



May 8, 2020

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**RE: Guidance Concerning the Deduction for Qualified Business Income Under Section 199A and Indirect Expenses and Loss Allocation of Trusts and Estates**

Dear Messrs. Kautter and Desmond, and Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to address the need for guidance related to Internal Revenue Code (“Code”) section 199A<sup>1</sup> as enacted under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA or “the Act”) and indirect expenses and loss allocation of trusts and estates. These comments are in addition to our previously submitted comments.<sup>2</sup>

Our recommendations are discussed in detail below.

**I. Indirect Expenses of Trusts**

Overview

Treasury and the IRS issued corrected final regulations [REG-107892-18](#) (released February 1, 2019) on the “Qualified Business Income Deduction” and [IRS Notice 2019-07](#) (released January 18, 2019) on “Section 199A Trade or Business Safe Harbor: Rental Real Estate.”

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<sup>1</sup> Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.

<sup>2</sup> AICPA Comment Letters “Guidance Concerning the Deduction for Qualified Business Income Under Section 199A of the Internal Revenue Code,” submitted [October 1, 2018](#), and [April 9, 2019](#).

Treasury Reg. § 1.199A-6(d)(3)(i) provides that the taxpayer must compute the QBI of a trust or estate by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under Treas. Reg. § 1.652(b)-3(a), and deductions not directly attributable within the meaning of Treas. Reg. § 1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in Treas. Reg. § 1.652(b)-3(b). In addition, the trust example in Treas. Reg. § 1.199A-6(d)(3)(viii) treats two deductions which are considered indirect expenses under Treas. Reg. § 1.652(b)-3(c) (state and local taxes and trustee fees) as, in part, directly attributable to the trust's QBI, thereby reducing QBI accordingly.

Based upon the above, taxpayers and practitioners have questioned whether the calculation of QBI for trusts and estates permits (or requires) the allocation of indirect expenses to QBI.

### Recommendations

The AICPA suggests the following recommendations:

1. Update Treas. Reg. § 1.199A-6(d)(3)(i) to specifically provide that the calculation of QBI for trusts and estates should not include indirect expenses as a reduction of QBI.
2. Update the QBI calculation example in Treas. Reg. § 1.199A-6(d)(3)(viii) to provide that the state and local taxes and trustee fees discussed therein are solely indirect expenses and, thus, not allocated to QBI.

### Analysis

Under section 199A(c)(3)(A)(i) and Treas. Reg. § 1.199A-3(b)(2)(i)(A), QBI only includes losses or deductions that are effectively connected with a trade or business in the United States. In addition, Treas. Reg. § 1.199A-3(b)(1)(vi) requires that a deduction is "attributable to a trade or business" in order to reduce QBI.

The cross-reference in Treas. Reg. § 1.199A-6(d)(3)(i) to the rules for the allocation of indirect expenses in Treas. Reg. § 1.652(b)-3(b) effectively creates an inconsistency between the regulations under section 199A. As discussed more fully below, indirect expenses of trusts and estates are generally not attributable to a trade or business, even if those expenses were viewed as effectively connected. The cross-reference to Treas. Reg. § 1.652(b)-3(b) thus suggests the possibility of non-business expenses reducing the QBI of a trust or estate, in contrast to the dual requirements under Treas. Reg. § 1.199A-3(b) regarding the relationship between the deduction and the trade or business.

This inconsistency creates unnecessary ambiguity. Some practitioners have interpreted Treas. Reg. § 1.199A-6(d)(3)(i) as permitting (or possibly requiring) the allocation of indirect expenses in the calculation of QBI for a trust or estate, with indirect expenses allocated in the same manner in the calculation of QBI as in the calculation of DNI. Other practitioners have interpreted the required connection to a trade or business under Treas. Reg. § 1.199A-3(b) as having primacy over any other methodology for allocating expenses to QBI. These different interpretations could result in a divergence in practice, with similarly situated taxpayers taking materially different positions based upon their respective interpretations of the regulations.

The trust example in Treas. Reg. § 1.199A-6(d)(3)(viii) adds to this lack of clarity. In the example, a portion of the trustee fees and state taxes are classified as direct expenses attributable to QBI, with no supporting calculations. Then, in the next paragraph, the example states that the remainder of the trustee fees and state taxes are not directly attributable and are allocated against tax-exempt income. The example as written seems contradictory, as it is unusual to treat the same expense as partly direct and partly indirect. Also, as discussed more fully below, long-standing regulatory guidance under subchapter J has identified state taxes and trustee fees as examples of indirect expenses. State taxes and trustee fees are considered directly attributable to business income only in rare circumstances (*e.g.*, a state income tax which is imposed solely on business income; fees of a special trustee or executor who solely administers business assets).

The following will briefly summarize the applicable principles for the allocation of expenses in calculating DNI, along with the interaction of those rules with the requirement that deductions are attributable to a trade or business in order to reduce a trust or estate's QBI.

#### *Allocation of Expenses in Calculating Distributable Net Income of Trusts and Estates*

For trusts and estates, DNI is the means by which income is allocated between the trust or estate and its beneficiaries for federal income tax purposes. To the extent that DNI is considered distributed to beneficiaries, they are taxed upon the DNI that they receive. Conversely, to the extent that the trust or estate retains DNI, it is taxed accordingly.

In calculating the DNI of trusts and estates, deductions are allocated among classes of income based upon a set of principles. Specifically, under Treas. Reg. § 1.652(b)-3(a), all deductions which are directly attributable to one class of income are allocated to that class. For example, all expenditures directly attributable to a business carried on by a trust are allocated to the income from that business. Treasury Reg. § 1.652(b)-3(b) provides that the taxpayer may allocate deductions which are not directly attributable to a specific class of income to any item of income (including capital gains) included in computing DNI, but the taxpayer must allocate a portion to nontaxable income pursuant to section 265. Treasury Reg. § 1.652(b)-3(c) identifies trustee's fees, the rental of safe deposit boxes, and state income and personal property taxes as examples of expenses which are not directly attributable to a specific class of income.

To the extent that deductions which are directly attributable to a class of income exceed that class of income, the taxpayer may allocate the deductions to any other class of income (including capital gains) included in DNI as described in Treas. Reg. § 1.652(b)-3(b), except that the taxpayer may not offset any excess deductions attributable to tax-exempt income against any other class of income.

In drafting Treas. Reg. § 1.652(b)-3 in 1956, Treasury specifically rejected the approach of requiring the taxpayer to allocate all deductions which are indirectly attributable to a trade or business carried on by a trust or estate to the income from that business.<sup>3</sup>

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<sup>3</sup> Prop. Reg. § 1.652(b)-1(c)(1) contained a requirement that "all expenditures indirectly attributable to a business carried on by a trust shall be allocated to the income from such business." See 21 Fed. Reg. 2873 (1956). That requirement was removed from the final regulation in Treasury Decision 6217.

To summarize, a taxpayer may allocate indirect expenses of trusts and estates to QBI *for the purpose of calculating DNI*. As discussed below, however, indirect expenses typically are not attributable to a trade or business. Therefore, taxpayers should not allocate indirect expenses to QBI *for the purpose of calculating QBI* under section 199A.

#### *Interpretation of “Attributable to a Trade or Business” under Section 199A and Other Provisions*

The preamble to the final regulations under section 199A ([Treasury Decision 9847](#)) states that “[w]hether a deduction is attributable to a trade or business must be determined under the section of the Code governing the deduction.” Although there is no uniform definition of whether a deduction is “attributable to a trade or business” for the purpose of section 199A, based upon the interpretation of that phrase under other sections of the Code, the indirect expenses of trusts and estates would generally fail to meet that standard.

Section 62(a)(1) provides that adjusted gross income is calculated after subtracting, *inter alia*, “deductions allowed by this chapter... which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.” Treasury Reg. § 1.62-1T(d) interprets this provision to mean that expenses are deductible in calculating adjusted gross income when they are “directly, and not... merely remotely, connected with the conduct of a trade or business.” For this purpose, state taxes on net income are not deductible even though the taxpayer’s income is derived from the conduct of a trade or business. Regulations to this effect have existed since 1945.<sup>4</sup> Indirect expenses of trusts or estates, such as trustee’s fees and state income taxes of general applicability, are not considered as directly connected with the conduct of a trade or business under Temp. Reg. § 1.62-1T(d). State taxes which are uniquely associated with the operation of a business are considered directly attributable to business income under Treas. Reg. § 1.652(b)-3(a) rather than indirect expense.<sup>5</sup>

Elsewhere in the Code, section 172(d)(4) provides that in calculating the net operating loss of a non-corporate taxpayer, “the deductions...which are not attributable to a taxpayer’s trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business.” Thus, the calculation of a net operating loss requires a non-corporate taxpayer to distinguish between deductions which are attributable to a trade or business and those which are not. For this purpose, the normal activities of a trustee in investing trust assets, collecting income and making distributions to trust beneficiaries are not considered a trade or business.<sup>6</sup> Likewise, the normal activities of an executor in gathering the decedent’s assets, paying debts and

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<sup>4</sup> T.D. 5425 (approved June 15, 1945), 1945 C.B. 10, 16; *see also* the discussion in *Tanner v. Commissioner*, 45 T.C. 145 (1965), *aff’d* 363 F.2d 36 (4<sup>th</sup> Cir. 1966) and *Cutler v. Commissioner*, T.C. Memo 2015-73.

<sup>5</sup> An example of a tax uniquely associated with the operation of a trade or business is the New Hampshire Business Profits Tax, which Rev. Rul. 81-288 identifies as a tax only on the privilege of entering into a trade or business in that state. Another example is a state tax on gross income directly attributable to a trade or business. *See* Rev. Rul. 70-40.

<sup>6</sup> *Estate of Green v. Commissioner*, 27 B.T.A. 1195, 1197 (1933); *see also* Freitag, 539-4th T.M., *Net Operating Losses — Concepts and Computations*, Section II.A.3.

distributing assets to beneficiaries are not considered a trade or business.<sup>7</sup> Consistent with that treatment, the fees paid to a fiduciary for the management of an ordinary trust or decedent's estate are deducted under section 212 rather than section 162.<sup>8</sup> Any such fiduciary fees deducted under section 212 are not considered attributable to a trade or business in calculating a net operating loss.

State income tax associated with business income is a business deduction for computing the taxpayer's net operating loss (NOL) under section 172.<sup>9</sup> However, as discussed in our comment letter of October 1, 2018, including this state income tax amount in the QBI computation requires the determination of which tax is included in the \$10,000 limitation under section 164(b)(6) (state income associated with business income, state income tax associated with nonbusiness income, real property tax). We recommend that the determination of QBI ignore state income tax.

### *Effect of Treas. Reg. § 1.199A-6 regarding Parity among Similarly Situated Taxpayers*

To the extent that Treas. Reg. § 1.199A-6 would result in the allocation of indirect trust expenses against QBI for the purpose of calculating QBI, the treatment of trusts may differ from similarly situated individual taxpayers. For example, an individual who does not use his/her personal residence for business purposes is not required (or permitted) to allocate a portion of the mortgage interest deduction or property taxes to QBI because those deductions are not considered attributable to a trade or business. In calculating QBI, the treatment of trusts and estates should neither result in an advantage nor disadvantage relative to individual taxpayers, absent a strong policy reason to the contrary.

## **II. Allocation of QBI Net Losses**

### Overview

Treasury Reg. § 1.199A-6(d)(3)(ii) provides that the QBI (including any amounts that are less than zero as calculated at the trust or estate level), W-2 wages, unadjusted basis immediately after acquisition (UBIA) of qualified property, qualified real estate investment trust (REIT) dividends, and qualified publicly traded partnership (PTP) income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's DNI for the taxable year that is distributed or a required distribution to the beneficiary or is retained by the trust or estate. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate. The trust example in Treas. Reg. § 1.199A-6(d)(3)(viii) reflects the allocation of a QBI net loss to two trust beneficiaries. Under subchapter J, estates and trusts do not distribute losses to beneficiaries, except in the year of termination, as described in section 642(h).

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<sup>7</sup> *Refling v. Burnet*, 47 F.2d 859, 862 (8th Cir. 1931); see also Freitag, 539-4th T.M., *Net Operating Losses — Concepts and Computations*, Section II.A.3.

<sup>8</sup> *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); Treas. Reg. § 1.212-1(i); Treas. Reg. § 1.67-4.

<sup>9</sup> Rev. Rul. 70-40.

## Recommendations

The AICPA suggests the following recommendations:

1. Update Treas. Reg. § 1.199A-6(d)(3)(ii) to provide that if a trust or estate has a QBI net loss, the loss carryover is retained at the trust or estate level.
2. Update the QBI calculation example in Treas. Reg. § 1.199A-6(d)(3)(viii) to reflect the retention of the QBI net loss at the trust level or, alternatively, modify the facts to show QBI net income which is allocated between the trust and beneficiaries based upon the relative portions of the trust's DNI.

## Analysis

The allocation of QBI net losses to trust beneficiaries represents a departure from a long-standing principle that trusts and estates typically do not distribute losses to beneficiaries. This methodology could result in significant differences between the respective shares of DNI and QBI reported on a beneficiary's Schedule K-1. In addition, the allocation of QBI net losses to trust beneficiaries could make it more difficult for the beneficiaries to estimate their personal income taxes, as a relatively modest distribution of DNI could accompany a greater allocation of a QBI net loss (as in the example in Treas. Reg. § 1.199A-6(d)(3)(viii)), which the beneficiary may have little (or no) ability to control. Providing for the retention of QBI net losses at the estate or trust level would thus promote simpler estimated tax planning for trust beneficiaries and greater conformity between the beneficiaries' allocations of DNI and QBI.

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Sincerely,



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