This document will be submitted to the Office of the Federal Register (OFR) for publication. The version of the proposed rule released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-134652-18]

RIN 1545-BP12

Qualified Business Income Deduction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations concerning the deduction for qualified business income under section 199A of the Internal Revenue Code (Code). The proposed regulations will affect certain individuals, partnerships, S corporations, trusts, and estates. The proposed regulations provide guidance on the treatment of previously suspended losses that constitute qualified business income. The proposed regulations also provide guidance on the determination of the section 199A deduction for taxpayers that hold interests in regulated investment companies, charitable remainder trusts, and split-interest trusts.

DATES: Written or electronic comments and requests for a public hearing must be received by [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

ADDRESSES: Submit electronic submissions to the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-134652-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to CC:PA:LPD:PR (REG-134652-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-134652-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., 20224.

FOR FURTHER INFORMATION CONTACT: Concerning §1.199A-3(d), Michael Y. Chin or Steven Harrison at (202) 317-6842; concerning §1.199A-3(b) and §1.199A-6, Vishal R. Amin or Frank J. Fisher at (202) 317-6850 or Robert D. Alinsky or Margaret Burow at 202-317-5279; concerning submissions of comments or requests for a public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 199A of the Code.

Section 199A was enacted on December 22, 2017, by §11011 of “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” Pub.L. 115-97 (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by §101 of Division T of the Consolidated Appropriations Act, 2018, Pub.L. 115-141, (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.

Section 199A provides a deduction of up to 20 percent of qualified business income from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate (section 199A deduction). The section 199A deduction may be taken by individuals and by some estates and trusts. A section 199A deduction is not available for wage income or for income earned by a C corporation. For taxpayers whose taxable income exceeds a statutorily-defined amount (threshold amount), section 199A may limit the taxpayer’s section 199A deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) the unadjusted basis immediately after acquisition (UBIA) of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules based upon taxable income above the threshold amount.

Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the section 199A deduction is not limited by W-2 wages or UBIA of qualified property.

The section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.

Additionally, section 199A(g) provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199.

The statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of section 199A (section 199A(f)(4)), and also provides specific grants of authority with respect to certain issues: the treatment of acquisitions, dispositions, and short-tax years (section 199A(b)(5)); certain payments to partners for services rendered in a non-partner capacity (section 199A(c)(4)(C)); the allocation of W-2 wages and UBIA of qualified property (section 199A(f)(1)(A)(iii)); restricting the allocation of items and wages under section 199A and such reporting requirements as the Secretary determines appropriate (section 199A(f)(4)(A)); the application of section 199A in the case of tiered entities (section 199A(f)(4)(B); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (section 199A(h)(2)).

The Treasury Department and the Internal Revenue Service published proposed regulations interpreting section 199A on August 16, 2018 (the August Proposed Regulations). The August Proposed Regulations contain six substantive sections, §§1.199A-1 through 1.199A-6, each of which provides rules relevant to the calculation of the section 199A deduction. The August Proposed Regulations, with modifications in response to comments and testimony received, were adopted as final regulations in **TD XXXX**, issued concurrently with this notice of proposed rulemaking.

Explanation of Provisions

These proposed regulations propose rules addressing issues not addressed in the August Proposed Regulations that are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. Specifically, these proposed regulations contain amendments to two substantive sections of the August Proposed Regulations, §§1.199A-3 and 1.199A-6, each of which provides rules relevant to the calculation of the section 199A deduction. These additional proposed rules respond to comments received on the August Proposed Regulations as well as address certain issues identified after additional study. This Explanation of Provisions describes each of the proposed rules contained in this document in turn. The Treasury Department and the IRS request comments on all aspects of these proposed regulations.

I. Treatment of Previously Suspended Losses That Constitute QBI.

Section 1.199A-3(b)(1)(iv) of the final regulations provides that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018. The final regulations also provide a first-in-first-out ordering rule. One commenter on the August Proposed Regulations suggested that a special rule should be provided to identify the section 469 trade or business losses that are used to offset income if the taxpayer's section 469 groupings differ from the taxpayer's section 199A aggregations. The commenter recommended that any section 469 loss carryforward that is later used should be allocated across the taxpayer's section 199A aggregations based on income with respect to such aggregations in the year the loss was generated.

The Treasury Department and the IRS believe that that previously disallowed losses should be treated as losses from a separate trade or business for both the reasons stated by the commenter and because the losses may relate to a trade or business that is no longer in existence. Accordingly, these proposed regulations amend §1.199A-3(b)(1)(iv) to provide that such losses are treated as loss from a separate trade or business. To the extent that losses relate to a PTP, they must be treated as losses from a separate PTP. Section 1.199A-3(b)(1)(iv)(B) provides that attributes of the disallowed loss are determined in the year the loss is incurred.

II. Regulated Investment Companies with Interests in REITs and PTPs

A. REITs

Section 1.199A-3 restates the definitions in section 199A(c) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income. For simplicity, the regulations use the term individual when referring to an individual, trust, estate, or other person eligible to claim the section 199A deduction.

See § 1.199A-1(a)(2). The term relevant passthrough entity (RPE) is used to describe passthrough entities that directly operate the trade or business or pass through the trade or business' items of income, gain, loss, or deduction from lower-tier RPEs to the individual. See § 1.199A-1(b)(10).

A number of commenters on the August Proposed Regulations requested guidance that would allow a shareholder in a regulated investment company within the meaning of section 851(a) (RIC) to take a section 199A deduction with respect to certain income of, or distributions from, the RIC. Because a RIC is a subchapter C corporation, a shareholder in a RIC generally does not take into account a share of the RIC's items of income, deduction, gain, or loss. Part 1 of subchapter M, however, has features that allow the tax consequences of investing in a RIC to approximate those of a direct investment in the assets of the RIC. The principal feature is the allowance of the deduction for dividends paid under section 852(b)(2)(D). If a corporation qualifies as a RIC under section 851 and meets the distribution requirements and other requirements in section 852(a), the RIC's income tax is computed on its investment company taxable income (ICTI), which is its taxable income with certain adjustments, including the allowance of the deduction for dividends paid. See section 852(b)(2). ICTI also excludes the amount of the RIC's net capital gain, but tax is separately imposed on that amount to the extent it exceeds the deduction for dividends paid, taking into account only capital gain dividends. See section 852(b)(3)(A). The deduction for dividends paid allows RICs to eliminate all or most of their corporate income tax liability.

If a RIC has certain items of income or gain, subchapter M also provides rules under which a RIC may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly. Although this treatment differs fundamentally from the pass-through treatment of partners or trust beneficiaries, this preamble refers to is as “conduit treatment.” For example, under section 852(b)(3), a RIC that has net capital gain for a taxable year generally may pay capital gain dividends, and shareholders receiving the capital gain dividends treat them as gain from the sale or exchange of a capital asset held for more than one year. Section 852(b)(3) provides necessary limits and procedures that apply to capital gain dividends. There are similar statutory provisions for exempt-interest dividends under section 852(b)(5), interest-related dividends under section 871(k)(1), short-term capital gain dividends under section 871(k)(2), dividends eligible for the dividends received deduction under section 854(b)(1)(A), and qualified dividend income under section 854(b)(1)(B). Rules for paying dividends corresponding to different types of long-term capital gain have been provided in guidance under regulatory authority granted in section 1(h). See Notice 2015-41, 2015-24 I.R.B. 1058, modifying Notice 2004-39, 2004-1 C.B. 982 and Notice 97-64, 1997-2 C.B. 323.

Investing in RICs enables small investors to gain benefits, such as professional management and broad diversification, that otherwise would be available only to investors with more resources. The House Report for the enactment of the Internal Revenue Code of 1954 explained that the RIC regime “permits investors to pool their funds through the use of a corporation in order to obtain skilled, diversified investment in corporate securities without having to pay an additional layer of corporate tax.” H.R. Rep. No. 83-1337, p. 73 (1954). The ability to elect to be taxed as a RIC is available typically only to domestic corporations that, at all times during the taxable year, are registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2). See section 851(a)(1)(A).

Section 199A(f)(4) directs the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199A, including regulations for its application in the case of tiered entities. The Treasury Department and the IRS have determined that it is consistent with the grant of authority under section 199A and the purposes of part 1 of subchapter M of chapter 1 of the Code to provide for conduit treatment of qualified REIT dividends. The Treasury Department and the IRS continue to consider whether it is appropriate to provide for conduit treatment of qualified PTP income.

These proposed regulations provide rules under which a RIC that receives qualified REIT dividends may pay section 199A dividends. Non-corporate shareholders receiving section 199A dividends would treat them as qualified REIT dividends under section 199A(e)(3), provided the shareholder meets the holding period requirements for its shares in the RIC.

The rules under which a RIC would compute and report section 199A dividends are based on the rules for capital gain dividends in section 852(b)(3) and exempt-interest dividends in section 852(b)(5). The amount of a RIC's section 199A dividends for a taxable year would be limited to the excess of the RIC's qualified REIT dividends for the taxable year over allocable expenses. Section 199A dividends generally are also subject to the principles that apply to other RIC dividends. See, e.g., Rev. Rul. 2005-31, 2005-1 C.B. 1084; Rev. Rul. 89-81, 1989-1 C.B. 226.

B. PTPs

One of the commenters recommending that the regulations permit conduit treatment for qualified REIT dividends received by a RIC also recommended that the regulations permit conduit treatment for qualified PTP income received by a RIC. In response to this comment, the Treasury Department and the IRS have given significant consideration to including in this notice of proposed rulemaking regulations that would provide conduit treatment for qualified PTP income. However, unlike conduit treatment for qualified REIT dividends received by a RIC, conduit treatment of qualified PTP income received by a RIC presents several novel issues. The commenter recommending this conduit treatment did not address these issues or make any suggestions as to how they should be resolved. The need to resolve these issues in a way that would afford RIC shareholders treatment that is similar to the treatment they would receive if they held the PTP interests directly while preserving the relative simplicity of the tax treatment of RIC investors has prevented the Treasury Department and the IRS from crafting and including appropriate rules in these proposed regulations. As noted later in this part of the Explanation of Provisions, the Treasury Department and the IRS continue to consider permitting conduit treatment for qualified PTP income received by a RIC to further the purposes of section 199A(b)(1)(B) and seek public comment to assist in resolving these novel issues with a view to developing regulations permitting conduit treatment for qualified PTP income.

These issues arise in part from the fact that income attributable to a specified service trade or business within the meaning of section 199A(d)(2) (SSTB) of a PTP may be qualified PTP income for taxpayers with taxable income below the threshold amount, but not for taxpayers with taxable income above the top of the phase-out range. For taxpayers with taxable income in the phase-out range, a portion of PTP income attributable to an SSTB is qualified PTP income. There is no precedent for providing conduit treatment for a RIC (or any other C corporation) with respect to income of a PTP or other partnership taxed in this manner, and the complexity and potential confusion such treatment might create for RIC investors is arguably inconsistent with the relative simplicity that the tax system has historically provided for RIC investors. This is particularly true given the limitation on the portion of a RIC's assets that can be invested in qualified PTPs as defined in section 851(h) (the type of PTP likely to be engaged in a trade or business) and the limited portion of the RIC's dividends that would likely be attributable to income from such PTPs.

Another novel issue is presented by the rules relating to the treatment of losses for purposes of section 199A. First, a PTP may not net losses from an SSTB against income from a non-SSTB, and vice versa, in determining the amounts that it reports to its partners. Thus, PTPs are required to separately calculate income and deductions from SSTBs and non-SSTBs and report that information to their partners. Second, if a taxpayer has a net loss from an SSTB or a non-SSTB that is allowed in determining taxable income for a taxable year, that loss may be required to be carried over to the subsequent year for section 199A attribute purposes. In the case of a RIC, it is not clear to what extent these requirements can be implemented by permitting RIC dividends to reflect attributes of the RIC's investment experiences in PTPs. For example, it is difficult to conceive how losses of a RIC can be passed through to shareholders upon the payment of a dividend, which would be inconsistent with the status of a RIC as a C corporation. See section 311(a). In addition, RICs and RIC shareholders would experience complexity inconsistent with the longstanding tax policy of providing simplified reporting for RIC investors.

Consistent with RICs' status as C corporations, RICs could instead offset losses from PTPs against qualified REIT dividends received, with any excess PTP losses carried forward as negative qualified PTP income for section 199A attribute purposes at the RIC level. To the extent RICs would be required to carry forward PTP losses, it would appear that RICs would need to track separate loss carryforwards for SSTB PTP losses and non-SSTB PTP losses. While netting qualified non-SSTB losses from PTPs against larger amounts of qualified REIT dividends would support RIC dividends that could be treated as eligible for the section 199A deduction by the RICs' shareholders regardless of income level, SSTB losses from PTPs would complicate the offset of qualified PTP losses against qualified REIT dividends by RICs because SSTB losses from a PTP do not offset qualified REIT dividends for taxpayers with taxable income above the phase-out range. Such losses do, however, offset qualified REIT dividends for taxpayers with income below the threshold amount. For taxpayers with income in the phase-out range, these losses partially offset qualified REIT dividends to a greater or lesser extent depending on where the taxpayer's income falls in the phase-out range. It is not clear how a conduit regime for qualified PTP income could work in terms of treating RIC shareholders in the phase-out range in a manner that is consistent with the treatment they would receive if they received the qualified REIT dividend and the qualified PTP loss from an SSTB directly rather than through a RIC.

Providing conduit treatment for qualified PTP income would also raise potentially significant issues with respect to the treatment of RIC shareholders that are non-U.S. persons, tax-exempt organizations, and trusts underlying individual retirement accounts (IRAs) and qualified retirement plans. In order to be qualified PTP income, section 199A(c)(3)(A)(i) requires that the income must be effectively connected with a U.S. trade or business. If conduit treatment is afforded to RIC dividends attributable to such PTP income for section 199A purposes, it is not clear that a RIC dividend attributable to such income could be disregarded for purposes of calculating effectively connected income of a non-U.S. shareholder or unrelated business taxable income of a tax-exempt organization or trust underlying an IRA or qualified retirement plan. Given that such investors typically do not hold directly interests in PTPs intentionally, but do so through corporate “blockers,” allowing conduit treatment for qualified PTP income through RICs could cause unwelcome results for non-U.S. shareholders, tax-exempt organizations, and trusts underlying IRAs and qualified retirement plans holding RIC stock.

The Treasury Department and the IRS continue to evaluate whether it is appropriate to provide conduit treatment for qualified PTP income through RICs, and request detailed comments on these novel issues. In particular, comments are requested concerning: (1) Whether RICs have sufficient qualified items of PTP income, gain, deduction, or loss to warrant a conduit regime that would permit RICs to pay qualified PTP dividends to shareholders; (2) How to provide conduit treatment for qualified PTP income for taxpayers with income below the threshold amount or within the phase-out range, particularly where a RIC has qualified REIT dividends and a qualified PTP loss from an SSTB; (3) How to treat losses of PTPs arising from SSTBs and non-SSTBs; (4) Whether conduit treatment for qualified PTP income can be disregarded for purposes of determining the effectively connected income or unrelated business taxable income of certain RIC shareholders; (5) Whether SSTB items are sufficiently rare or incidental for PTPs that a conduit regime for PTP dividends should exclude all SSTB items; and (6) How to implement conduit treatment for qualified PTP income in a way that is consistent with the policy goal of preserving the overall relative simplicity of the tax treatment of investors in RICs while still achieving the policy goals of section 199A and section 199A(b)(1)(B) in particular.

III. Special Rules for Trusts and Estates

Section 1.199A-6 provides guidance that certain specified entities (for example, trusts and estates) may need to follow to enable the computation of the section 199A deduction of the entity and each of its owners. Section 1.199A-6(d) contains special rules for applying section 199A to trusts and decedents' estates. The August Proposed Regulations expressly requested comments, and comments were submitted, on whether and how certain trusts and other entities would be able to take a deduction under section 199A. These proposed regulations take those suggestions into consideration in proposing rules applicable to those particular situations identified by commenters.

In the case of a section 199A deduction claimed by a non-grantor trust or estate, section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W–2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, §1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's QBI and W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

In addition, §1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportions as is the DNI of the trust or estate. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than section 199A.

Under §1.199A-6(d)(3)(iv), the threshold amount is determined at the trust level after 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 inappropriate and inconsistent with the purpose of section 199A. Therefore, §1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of receiving a deduction under section 199A will not be respected for purposes of determining the threshold amount under section 199A.

In the August Proposed Regulations, the Treasury Department and the IRS 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 the deduction. The request for such comments indicated that such comments should include explanations of how amounts that may give rise to the section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

A. Charitable remainder trust beneficiary's eligibility for the deduction

A few commenters suggested that a charitable remainder trust under section 664 should be allowed to calculate the deduction at the trust level and that the charitable remainder trust should be treated as a single taxpayer for purposes of the thresholds for taxable income, W-2 wages, and UBIA of qualified property.

Several commenters recommended that, if unrelated business taxable income (UBTI) is qualified business income, the section 199A deduction should be allowed before the UBTI excise tax is imposed. However, other commenters disagreed. Another commenter stated that the section 199A deduction should not be allowed when calculating UBTI because it is not a deduction directly connected with carrying on the trade or business and is allowable only for purposes of chapter 1, while the excise tax on UBTI is imposed under chapter 42 (that is, it is not an income tax). Another commenter said the UBTI excise tax under section 664(c) should not affect QBI because that tax is charged to principal.

One commenter recommended that QBI should be allocated to the ordinary income tier. Another recommended that QBI should be the bottom of the first tier (last to be distributed) and section 199A items should be reported on the Schedule K-1 when QBI is deemed distributed. Another commenter stated that a charitable remainder trust has no taxable income and no DNI, so the allocation of QBI, W-2 wages, and UBIA of qualified property should be allocated to beneficiaries based on the percentage of distributions from the ordinary income tier, with QBI allocated to the charitable remainder trust remaining a tier one item. Another commenter stated that QBI cannot be a separate tier because it is a deduction, rather than a rate difference.

The Treasury Department and the IRS believe that, because a charitable remainder trust described in section 664 is not subject to income tax, and because the excise tax imposed by section 664(c) is treated as imposed under chapter 42, the trust does not either have or calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. Furthermore, application of section 199A to effectively reduce the 100 percent rate of tax imposed by section 664(c) on any UBTI would be inconsistent with the intent of section 664(c) to deter trusts from making investments that generate significant UBTI. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A, taking into account any annuity or unitrust amounts received from the trust. Therefore, a taxable recipient of a unitrust or annuity amount from a charitable remainder trust may take into account QBI, qualified

REIT dividends, and qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such section 199A items under §1.664-1(d).

In order to determine the order of distribution of the various classes of income of the trust for purposes of applying §1.664-1(d), QBI, qualified REIT dividends, and qualified PTP income of a charitable remainder trust will be allocated to the classes of income within the category of income described in §1.664-1(d)(1)(i)(a)(1) based on the rate of tax that normally would apply to that type of income, not taking into account the characterization of that income as QBI, qualified REIT dividends, or qualified PTP income for purposes of section 199A. Accordingly, any QBI, qualified REIT dividends, and qualified PTP income will be treated as distributed from the trust to a unitrust or annuity recipient only when all other classes of income within the ordinary income category subject to a higher rate of tax (not taking into account section 199A) have been exhausted. The unitrust or annuity recipient will be treated as receiving a proportionate amount of any QBI, qualified REIT dividends, and qualified PTP income that is distributed along with other income in the same class within the ordinary income category. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of the total of QBI, qualified REIT dividends, and qualified PTP income distributed for that year. The amount of any W-2 wages or UBIA of qualified property of the charitable remainder trust in a taxable year will be allocable to unitrust or annuity recipients based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year.

Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and §1.664-1(c) requires that tax to be allocated to the corpus of the trust. Certain other rules relating to charitable remainder trusts are provided.

B. <u>Split-interest trusts</u>

The August Proposed Regulations requested comments on whether any special rules were necessary with respect to split-interest trusts. One commenter suggested that additional rules may be necessary for split-interest trusts other than charitable reminder trusts. After considering the comment and studying other split-interest trusts in more depth after the publication of the August Proposed Regulations, the Treasury Department and the IRS have determined that special rules for other split-interest trusts, such as non-grantor charitable lead trusts or pooled income funds, are not necessary because such trusts are taxable under part I, subchapter J, chapter 1 of the Code, except subpart E. Such split-interest trusts would apply the rules for non-grantor trusts and estates set forth in § 1.199A-6(d)(3) to determine any applicable section 199A deduction for the trust or its taxable beneficiaries.

C. <u>Separate shares</u>

Although no comments were received with respect the application of the threshold amount to separate shares, the Treasury Department and the IRS believe that clarification with respect to this issue may be necessary. These proposed regulations provide that, in the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such separate shares will not be treated as separate trusts for purposes of applying the threshold amount. Instead, the trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. The purpose of the separate share rule in section 663(c) is to treat distributions of trust DNI to trust beneficiaries as independent taxable events solely for purposes of applying sections 661 and 662 with respect to each beneficiary's separate share. The rule determines each beneficiary's share of DNI based on the amount of DNI from that beneficiary's separate share, rather than as a percentage of the trust's DNI.

Nevertheless, under the separate share rule, if a trust retains any portion of DNI, the trust will be subject to tax as a single trust with respect to the retained DNI. Only trusts with retained DNI will be eligible for the section 199A deduction, because a trust will be allocated QBI, qualified REIT dividends, and qualified PTP income only in proportion to the amount of DNI retained by the trust for the taxable year. For this reason, a trust, regardless of the number of separate shares it has for its beneficiaries under the separate share rule of section 663(c), will be treated as a single trust for purposes of applying the threshold amount under section 199A. To the extent that a taxable beneficiary of a trust receives a distribution of DNI from the beneficiary's separate share of the trust which includes section 199A items, the beneficiary would apply its own threshold amount to those section 199A items in computing its section 199A deduction in accordance with the rules of § 1.199A-6(d).

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**.

The amendments to §§1.199A-3 and 1.199A-6 set forth in this notice of proposed rulemaking generally are proposed to apply to taxable years ending after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, taxpayers may rely on the rules in the amendments to §§1.199A-3 and 1.199A-6 set forth in this notice of proposed rulemaking, in their entirety, until the date a Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order

13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

The proposed regulations have been designated by the Office of Management and Budget's ("OMB") Office of Information and Regulatory Affairs ("OIRA") as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and OMB regarding review of tax regulations. It has been determined that the proposed rulemaking is economically significant under section 1(c) of the Memorandum of Agreement and thereby subject to review. Accordingly, the proposed regulations have been reviewed by OMB.

A. Overview

Congress enacted section 199A to provide taxpayers other than corporations a deduction of up to 20 percent of QBI from domestic businesses plus up to 20 percent of their combined qualified REIT dividends and qualified PTP income. As stated in the Explanation of Provisions, these regulations are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of section 199A. These proposed regulations contain amendments to §1.199A-3, providing further guidance to taxpayers for purposes of calculating the section 199A deduction. They provide clarity for taxpayers in determining their eligibility for the deduction and the amount of the allowed deduction. Among other benefits, this clarity helps ensure that taxpayers all calculate the deduction in a similar manner, which encourages decision-making that is economically efficient contingent on the provisions of the overall Code.

B. Baseline

The analysis in this section compares the proposed regulation to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

C. Economic Analysis of the Proposed Amendments to §1.199A-3

1. Background

Because the section 199A deduction has not previously been available, §§1.199A-1 to -6 provide greater specificity for a large number of the relevant terms and necessary calculations taxpayers are currently required to apply under the statute. However, one subject not covered by the August 2018 Proposed Regulations is the treatment of REIT dividends received by RICs. Because RICs are taxed as C corporations, they are ineligible for the section 199A deduction under the statute, which generally does not apply to C corporations. However, the statute also directs the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199A, including regulations for its application in the case of tiered entities. Thus these proposed regulations establish rules under which a RIC that earns qualified REIT dividends may pay section 199A dividends to its shareholders.

An alternative approach the Treasury Department and the IRS could have taken would be to remain silent on this issue. For reasons given below, the Treasury Department and the IRS concluded such an approach would likely give rise to less economically efficient decisions than the approach taken in these proposed regulations.

2. Anticipated benefits of the Proposed Amendments to §1.199A-3

The Treasury Department and the IRS expect that the definitions and guidance provided in the proposed amendments to §1.199A-3 will implement the section 199A deduction in an economically efficient manner. An economically efficient tax system generally aims to treat income derived from similar economic decisions similarly in order to reduce incentives to make choices based on tax rather than market incentives. In absence of these proposed regulations, the section 199A statute would not accomplish this in the case of REIT dividends. Under the statute and the section 199A final regulations, individuals who directly hold ownership interests in a REIT would generally qualify for the section 199A deduction on their qualified REIT dividends. However, individuals who are shareholders of a RIC that has an ownership interest in a REIT would not receive any benefit from section 199A on REIT dividends received by the RIC, even if the RIC pays dividends to the individual. Thus, in the absence of these supplemental proposed regulations, a market distortion is introduced by section 199A whereby direct ownership of REITs is tax-advantaged relative to indirect ownership of REITs through RICs.

These proposed regulations remove this distortion. The proposed amendments to §1.199A-3 establish rules under which a RIC that earns qualified REIT dividends may pay section 199A dividends to its shareholders, such that the effective tax treatment of qualified REIT dividends is similar under the proposed regulations regardless of whether a taxpayer invests in a REIT directly or through a RIC.

3. <u>Anticipated costs of the Proposed Amendments to §1.199A-3</u>

The Treasury Department and the IRS do not anticipate any meaningful economic distortions to be induced by the proposed amendments to §1.199A-3 because the proposed amendments seek to continue to provide similar tax treatment to REIT income regardless of whether it is held directly or through a RIC. Prior to TCJA, the tax treatment was similar, but TCJA made REIT dividends eligible for the section 199A deduction, and the section 199A final regulations did not address this uncertainty. This proposed amendment ensures that REIT income earned through a RIC is also eligible for the same deduction. RICs are financial intermediaries, and, as a general rule, economic distortion is minimized to the extent that the tax consequences of investment through an intermediary correspond to the tax consequences of direct investment. The Treasury Department and the IRS request comments regarding any anticipated economic costs. Changes to the collective paperwork burden arising from this and other sections of these regulations are discussed in section D, *Anticipated impacts on administrative and compliance costs*, of this analysis.

D. Anticipated impacts on administrative and compliance costs

The proposed regulations add to the compliance costs of RICs and intermediaries such as brokerage firms that hold RIC shares. In order for a RIC's shareholders to benefit from the section 199A deduction on qualified REIT dividends earned by the RIC, the proposed regulations require the RIC to compute and report section 199A dividends to its shareholders. Though many RICs keep detailed records of their investment portfolios, this action nonetheless creates non-trivial administrative costs for any RICs and intermediaries that wish to provide section 199A dividends to their shareholders. These costs and the associated impacted tax forms are described in the Paperwork Reduction Act section of this proposed amendment.

E. Executive Order 13771.

These final regulations have been designated as regulatory under E.O. 13771.

II. **Paperwork Reduction Act**

The collection of information required by this proposed regulation is in proposed §1.199A-3. The collection of information in proposed §1.199A-3 is required for RICs that choose to report information regarding qualified REIT dividends to their shareholders. It is necessary to report the information to the IRS and relevant taxpayers in order to ensure that taxpayers properly report in accordance with the rules of the proposed regulations the correct amount of deduction under section 199A. The collection of information in proposed §1.199A-3 is satisfied by providing information about section 199A dividends as Form 1099-DIV and its instructions may prescribe.

For purpose of the PRA, the reporting burden associated with §1.199A-3 will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 1099-DIV (OMB control number 1545-0110). The burden associated with the information collection in the proposed regulations represents 1.567 million hours and $149 million ($2018) annually to comply with the information collection requirement in the proposed regulations. The burden hours estimate was derived from IRS's legacy burden model and is discussed in further detail on 1545-0110. The hourly rate is derived from RAAS's Business Taxpayer Burden model that relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables, and converted by the Treasury Department to $2017. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations. In addition, when available, drafts of the applicable IRS forms are posted for comment at https://www.irs.gov/pub/irs-pdf/f1099div.pdf.

III. Regulatory Flexibility Act

It is hereby certified that the collections of information in proposed §§1.199A-3 will not have a significant economic impact on a substantial number of small entities.

The collection in proposed §1.199A-3 applies only to RICs that pay section 199A dividends. As described above, Congress created RICs to give small investors access to the professional management and asset diversification that are available only with very large investment portfolios. To insure appropriate non-tax regulation of these substantial investment portfolios, subchapter M of chapter 1 of subtitle A the Code requires that such RICs must be eligible for registration, and must actually be registered, with the Securities and Exchange Commission under the Investment Company Act of 1940. There are some small businesses that are publicly traded, but most publicly traded businesses are not small entities as defined by the Regulatory Flexibility Act. Thus, the Treasury Department and IRS expect that most RICs are not small entities for purposes of the Regulatory Flexibility Act. Accordingly, the Treasury Department and the IRS have determined that the collection of information in this notice of proposed rulemaking will not have a significant economic impact. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Notwithstanding this certification, the Treasury Department and the IRS invite comments from interested members of the public on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

The Treasury Department and the IRS request comments on all aspects of the proposed rules.

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, then notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Michael Y. Chin and Steven Harrison, Office of the Associate Chief Counsel (Financial Institutions and Products) and Robert Alinsky, Vishal R. Amin, Margaret Burow, and Frank J. Fisher, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citations for part 1 are revised by amending sectional authorities for §§1.199A-3 and 1.199A-6 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.199A-3 also issued under 26 U.S.C. 199A(c)(4)(C) and (f)(4).

* * * * *

Section 1.199A-6 also issued under 26 U.S.C. 199A(f)(1)(B) and (f)(4).

* * * * *

Par. 2. Section 1.199A-0 is amended by:

1. Revising the entry for §1.199A-3(b)(iv).

2. Revising the entry for §1.199A-3(d).

3. Revising the entry for §1.199A-6(d)(3)(iii).

4. Revising the entry for §1.199A-6(d)(3)(v).

The revisions read as follows:

§1.199A-0 Table of Contents.

This section lists the section headings that appear in §§1.199A-3 and 1.199A-6.

§1.199A-1 Operational rules.

* * * * *

§1.199A-3 Qualified business income, qualified REIT dividends, and qualified PTP income.
(a) In general.

* * * * *
(b) Definition of qualified business income.
(1) In general.
(iv) Previously disallowed loss.
(A) In general.
(B) Attributes of disallowed loss determined in year loss is incurred.

(d) Section 199A dividends paid by a regulated investment company.
(1) In general.
(2) Definition of section 199A dividend.
(i) In general.
(ii) Reduction in the case of excess reported amounts.
(iii) Allocation of excess reported amount.
(A) In general.
(B) Special rule for noncalendar-year RICs.
(3) Definitions.
(i) Reported section 199A dividend amount.
(ii) Excess reported amount.
(iii) Aggregate reported amount.
(iv) Post-December reported amount.
(v) Qualified REIT dividend income.
(4) Treatment of section 199A dividends by shareholders.
(i) In general.
(ii) Holding period.
(5) Example.
(6) Effective/applicability date
(e) Effective/applicability date. * * *

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§1.199A-6 Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

* * * * *

(d) Application to trusts, estates, and beneficiaries.

* * *

(3) Non-grantor trusts and estates.

* * *

(iii) Separate shares.
(iv) Threshold amount.
(v) Charitable remainder trusts.
(vi) Electing small business trusts.
(vii) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount.
(viii) Example.
(e) Effective/applicability date.

* * * * *

Par. 3. Section 1.199A-3 is amended by:

1. Revising paragraph (b)(1)(iv).

2. Revising paragraph (d).

The revisions read as follows:

§1.199A-3 Qualified business income, qualified REIT dividends, and qualified PTP income.

* * * * *

(b) Definition of qualified business income—(1) In general. * * *

(iv) Previously disallowed losses--(A) In general. Previously disallowed losses or deductions (including losses disallowed under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by section 199A and this section. These losses shall be used, for purposes of section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and shall be treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(B) Attributes of disallowed loss determined in year loss is incurred. Whether a disallowed loss or deduction is attributable to a trade or business, and otherwise meets the requirements of this section is determined in the year the loss is incurred. Whether a disallowed loss or deduction is attributable to a specified service trade or business (including whether an individual has taxable income under the threshold amount, within the phase-in range, or in excess of the phase-in range) also is determined in the year the loss is incurred. To the extent a loss is partially disallowed, QBI in the year of disallowance must be reduced proportionately.

* * * * *

(d) <u>Section 199A dividends paid by a regulated investment company</u>--(1) <u>In general</u>. If section 852(b) applies to a regulated investment company (RIC) for a taxable year, the RIC may pay section 199A dividends, as defined in this paragraph (d).

(2) <u>Definition of section 199A dividend</u>--(i) <u>In general</u>. Except as provided in paragraph (d)(2)(ii) of this section, a section 199A dividend is any dividend or part of such a dividend that a RIC pays to its shareholders and reports as a section 199A dividend in written statements furnished to its shareholders.

(ii) <u>Reduction in the case of excess reported amounts</u>. If the aggregate reported amount with respect to the RIC for any taxable year exceeds the RIC's qualified REIT dividend income for the taxable year, then a section 199A dividend is equal to--

(A) The reported section 199A dividend amount, reduced by

(B) The excess reported amount that is allocable to that reported section 199A dividend amount.

(iii) <u>Allocation of excess reported amount</u>--(A) <u>In general</u>. Except as provided in paragraph (d)(2)(iii)(B) of this section, the excess reported amount (if any) that is allocable to the reported section 199A dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 199A dividend amount bears to the aggregate reported amount.

(B) Special rule for noncalendar-year RICs. In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (d)(2)(iii)(A) of this section is applied by substituting "post-December reported amount" for "aggregate reported amount," and no excess reported amount is allocated to any dividend paid on or before December 31 of that taxable year.

(3) Definitions--For purposes of paragraph (d) of this section--

(i) Reported section 199A dividend amount. The term reported section 199A dividend amount means the amount of a dividend distribution reported to the RIC's shareholders under paragraph (d)(2)(i) of this section as a section 199A dividend.

(ii) Excess reported amount. The term excess reported amount means the excess of the aggregate reported amount over the RIC's qualified REIT dividend income for the taxable year.

(iii) Aggregate reported amount. The term aggregate reported amount means the aggregate amount of dividends reported by the RIC under paragraph (d)(2)(i) of this section as section 199A dividends for the taxable year (including section 199A dividends paid after the close of the taxable year and described in section 855).

(iv) Post-December reported amount. The term post-December reported amount means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(v) Qualified REIT dividend income. The term qualified REIT dividend income means, with respect to a taxable year of a RIC, the excess of the amount of qualified REIT dividends, as defined in §1.199A-3(c)(2), includible in the RIC's taxable income for the taxable year over the amount of the RIC's deductions that are properly allocable to such income.

(4) Treatment of section 199A dividends by shareholders. (i) In general. For purposes of section 199A and the regulations under section 199A, a section 199A dividend is treated by a taxpayer that receives the section 199A dividend as a qualified REIT dividend.

(ii) Holding period. Paragraph (d)(4)(i) does not apply to any dividend received with respect to a share of RIC stock--

(A) that is held by the shareholder for 45 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to such dividend, or

(B) to the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(5) Example. The following example illustrates the provisions of this paragraph (d).

(i) Example 1 to paragraph (d)(5). (A) X is a corporation that has elected to be a RIC. For its taxable year ending March 31, 2019, X has $25,000x of net long-term capital gain, $60,000x of qualified dividend income, $25,000x of taxable interest income, $15,000x of net short-term capital gain, and $25,000x of qualified REIT dividends. X has $15,000x of deductible expenses, of which $3,000x is allocable to the qualified REIT dividends. On December 31, 2018, X pays a single dividend of $100,000x on

December 31, and reports $20,000x of the dividend as a section 199A dividend in written statements to its shareholders. On March 31, 2019, X pays a dividend of $35,000x, and reports $5,000x of the dividend as a section 199A dividend in written statements to its shareholders.

(B) X's qualified REIT dividend income under paragraph (d)(3)(v) of this section is $22,000x, which is the excess of X's $25,000x of qualified REIT dividends over $3,000x in allocable expenses. The reported section 199A dividend amounts for the December 31, 2018, and March 31, 2019, distributions are $20,000x and $5,000x, respectively. For the taxable year ending March 31, 2019, the aggregate reported amount of section 199A dividends is $25,000x, and the excess reported amount under paragraph (d)(3)(ii) of this section is $3,000x. Because X is a noncalendar-year RIC and the post-December reported amount of $5,000x exceeds the excess reported amount of $3,000x, the entire excess reported amount is allocated under paragraphs (d)(2)(iii)(A) and (B) to the reported section 199A dividend amount for the March 31, 2019, distribution. No portion of the excess reported amount is allocated to the reported section 199A dividend amount for the December 31, 2018, distribution. Thus, the section 199A dividend on March 31, 2019, is $2,000x, which is the reported section 199A dividend amount of $5,000x reduced by the $3,000x of allocable excess reported amount. The section 199A dividend on December 31, 2018, is the $20,000x that X reports as a section 199A dividend.

(C) Shareholder A, a United States person, receives a dividend from X of $100x on December 31, 2018, of which $20x is reported as a section 199A dividend. If A meets the holding period requirements in paragraph (d)(4)(ii) of this section with respect to the stock of X, A treats $20x of the dividend from X as a qualified REIT dividend for purposes of section 199A for A's 2018 taxable year.

(D) A receives a dividend from X of $35x on March 31, 2019, of which $5x is reported as a section 199A dividend. If A meets the holding period requirements in paragraph (d)(4)(ii) of this section with respect to the stock of X, A may only treat $2x of the dividend from X as a section 199A dividend for A's 2019 taxable year.

(6) Effective/applicability date. The provisions of paragraph (d) of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

* * * * *

Par. 4. Section 1.199A-6 is amended by:

1. Revising paragraph (d)(1)(3)(iii).

2. Revising paragraph (d)(1)(3)(v).

The revisions read as follows:

§1.199A-6 Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

* * * * *

(d) Application to trusts, estates, and beneficiaries--(1) In general. * * *

(3) Non-grantor trusts and estates--(i) Calculation at entity level. * * *

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

* * * * *

(v) Charitable remainder trusts. A charitable remainder trust described in section 664 is not entitled to and does not calculate a section 199A deduction and the threshold amount described in section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such section 199A items under § 1.664-1(d).

For example, if a charitable remainder trust has investment income of $500, qualified dividend income of $200, and qualified REIT dividends of $1,000, and distributes $1,000 to the recipient, the trust would be treated as having income in two classes within the category of income described in § 1.664-1(d)(1)(i)(a)(1), for purposes of § 1.664-1(d)(1)(ii)(b). Because the annuity amount first carries out income in the class subject to the highest income tax rate, the entire annuity payment comes from the class with the investment income and qualified REIT dividends. Thus, the charitable remainder trust would be treated as distributing a proportionate amount of the investment income ($500/(1,000+500)*1,000 = $333) and qualified REIT dividends ($1000/(1,000+500)*1000 = $667) because the investment income and qualified REIT dividends are taxed at the same rate and within the same class, which is higher than the rate of tax for the qualified dividend income which is in a separate class. The charitable remainder trust in this example would not be treated as distributing any of the qualified dividend income until it distributed all of the investment income and qualified REIT dividends (more than $1,500 in total) to the recipient. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of the total of QBI, qualified REIT dividends, or qualified PTP income distributed for that year. The trust allocates and reports any W-2 wages or UBIA of qualified property to the taxable recipient of the annuity or unitrust interest based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year. Accordingly, if 10 percent of the QBI of a charitable remainder trust is distributed to the recipient and 90 percent of the QBI is retained by the trust, 10 percent of the W-2 wages and UBIA of qualified property is allocated and reported to the recipient and 90 percent of the W-2 wages and UBIA of qualified property is treated as retained by the trust. However, any W-2 wages retained by the trust do not carry over to subsequent taxable years for section 199A purposes. Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and that tax must be allocated to the corpus of the trust under § 1.664-1(c).

* * * * *

Deputy Commissioner for Services and Enforcement.