Davis Brown Tax Law Blog

Proposed Tax Reform Regulations: Application of Section 199A to Estates, Trusts, and Beneficiaries – August 23, 2018

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This update covers the proposed Treasury regulations associated with the new IRS Code 199A as it relates to estates, trusts, and beneficiaries. An overview of Section 199A can be found here.

Section 199A provides a deduction of up to 20% of income from a pass-through entity. This deduction can be taken by certain individuals, and by some estates and trusts.

In certain situations, a trust is treated as owned by the grantor, or creator, of the trust. In those cases, the grantor would calculate qualified business income (QBI) for purposes of Section 199A as if the QBI had been received directly by the grantor.

For estates or trusts that are not grantor trusts, determining the deduction requires a bit more calculation. Before looking at how the deduction is calculated, it is helpful to understand how trusts and estates are taxed, and the definition of certain terms, particularly distributable net income (DNI), income, and beneficiary.

- **Distributable Net Income** (DNI) - IRC 643(a)
  - The taxable income of the estate calculated with no deduction for personal exemptions or distributions, excluding gains from the sale of capital assets, and adding back tax-exempt income.
- **Income** - IRC 643(b)
  - The amount of income for the estate or trust as defined by the applicable governing instrument and state law. In Iowa, this is determined under Iowa Code 637, the Uniform Principal and Income Act. This is commonly thought of as accounting income.
- **Beneficiary** - IRC 643(c)
  - Any individual or entity receiving assets from the trust or estate, whether the assets are received pursuant to the trust instrument or by operation of law. In other words: heir, legatee, and devisee.

DNI is a mechanism to allocate income between an estate or trust and its beneficiaries to prevent double taxation.

For example, if the trust pays income tax on the gain from the sale of a stock, the beneficiaries should not also pay tax on that gain. However, if the trust distributes the sale proceeds to the beneficiary and does not pay the income tax, the beneficiary would pay income tax on the sale. To avoid double taxation, the trust or estate is allowed a deduction for the lesser of the DNI, or the amounts actually distributed to beneficiaries. The DNI is the maximum deduction.

Internal Revenue Code Section 643(f) aims to prevent abuse by taxpayers establishing more than one trust to get around the rules. This provision was already in place related to the DNI calculations before the Treasury regulations and will similarly apply for the QBI calculation. We will address how to calculate and report QBI at is relates to trusts, estates, and beneficiaries in the coming weeks.