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THE OBBBA and Planning with Nongrantor Trusts

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Qualified Business Income Deduction

IRC §199A

Qualified Business Income Deduction

- Originally created by the Tax Cuts and Jobs Act
- Available to individuals, trusts and estates
- Up to 20% of qualifying income
- Subject to limitations
- Was set to expire after 2025

Qualifying Business Activities

- Must rise to the level of a trade or business
- Not available to specified service trades or businesses (SSTB's) unless under the income threshold

Limitations on the Deduction

W-2 Wages

Unadjusted Basis Immediately after Acquisition (UBIA)

Taxable Income

Changes Under OBBBA

- Permanent Extension of the Deduction
- Creates a Minimum Deduction of $400

Use of Nongrantor Trusts for 199A Planning

Nongrantor Trusts – Overview

- Trust is treated as a separate taxpayer for income tax purposes
- Irrevocable
- Pays tax on undistributed income
    - Compressed tax brackets – For 2025, taxed at 37% once taxable income exceeds $15,650
- Receives a deduction for distributed net income (DNI)
- Beneficiaries include the DNI distributed to them on their individual income tax returns
- Two general types:
    - Simple trust – must distribute its income (fiduciary accounting income) at least annually to the trust's income beneficiaries
    - Complex trust – distributions of income and principal are made to the beneficiaries at the discretion of the trustee(s)

Nongrantor Trusts – Planning for 199A Deduction

- Create multiple nongrantor trusts and allocate business interests across trusts

- Each trust receives a separate QBI deduction threshold
    - Additional benefit, each trust has its own SALT deduction

- 199A threshold for nongrantor trusts
    - Phaseout range for deduction in 2025 is $197,300 to $247,300
    - In determining whether a trust has taxable income that exceeds the threshold amount, the taxable income of the trust is determined after taking into account the distribution deduction

- In addition to the 20% of QBI deduction, some trusts can also get a deduction for 20% of qualified REIT dividends and qualified PTP income

- Valuable for high-income business owners near or over 199A limits

Nongrantor Trusts – Planning for 199A Deduction

- Trust is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries and is treated as an individual to the extent it retains the QBI and other items

- The allocation of the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, relevant UBIA of qualified property, qualified REIT dividends, and qualified PTP income, is based on the proportion of the trust's DNI distributed to the beneficiary(s) vs. retained by the trust
  - For this purpose, the DNI is determined without regard to IRC Sec. 199A.

Nongrantor Trusts – Planning for 199A Deduction

- State income tax planning
  - Not all states follow the federal income tax treatment of 199A (NJ and NY do not)

  - Completed gift vs incomplete gift transfers
    - Consider creating a nongrantor trust in a state that provides state income tax benefits (for example, DE, AK, TN, NV)
    - Use of a Delaware incomplete-gift non-grantor (DING) trust, Nevada incomplete-gift non-grantor trust (NING) or comparable trust in an income tax friendly state to transfer the business interest
      - New York and California do not recognize ING trusts as nongrantor trusts
      - Caution: The IRS has stopped issuing rulings related to ING trusts

  - **Note:** State-sourced income will still be subject to tax if sourced to a state with a state income tax

Nongrantor Trusts – Planning for 199A Deduction

- Must be used carefully to avoid anti-abuse rules
- **IRS Notice 2018-64:** Anti-abuse rules against "trust stacking" if trusts are not independent
- **IRC Section 643(f):** Multiple trusts treated as one if formed to avoid tax
  - **Key Compliance Factors:**
    - Legitimate, non-tax-related purpose
    - Different primary beneficiaries for trusts with the same grantor
    - Proposed Regulations state that a principal purpose of avoidance will be presumed if creating multiple trusts results in a significant income tax benefit unless there is a significant non-tax purpose that could not have been achieved without the creation of separate trusts. There must be a sufficient differentiation with respect to the trust beneficiaries and trust terms to avoid aggregation under IRC 643(f)

Qualified Small Business Stock (QSBS) Expansion

IRC §1202

§1202 Big Picture

- Stock must be in a C Corporation
- Stock acquired directly from the company (original issuance)
- Corporation's gross assets ≤ $50 million at the time of issuance
- Company must be an active business (≥80% of assets in qualified trade)
- Held for ≥5 years to qualify for exclusion

Benefits

- Up to 100% capital gains exclusion
- Exclusion cap: Greater of $10M or 10x basis

Exclusion Percentages

- Pre-OBBB
  - The QSBS must be held for five years to qualify for the gain exclusion
  - Sales prior to meeting the five-year holding period fully taxable (unless §1045 rollover utilized)

- Stock Issued Post 07.04.25
  - The QSBS must be held by the taxpayer for at least 3 years to qualify for the phased gain exclusion

Holding Period	Exclusion % for Gain on Sale of QSBS
Held ≥ 3 Years	50%
Held ≥ 4 Years	75%
Held ≥ 5 Years	100%

Aggregate Gross Assets

- **Pre-OBBB**
  - The threshold for a C-Corporation to qualify as a QSBS issuer was $50,000,000 of aggregate gross assets

- **Stock Issued Post 07.04.25**
  - The aggregate gross asset test has increased to $75,000,000 of aggregate gross assets, which will be indexed for inflation, starting in 2026

Limitation on Excludable Gain

- Pre-OBBB
  - The maximum “per issuer” gain exclusion for investments was capped at $10,000,000 or 10 times the aggregate cost basis of the stock

- Stock Issued Post 07.04.25
  - This was adjusted to be capped at $15,000,000 or 10 times the aggregate cost basis of the stock
  - The $15,000,000 will be adjusted each year for inflation starting in 2026
  - If the taxpayer reaches the cap, future adjustments for inflation will not “free up” exclusion

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Excluded Gain and AMT

- Pre-OBBB
    - The amount of potential gain that can be excluded depends on the taxpayer's initial date of acquisition, as follows:
- Stock Issued Post 07.04.25
    - The amount of potential gain that can be excluded is 50%, unaffected by the taxpayer's initial date of acquisition
    - The excluded portion will not be an Alternative Minimum Tax (AMT) adjustment
    - If the taxpayer reaches the cap, future adjustments for inflation will not "free up" exclusion

Stock Issued	Gain Exclusion
August 11, 1993, to February 17, 2009	50%
February 18, 2009, to September 27, 2010	75%
September 28, 2010, or after	100%

New Jersey Conformity

- June 30, 2025, Bill A4455/S4503 was signed, bringing NJ in conformity with Federal 1202 laws
- NJ taxpayers will now be entitled to a 1202 exclusion for tax years beginning on or after January 1, 2026
- While initially drafted to be narrower and focus on NJ-based businesses, the final law adopts the Federal treatment

Planning Considerations

- Can selling pre-Effective Date QSBS first maximize the 1202 exclusion when considering both caps?
- Revisit existing S Corporations and consider a Type F reorganization (or consider conversion of an existing LLC)
- State-level planning

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Use of Nongrantor Trusts – Planning with IRC 1202 Stock

- Spread QSBS exclusion across multiple nongrantor trusts “stacking”

- Must acquire QSBS directly or by gift
  - Transfer of QSBS by gift is an exception to the general rule that the original holder must be the seller of QSBS in order to take advantage of the gain exclusion
  - QSBS basis carries over and holding period tacks to recipient when gifted
  - Upon sale, each trust claims its own §1202 exclusion

- Separate $10M or $15M/$10x basis exclusion per trust
  - $10M if stock issued before July 5, 2025
  - $15M if stock issued after July 4, 2025

- **Note:** Must meet timing, documentation, and business activity tests discussed previously

Use of Nongrantor Trusts – Planning with IRC 1202 Stock

- Estate planning
  - If the trust is structured so that the transfer is a completed gift, then the grantor files a gift tax return, lifetime exemption is utilized, and the assets in the trust(s) are outside of the taxpayer's estate
    - Best to gift stock early (before value appreciates)
  - If the trust is structured so that the transfer is not a completed gift for gift and estate tax purposes, then the transfer would still qualify for the IRC 1202 gain exclusion benefits, but the assets of the trust(s) would be included in the taxpayer's estate
  - Watch for IRC 643(f) – anti-abuse rules: multiple trusts with substantially the same grantor and beneficiaries, and principal purpose of establishing multiple trusts is avoidance of federal income tax
  - Avoid last-minute transfers close to sale of QSBS (assignment of income doctrine)

Use of Nongrantor Trusts – Planning with IRC 1202 Stock

- State income tax planning
  - Not all states follow the federal income tax treatment of QSBS (NJ does beginning 1/1/26)
  - Completed gift vs incomplete gift transfers
    - Consider creating a nongrantor trust in a state that provides state income tax benefits (for example, DE, AK, TN, NV) to receive the gift or purchase the QSBS from the issuing corporation
    - Use a Delaware incomplete-gift non-grantor (DING) trust, Nevada incomplete-gift non-grantor trust (NING) or comparable trust in an income tax friendly state to transfer the business interest
      - New York and California do not recognize ING trusts as nongrantor trusts
      - Caution: The IRS has stopped issuing rulings related to ING trusts

Nongrantor Trusts – Planning for State and Local Tax (SALT) Deductions

- The Tax Cuts and Jobs Act of 2017 limited the deduction for state and local taxes to $10,000 for nongrantor trusts
- The OBBBA has increased the SALT deduction to $40,000 for 2025 with 1% increases to this amount through 2029
- This new $40,000 limit is reduced (but not below $10,000) by 30% of the taxpayer's modified adjusted gross income over $500,000
- This is a temporary increase in the SALT deduction. It will revert to $10,000 in 2030
- Nongrantor trusts can be used to get additional SALT deductions of up to $40,000 each since each trust is considered a separate taxpayer
- Transferring income-producing assets to a nongrantor trust could result in lowering the grantor's taxable income below the SALT phase-out

Questions?

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