Impact of the TCJA on Trust and Estate Income Taxation

by Donald T. Williamson

While taxpayers and their advisers have largely focused their attention on the changes made by the Tax Cuts and Jobs Act that will affect the preparation of estate and trust income tax returns, and he offers planning suggestions for dealing with the new rules.

I. Tax Rates and Brackets

For tax years beginning after 2017 and before 2026, the tax rates and brackets for estates and trusts are as follows:

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II. QBI Deduction

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While taxpayers and their advisers have largely focused their attention on the changes made by the Tax Cuts and Jobs Act to the income taxation of individuals and business entities, the impact of the new law on trusts and estates is equally significant. In addition to lower tax rates and the ability to claim the new deduction for qualified business income (QBI), estates and trusts are subject to the same new restrictions on itemized deductions that apply to individuals.

This report examines the revised tax rates and brackets, the QBI deduction, and the new restrictions on itemized deductions as they apply to estates and trusts. The changes offer opportunities and challenges for these entities in planning for the taxation of income that may be distributed to beneficiaries or retained by an estate or trust.

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After 2018 the above brackets will be adjusted annually for inflation using the chained consumer price index for all urban consumers. The TCJA, however, did not change the rates governing the taxation of qualified dividends and long-term capital gains; the 0 percent, 15 percent, and 20 percent rates on that income continue as under prior law. Thus, when taxable income does not exceed $2,550, qualified dividends and long-term capital gain will not be subject to tax, and when taxable income exceeds the highest tax bracket, the 15 percent tax rate on that income rises to 20 percent.

Because these rate changes are to expire in 2026 or might change if another administration takes power in 2020, taxpayers and their advisers should not necessarily modify their trust agreements unless that planning can be reversed to accommodate further changes that are likely to come. In any event, for the short term, income should be accelerated to take advantage of these lower rates.

Rules governing the application of the net investment income tax of section 1411 that impose a 3.8 percent tax on the NII of a trust and estate investment trust dividends and publicly traded partnership (PTP) income. However, when the taxable income of the trust or estate exceeds $157,500, the deduction is reduced, as described later, depending on the entity’s Form W-2 wages and its unadjusted basis of depreciable property immediately after acquisition (UBIA). All items that reduce taxable income (other than the section 199A deduction itself) are taken into account — for example, additional charitable contributions, increasing investments producing tax-exempt income, and, most important, distributions to beneficiaries.

Finally, the trust’s or estate’s section 199A deduction includes 20 percent of specific real estate investment trust dividends and publicly traded partnership (PTP) income. Because the taxable income of an estate or trust is arrived at using the same rules as for an individual, a trust or estate determines the components of the section 199A deduction — that is, QBI (including wages and UBIA), REIT

II. QBI Deduction

Of particular importance to estates and trusts conducting a trade or business is the new deduction under section 199A providing for up to a 20 percent deduction of a taxpayer’s QBI, not to exceed 20 percent of taxable income for the year. Thus, for an estate or trust subject to a 37 percent marginal tax rate, QBI is taxed at an effective rate of 29.6 percent. To the extent the grantor or another person is treated as owning all or part of a trust and is taxable on its income, that person is entitled to the deduction. This reduction in effective rate is also available to an electing small business trust (ESBT) owning stock in an S corporation.

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dividends, and PTP income — at the entity level, using the same rates as for individuals. Those items are then allocated between the entity and its beneficiaries by the relative proportion of the distributable net income (DNI) for the tax year that is distributed to beneficiaries or retained by the trust or estate. If the trust or estate has no DNI for the tax year, all attributes of the deduction are allocated entirely to the entity.

**Example 1**: An irrevocable testamentary trust (T) operates a business that for the tax year has $100,000 of gross income and $90,000 of expenses, consisting of $50,000 of Form W-2 wages and $40,000 of other expenses. T’s DNI and QBI are $10,000, and $5,000 is distributed to T’s sole beneficiary. As a result, T allocates $5,000 of QBI and $25,000 of Form W-2 wages to the beneficiary and retains the rest for computation of its section 199A deduction.

This example illustrates that generally, the passthrough treatment of deductions for partnerships usually applies to trusts and estates, subject to the general rule that deductions are allocated between the entity and its beneficiaries in proportion to distributions of DNI.

The QBI component of the deduction is determined for each trade or business of the estate or trust. In general, QBI is arrived at using the same rules as for determining taxable income. Thus, for example, the same depreciation rules and section 179 elections for measuring taxable income are adopted for determining QBI. If there is an overall loss from all trades or businesses, the loss is carried forward to the next tax year as a separate loss to measure QBI for the subsequent year.

Estates and trusts with taxable income (after taking into account the income distribution deduction of section 651 or 661) exceeding a threshold of $157,500 are subject to a limitation on the deduction (described later) based on Form W-2 wages paid by each qualified trade or business and the UBIA of each business. UBIA for this purpose is tangible depreciable property whose unadjusted basis is taken into account for the longer of its recovery period or 10 years. The limitation phases in for taxable income exceeding $157,500, with the limit fully phased in when taxable income reaches $207,500.

To prevent circumvention of the threshold by dividing assets among multiple trusts, each of which would claim its own threshold amount, a trust formed or funded with a principal purpose of receiving a deduction under section 199A will not be respected in determining the threshold amount.

Further, the multiple trust rules, discussed later, discourage the creation of trusts to maximize the overall section 199A deduction. The proposed regulations set out an example (not included in the final regulations) in which an individual transfers a pizzeria and gas stations to three trusts for the grantor’s sisters and brothers after reading an article suggesting that transferring business interests to multiple identical trusts for family members can increase the section 199A deduction. The trusts are not identical but have substantially the same beneficiaries. The example concludes that the trusts would not have been funded but for the enactment of section 199A and therefore finds that the three trusts should be treated as a single trust. Nevertheless, if an individual has taxable income exceeding the phaseout range,
transferring an interest in a business to a non-grantor trust to establish a separate threshold and phaseout range remains feasible as a means to increase the deduction.

A. Computation of Deduction

If the taxable income of the estate or trust for a year does not exceed the threshold amount, the deduction is 20 percent of the net QBI for the year without regard to wages or property of the business. But when taxable income exceeds the threshold amount, the deduction is the lesser of:

- 20 percent of QBI; or
- the greater of:
  - 50 percent of the Form W-2 wages of the qualified trade or business; or
  - the sum of 25 percent of the qualified business’s Form W-2 wages, plus 2.5 percent of its UBIA at the end of the tax year.

For this purpose, Form W-2 wages are those wages under section 3401(a) paid to employees subject to withholding, including elective deferrals (for example, 401(k) contributions). Form W-2 wages include only amounts reported to the Social Security Administration on or before the 60th day after the due date (including extensions) for an employment tax return.

The allocation of QBI, Form W-2 wages, and UBIA between the entity and its beneficiaries is based on the proportion of the trust’s or estate’s DNI distributed to the beneficiaries for the tax year and the proportion of the DNI retained by the estate or trust. If the trust or estate has no DNI for the tax year, all QBI, Form W-2 wages, and UBIA are allocated to the trust or estate. Finally, the allocation of UBIA is made in proportion to the distributed and retained DNI regardless of any special allocation of depreciable property for other purposes.

B. Phaseout

If taxable income of the estate or trust exceeds $157,500 by no more than $50,000, and 20 percent of QBI exceeds the greater of 50 percent of wages or 25 percent of wages plus 2.5 percent of UBIA, the deduction is calculated by multiplying that difference by a phaseout percentage arrived at by dividing the amount by which taxable income exceeds $157,500 and subtracting that difference from 20 percent of QBI.

Example 2: A trust with QBI of $150,000 and taxable income of $182,500 pays wages of $20,000. There is no depreciable property. Therefore, the trust’s phaseout percentage is 50 percent — that is, ($182,500 - $157,500)/$50,000 — and the deduction is as follows:

- 20 percent of QBI ($150,000) $30,000
- 50 percent of Form W-2 wages ($20,000) ($10,000)
- Excess $20,000
- Phaseout percentage 50 percent
- Reduction $10,000
- QBI deduction ($30,000 - $10,000) $20,000

Example 3: Same as Example 2, except no wages were paid. Consequently, the full 20 percent of QBI is subject to the 50 percent phaseout percentage, and the deduction is as follows:

- 20 percent of QBI ($150,000) $30,000
- 50 percent of Form W-2 wages $0
- Excess $30,000
- Phaseout percentage 50 percent
- Reduction $15,000
- QBI deduction ($30,000 - $15,000) $15,000

These examples demonstrate that if taxable income equals or exceeds the threshold amount by $50,000 and no wages were paid or assets were used in the business, no QBI deduction can be claimed. Unfortunately, many trustees may not make deductible distributions to beneficiaries.

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39 Section 199A(b)(3)(A).
40 Section 199A(b)(3)(B).
43 Section 199A(f)(1)(B) adopts the regulations under former section 199(d)(1)(B)(i) that governed the allocation of the deduction for qualified production activities income. See reg. section 1.199A-6(d)(3)(i) and (iv).
44 Reg. section 1.199A-6(d)(3)(d).
45 Reg. section 1.199A-6(d)(3)(i).
based on the belief that their trusts are eligible for a QBI deduction — only to discover that the lack of wages and assets in the business will disqualify them for the benefit.

C. Qualified Trade or Business

The estate or trust must conduct a trade or business to qualify for the deduction. For this purpose, a qualified trade or business is any trade or business other than a specified service trade or business (SSTB) or the business of performing services as an employee. Neither the trustee nor any other person needs to materially participate in the business, within the meaning of section 469, to qualify for the deduction.

Only income effectively connected with the conduct of a trade or business in the United States qualifies for the deduction, and QBI is net of reasonable compensation to the business owners as well as guaranteed payments and other payments to partners for services rendered to a partnership. Finally, income from the following do not constitute QBI:

- qualified REIT dividends and PTP income (these items are separately included in the section 199A deduction calculation);
- short- and long-term capital gains and losses;
- dividends, investment interest, and other nonbusiness passive income; and
- commodity and foreign currency gains and losses.

D. Specified Service Trade or Business

The conduct by an estate or trust of any of the following fields are SSTBs and do not constitute qualified trades or businesses for the deduction:

- health;
- law;
- accounting;
- actuarial science;
- performing arts;
- consulting;
- financial services;
- brokerage services;
- investment management;
- trading;
- dealing in securities; and
- any business in which the principal asset is the reputation or skill of one or more of its employees or owners.

However, an estate or trust conducting an SSTB with taxable income below $157,500 still treats that service income as QBI eligible for the deduction, subject to a phaseout until taxable income reaches $207,500.

Example 4: A trust operates an SSTB with net income of $100,000 and taxable income of $200,000. The trust may claim the QBI deduction subject to a phaseout as follows:

<table>
<thead>
<tr>
<th>20 percent of SSTB income ($100,000)</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable percentage 100 percent - ($200,000 - $157,500) x 0.15</td>
<td>$50,000</td>
</tr>
<tr>
<td>QBI deduction</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

E. Comprehensive Example

The example below, summarized from the section 199A regulations, illustrates the determination of the QBI component of the section 199A deduction as it applies to a trust and its beneficiaries.

Example 5: T, a complex trust, has beneficiaries A and B. T is a 25 percent partner in a partnership of which the remaining 75 percent is held by A and B. The partnership allocates $55,000 of gross income, $25,000 of Form W-2 wages, and other expenses of $20,000 to T. The partnership distributes $10,000 of cash to T. T also directly

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37 Section 199A(d)(1).
38 Id. Notice 2019-7, 2019-9 IRB 740, which was issued concurrently with the final section 199A regulations, provides a safe harbor in a proposed revenue procedure whereby 250 hours of participation by the taxpayer or its agents in rental real estate for a year constitutes a trade or business. The trust or estate must keep separate books and records for each property, along with contemporaneous documentation showing the service. Property used as a residence for any part of the year or rented under a triple net lease is ineligible.
39 Section 199A(c)(3)(A)(i) and reg. section 1.199A-3(b)(2)(i)(A).
40 Reg. section 1.199A-3(b)(1)(ii), (b)(2)(ii)(I), and (b)(2)(ii)(J).
41 Section 199A(c)(3)(B) and reg. section 1.199A-3(b)(2)(ii).
42 Section 199A(d)(2) and reg. section 1.199A-5(b)(1).
43 Section 199A(d)(3); reg. section 1.199A-5(a)(2); and reg. section 1.199A-1(d)(2)(i).
44 See reg. section 1.199A-6(d)(3)(viii).
conducts a business that produces $100,000 of gross income, $50,000 of Form W-2 wages, $75,000 of rental expense, depreciation of $5,000, and other expenses of $25,000. T has $125,000 of UBIA and the following other items: interest income of $15,000; dividends of $25,000; tax-exempt income of $15,000; trustee commissions of $3,000 ($1,000 of which is directly attributable to T’s business), and state and local taxes of $5,000 ($1,000 of which is directly attributable to T’s business).

Thus, T has $9,000 of net income from the partnership and a net loss of $56,000 from its own business. T therefore has excess business deductions of $47,000, which offset all the interest income and dividends, leaving $7,000 allocable to the tax-exempt interest.

The remaining trustee commissions ($2,000) and state and local taxes ($4,000) are allocated to tax-exempt income, resulting in $2,000 of tax-exempt income, which constitutes T’s DNI.

T distributes $1,000 to A and $500 to B, which constitutes tax-exempt income to them. There is no income distribution deduction because the distribution consists of tax-exempt income.

In calculating the QBI component of the section 199A deduction, T has a total of $75,000 of Form W-2 wages, $125,000 of UBIA property, and negative QBI of $47,000. Because A and B receive 50 percent and 25 percent, respectively, of T’s DNI — with T retaining the remaining 25 percent — Form W-2 wages of $37,500, $62,500 of UBIA, and negative QBI of $23,500 are allocated to A. B and T report $18,750 of Form W-2 wages, $56,250 of UBIA, and $11,750 of negative QBI.

F. Charitable Remainder Trust

The recently issued proposed regulations to section 199A clarify several questions regarding whether charitable remainder trusts (CRTs) under section 664 are entitled to the section 199A deduction. Because a CRT is not subject to income tax under subtitle A of the code, but rather must forfeit its unrelated business taxable income as an excise tax under chapter 42 of subtitle D, a CRT does not have nor can it calculate a section 199A deduction. However, a taxable recipient of a unitrust or annuity amount from a CRT may take into account the CRT’s QBI REIT dividends and PTP income to determine the recipient’s section 199A deduction. The deduction is based on the character and order of the distributions, with the income taxed at the highest rate deemed distributed first.

Example 6: A CRT has investment income of $500, qualified dividend income of $200, and qualified REIT dividends of $1,000. The trust distributes $1,000 to an individual beneficiary. Because the regulations under section 664 treat distributions of income taxed at the same rate in the same proportion as the income of the CRT, the beneficiary receives $333 of investment income and $667 of REIT dividends as follows:

\[
\frac{500}{1,000 + 500} \times 1,000 = 333 \\
\frac{1,000}{1,000 + 500} \times 1,000 = 667
\]

Distributions will not be treated as qualified dividends to the recipient until they exceed $1,500.

The CRT allocates any Form W-2 wages or UBIA to the recipient of the annuity or unitrust interest based on the recipient’s share of the trust’s QBI (whether or not distributed) for the tax years. Therefore, for example, if 10 percent of the CRT’s QBI is distributed to the recipient and 90 percent is retained by the trust, 10 percent of the Form W-2 wages and UBIA is allocated to the recipient, and 90 percent of the Form W-2 wages and UBIA is retained by the trust.

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45 Reg. section 1.652(b)-(a) and (b) provides that deductible items directly attributable to a specific class of income are to be allocated to that class. Deductions not directly attributable to a specific class of income may be allocated to any item of income, but a portion must be allocated to nontaxable income. Reg. section 1.652(b)-(d) also provides that any items of deduction that are directly attributable to a class of income exceeding that class must be allocated first to other classes of taxable income. Thus, if a trust has rent, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rent exceed rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect.

46 Section 662(b).

47 REG-134652-18.
48 Section 664(c)(1).
49 Section 664(c)(2).
51 Reg. section 1.664-1(d)(1)(i) and (ii).
52 Prop. reg. section 1.199A-6(d)(3)(v).
In accordance with the general rule, any Form W-2 wages retained by the trust do not carry over to subsequent years. Any QBI, REIT dividends, or PTP income of the trust that constitutes UBTI is subject to the 100 percent excise tax and allocated to the corpus of the trust.

III. Miscellaneous Deductions

Because estates and trusts are subject to the same rules governing the taxation of individuals, for tax years 2018 through 2025, they may not claim miscellaneous itemized deductions. The legislative history to the TCJA lists formerly deductible expenses subject to the 2 percent AGI floor as nondeductible to the extent they are not attributable to the conduct of trade or business. Nevertheless, section 67(e) provides that estates and non-grantor trusts may continue deducting “costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” Thus, an estate or trust may deduct investment management fees when the fees arise as the result of the property being held in an estate or trust.

When fiduciary fees or other advisory charges (for example, attorney or accounting fees) are embedded (bundled) in a total management charge, the fiduciary will need to determine the amount of those fees specifically arising out of the fiduciary arrangement. This task is now more important because the amount determined not incurred because the property is held by an estate or trust can no longer be deducted as a miscellaneous itemized expense subject to a 2 percent AGI floor.

To provide guidance on the effect of the suspension of miscellaneous itemized deductions by estates and trusts, Notice 2018-61, 2018-31 IRB 278, states that “deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust” are not “itemized expenses” and will remain deductible. Therefore, trustee commissions, attorney and accounting fees, estate tax attributable to income in respect of a decedent under section 691(c), and other itemized deductions that arose because the property is held in trust remain deductible.

Consequently, miscellaneous itemized expenditures meeting the standard of section 67(e), as well as those itemized deductions for which there is specific authority for deductibility — that is, interest under section 163, taxes under section 164, casualty/theft losses under section 165, and charitable contributions under section 170 — remain deductible. And the $10,000 annual limit for the deduction of taxes under section 164(b)(6) does not apply when they are incurred in connection with the trust or estate carrying on a trade or business or an activity for the production of income under section 212.

Thus, all ordinary and necessary expenses attributable to the production of income from real property remain deductible. However, for a personal residence in which a beneficiary resides, the IRS is likely to allege that the use of the

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53 Section 199A(c)(2) and reg. section 1.199A-1(d)(2)(iii)(B).
54 Section 664(c) and reg. section 1.664-1(c).
55 Section 641(b).
56 Section 67(g). Miscellaneous itemized deductions are itemized deductions in parts VI and VII of subchapter B other than those listed in section 67(b).
58 Reg. section 1.67-4(a) states that section 67(e) will apply when the cost would not “commonly or customarily” be incurred by a hypothetical individual holding the same property. In determining whether a cost would be commonly or customarily incurred by a hypothetical individual owning the same property, reg. section 1.67-4(b) states that the determination is based on the type of product or service rendered to the estate or non-grantor trust rather than the description of the cost of that product or service.
59 Reg. section 1.67-4(d) addresses the situation in which an estate or non-grantor trust pays a single fee, commission, or other expense for both costs that are subject to the 2 percent floor and costs (in more than a de minimis amount) that are not. It provides in computing AGI of the estate or non-grantor trust in compliance with section 67(e) the single fee, commission, or other expense (bundled fee) must be allocated between the costs that are subject to the 2 percent floor and those that are not — except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin.
60 For grantor trusts whose income and expenses are reported on the grantor’s individual return, these management expenses are totally nondeductible.
61 Section 164(b)(6) (flush language).
property and all associated expenses (for example, mortgage interest and taxes) are deemed distributions to that beneficiary carrying out DNI, with the individual receiving any deductions attributable to the distribution. 62

An unanswered question regarding the deductibility of trust and estate expenses is their treatment in the year of estate or trust termination. 63 Generally, deductions exceeding gross income in the year the estate or trust terminates are deductible to the beneficiaries succeeding to the property of the entity. 64 Treasury and the IRS are studying the extent to which this rule applies to miscellaneous expenses that are no longer deductible. 65 Although the IRS has confirmed that net operating losses and capital loss carryovers may be deducted by beneficiaries in the year of termination, 66 there is no assurance that this treatment will apply to expenses that exceed gross income in the termination year. Therefore, when these expenses cannot be attributed to a trade or business or other activity conducted primarily for the production of income, 67 they will likely be nondeductible to the beneficiaries. To avoid this consequence, post-death income should whenever possible be treated as trust or estate income to absorb any excess deductions.

IV. Multiple Trusts

In light of the $10,000 limit on the deductibility of taxes, 68 and the $157,500 threshold limiting the section 199A deduction, 69 some may consider the creation of multiple trusts to hold undivided interests in property with each trust having a $10,000 limit and/or section 199A threshold. However, section 643(f) treats multiple trusts as one taxpayer for income tax purposes if the trust has (1) substantially the same grantor or grantors (with spouses treated as one grantor), (2) substantially the same primary beneficiary or beneficiaries, and (3) was formed with a principal purpose of avoiding income tax. 70

Because all three tests must be met to collapse multiple trusts, having different beneficiaries should avoid the rule. Also, if one or more of the trusts were created for asset protection, a principal purpose for the trusts should not be tax avoidance, even when the arrangement may reduce the overall tax burden. 71 Although the proposed regulations to section 643(f) addressed those circumstances, the final regulations removed the “principal purpose” definition and examples illustrating when a principal purpose of the arrangement is tax avoidance. 72

The proposed regulations declared that a “principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of separate trusts. 73 The proposed regulations also had two examples illustrating the meaning of “significant” purpose. 74

63 In general, if a trust or estate is considered terminated because its administration has been unduly prolonged, its income deductions and other tax attributes are considered the income and deductions of the person or persons succeeding to the property of the estate or trust. Reg. section 1.641(b)-3(d).
64 Section 642(b)(2).
65 Notice 2018-61.
66 Section 642(b)(1).
67 See section 212.
68 Section 164(b)(6).
69 Section 199A(e)(2)(A).
70 Reg. section 1.643(f)-1(a). Reg. section 1.199A-3(d)(vii) also provides that a trust will be ignored if it is formed or funded with a principal purpose of avoiding or using more than one threshold amount in calculating the section 199A deduction.
71 Unfortunately, the IRS will not rule on circumstances dealing with the application of section 643(f). Rev. Proc. 2019-3, 2019-1 IRB 130.
72 Reg. section 1.643(f)-1(a).
73 Prop. reg. section 1.643(f)-1(b).
74 Prop. reg. section 1.643(f)-1(c), Example 2, illustrates the significant purpose test as follows:
X establishes two irrevocable trusts: one for the benefit of X’s son, G, and the other for X’s daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income to G for G’s life. H is the remainder person of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or pay income, in its discretion, to H for H’s education, support and maintenance. The trustee also may pay income or corpus for G’s medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G’s death. Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.
V. Conclusion

This discussion of the TCJA’s provisions affecting the income taxation of trusts and estates calls for taxpayers and their advisers to reconsider their strategies and techniques for minimizing the taxation of grantors and their beneficiaries through the use of trusts. Although the new rules require additional planning and perhaps restructuring of arrangements for transferring wealth from one generation to the next, the TCJA’s changes may, in some cases, actually enhance the use of trusts to offer additional planning opportunities.