/funding and its acquisition of a business generating qualified business income? What if the trusts serve a genuine business succession need? It is also unclear how the rule would apply to a trust that was created as a grantor trust pre-TCJA but becomes a non-grantor trust post-TCJA due to a voluntary termination of grantor trust status (e.g., through the grantor's release of a substitution or other power that triggers grantor trust status).

PRACTICAL APPLICATION: With this rule, the creation of multiple complex trusts for purposes of maximizing the §199A deduction is not an option. It also appears that a trust initially created and funded to avoid the §199A threshold cannot be rehabilitated, even if its purpose evolves over subsequent tax years.

The determination of a trust's purpose, however, is made at the time of the trust's creation or funding. Therefore, non-grantor trusts formed and funded before TCJA's enactment would not be suspect and could be used to acquire interests in businesses generating qualified business income. That said, the viability of this approach would depend on the trust being able to fall under the applicable §199A income threshold, likely requiring distributions of trust income to lower-threshold trust beneficiaries. Further, a trust either: ***(1) would need to be created before December 22, 2017*** (as these anti-abuse provisions apply retroactively to that date - the TCJA's date of enactment)***; or (2) not have a principal purpose of avoiding the §199A limitations*** (subject to the lack of clarity on what constitutes a "principal purpose," as discussed above). Note also that this anti-abuse rule does **not** apply to grantor trusts, including 678 trusts, regardless of whether created before or after the TCJA's enactment.

Note on Electing Small Business Trusts ("ESBTs"). S corporation tax rules generally restrict stock ownership to natural persons and certain types of trusts. In that regard, complex trusts can only hold S corporation stock if they elect to be treated as ESBTs. For income tax purposes, an ESBT is treated as comprised of two separate trusts, one holding the ESBT's S corporation stock ("S part") and the other holding all other assets ("non-S part"). The S part is taxed at the highest trust tax bracket, while the non-S part is taxed as a typical complex trust. For §199A deduction purposes, however, the S part and non-S part will be treated as a single trust for purposes of determining the applicable threshold.

EXPIRATION DATE

As noted above, some §199A planning options may require significant and potentially irrevocable restructurings of a business's organization and ownership and costs for the implementation and on-going monitoring and maintenance of the resulting businesses and/or trust structures. Yet, as of now ***§199A is temporary and scheduled to sunset in 2026***, if not before, depending on future tax law changes. Business owners and advisors should carefully weigh the impact of any significant long-term changes against potentially short-term gains.

TAKE-AWAYS

Depending on their current ownership structures and wealth transfer goals, some taxpayers may achieve more significant pass-through deductions in future tax years by making relatively minor changes to ownership or operations to satisfy the aggregation rules. Trusts can be useful tools in accomplishing these goals, although the anti-abuse rules may limit planning opportunities to the use of non-grantor trusts established before the TCJA or certain grantor trusts taxed to a trust beneficiary. As §199A is scheduled to sunset in 2026, clients and advisors should balance the practical considerations and long-term ramifications of any business restructuring for §199A purposes against the potential for only short-term gains.

NOTES

[1] The threshold and phase-out amounts are indexed annually for inflation. In 2018, the phase-outs for §199A were $157,500 to $207,500 (single filers) and $315,000 to $415,000 (married joint filers).

[2] Because the regulations rely on Internal Revenue Code §162 to define "trade or business" eligible for the deduction, they attracted considerable criticism from the rental real estate industry, where application of §162 precedents can be less than straightforward. In response, the IRS issued Notice 2019-07, providing a safe harbor under which a rental real estate enterprise will be treated as a trade or business eligible for the pass-through deduction. The safe harbor has three basic components: (1) maintain separate books and records for each real estate business; (2) perform 250 or more hours of rental services per year with respect to each business; and (3) maintain contemporaneous records regarding such services. For purposes of applying the safe harbor, taxpayers may combine similar properties, although residential and commercial properties may not be combined. The safe harbor election is available for 2018 tax years, although the contemporaneous documentation requirement will not apply.

[3] These trusts include so-called beneficiary defective irrevocable trusts," "beneficiary defective income trusts" or "beneficiary defective inheritor's trusts" ("BDITs") with a variant referred to as a beneficiary deemed owned trust ("BDOT"). The underlying premise of all such trusts is that the trust beneficiary, and not the trust creator, is deemed the owner of trust for income tax purposes, relying on the application of Code §678. See *WRMarketplace No. 15-32* for a more detailed discuss of the formation and tax treatment of BDITs.

[4] A "simple" trust cannot: (1) accumulate income (it must all be distributed currently); (2) make distributions of principal; or (3) pay money for charitable purposes. Otherwise, it is treated as a complex trust.

[5] The final regulations also cite Treas. Reg. 1.643(f)-1 of the regulations, which provide for the aggregation of two or more trusts as a single trust if they have substantially the same grantor(s) or primary beneficiary(ies), and if a "principal purpose" for establishing or contribution assets to such trusts is the avoidance of federal tax.