Income Taxation of Trusts - New Regulations

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Overview

On May 7, 2020, the IRS issued proposed regulations providing guidance on the deductibility of expenses that estates and non-grantor trusts incur. *REG-113295-18.* The reason for the proposed regulations is that the Tax Cuts and Jobs Act (TCJA), effective for tax years beginning after 2017 and before 2026, bars individual taxpayers from claiming miscellaneous itemized deductions. *I.R.C. §67(g).* This TCJA suspension of miscellaneous itemized deductions for individuals raised questions as to whether and/or how estates and non-grantor trusts are impacted. In late September, the IRS finalized the regulations. *TD 9918 (Sept. 21, 2020).*

New guidance on handling deductions of a non-grantor trust or estate and those that flow to beneficiaries – it's the topic of today's post.

Computing Trust/Estate AGI

In general, a trust's or estate's AGI is computed in the same manner as is AGI for an individual. *I.R.C. §67(e).* However, when computing AGI for trust or an estate, deductions are allowed for administration costs that are incurred in connection with a trust or an estate if those costs would *not* have been incurred if the property were held individually instead of in a trust or in the context of a decedent's estate. *I.R.C. §67(e)(1).* In addition, an estate or trust is entitled to a personal exemption (I.R.C. §642(b)), a deduction for current income distributed from a trust (I.R.C. §651), and a deduction for the distribution of income from an estate or a trust for accumulated income as well as the distribution of corpus (I.R.C. §661).

But, the TCJA added I.R.C. §67(g) which states, "…no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." That raised a question of whether the IRS would take the position that the new I.R.C. §67(g) caused the I.R.C. §67(e) expenses to be miscellaneous itemized deductions that a non-grantor trust or estate could no longer deduct. In 2018, however, the IRS issued Notice 2018-61 to announce pending regulations and stated that I.R.C. §67(e) expenses would remain deductible by virtue of removing them from the itemized deduction category.

Excess Deductions

Another aspect of non-grantor trust/estate taxation involves "excess deductions." When an estate or trust terminates, a beneficiary gets to deduct any carryover (excess) amount of a net operating loss or capital loss. *I.R.C. §642(h)(1).* The beneficiary can also deduct the trust's or estate's deductions for its last tax year that are in excess of the trust's or estate's gross income for the year. *I.R.C. §642(h)(2).* These deductions are allowed in computing the beneficiary's taxable income. While they must be taken into account in computing the beneficiary's tax preference items, they cannot be used to compute gross income. *Treas. Reg. §1.642(h)-2(a).* In addition, the character of the deductions remains the same in the hands of a beneficiary upon the termination of an estate or a trust.

But, the TCJA suspension of miscellaneous itemized deductions clouded the tax treatment of how excess deductions were to be handled. When a trust or estate terminates with excess deductions they *could be* treated in the hands of a beneficiary as a miscellaneous itemized deduction that I.R.C. §67(g) disallows. I say "could be" because an excess deduction could take one of three forms. It is either comprised of deductions that are allowed when computing AGI under I.R.C. §§62 and 67(e); or it is an itemized deduction under I.R.C. §63(d) that is allowed when computing taxable income; or it is a miscellaneous itemized deduction that the TCJA disallows (through 2025).

Proposed Regulations

The Proposed Regulations specify that certain deductions of an estate or trust are allowed in computing adjusted gross income (AGI) and are *not* miscellaneous itemized deductions and, thus, are not disallowed by I.R.C. §67(g). Instead, they are treated at above-the-line deductions that are allowed in determining AGI . The Proposed Regulations also provide guidance on determining the character, amount and manner for allocating excess deductions that beneficiaries succeeding to the property of a terminated estate or non-grantor trust may claim on their individual income tax returns.

Specifically, the Proposed Regulations amend Treas. Reg. §1.67-4 to clarify that I.R.C. §67(g) doesn't disallow an estate or non-grantor trust from claiming deductions: (1) 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 the trust or estate; and (2) for deductions that are allowed under I.R.C. §§642(b), 651 and 661 (personal exemption for an estate or trust; income distributed currently; and distributions for accumulated income and corpus).

As for excess deductions of an estate or trust, prior Proposed Regulations treated excess deductions upon termination of an estate or non-grantor trust as a single miscellaneous itemized deduction. The new Proposed Regulations, however, segregate excess deductions when determining their character, amount, and how they are to be allocated to beneficiaries. The new Proposed Regulations specified that the excess amount retains its separate character as either an amount that is used to arrive at AGI; a non-miscellaneous itemized deduction; or a miscellaneous deduction. That character doesn't change in the hands of the beneficiary. The fiduciary is to separately identify deductions that may be limited when the beneficiary claims the deductions.

The Proposed Regulations utilize Treas. Reg. §1.652(b)-3 such that, in the year that a trust or estate terminates, excess deductions that are directly attributable to a particular class of income are allocated to that income. The Preamble to the Proposed Regulations states that excess deductions are allocated to beneficiaries under the rules set forth in Treas. Reg. §1.642(h)-4. After allocation, the amount and character of any remaining deductions are treated as excess deductions in a beneficiary's hands in accordance with I.R.C. §642(h)(2). This accords with the legislative history of I.R.C. §642(h) in seeking to avoid "wasted" deductions.

The bifurcation of excess deductions into three categories by the Proposed Regulations rather than lumping them altogether miscellaneous itemized deductions disallowed by the TCJA is pro-taxpayer.

The IRS says that the Proposed Regulations can be relied on for tax years beginning after 2017, and on or before the proposed regulations are published as final regulations.

Final Regulations

I.R.C. §67(g) doesn't control. The Final Regulations affirm that deductions for costs which are paid or incurred in connection with the administration of an estate or trust and which would not have been incurred if the property were not held in such trust or estate remain deductible in computing AGI. In other words, I.R.C. §67(e) overrides I.R.C. §67(g). However, the Final Regulations do not provide any guidance on whether these deductions (including those under I.R.C. §§642(b), 651 and 661) are deductible in computing alternative minimum tax for an estate or trust. That point was deemed to be outside the scope of the Final Regulations.

Excess deductions. As for excess deductions, the Final Regulations confirm the position of the Proposed Regulations that excess deductions retain their nature in the hands of the beneficiary. *Treas. Reg. §1.642(h)-2(a)(2).* How is that nature determined? Excess deductions passing from a trust or an estate have their nature pegged by Treas. Reg. §1.652(b)-3. The nature of excess deductions of a trust or an estate is determined by a three-step process: 1) direct expenses are allocated first (e.g., real estate taxes offset real estate rental income); 2) the trustee can exercise discretion when allocating remaining deductions – in essence, offsetting less favored deductions for individuals by using them against remaining trust/estate income (also, if direct expenses exceed the associated income, the excess can be offset at this step); 3) once all of the trust/estate income has been offset any remaining deductions constitute excess deductions when the trust/estate is terminated that are allocated to the beneficiaries in accordance with Treas. Reg. §1.642(h)-4. *Treas. Reg. 1.642(h)-2(b)(2).*

Example 2 of the Proposed Regulations was modified in the Final Regulations to permit allocation of personal property tax to income, with any I.R.C. §67(e) expenses distributed to the beneficiary. Thus, the fiduciary has discretion to selectively allocate deductions to income or distribute them to a beneficiary. Those excess deductions that are, in a beneficiary's hands, allowed at arriving at AGI on Form 1040 are to be deducted as a negative item on Schedule 1.

As the Proposed Regulations required and the Preamble to the Final Regulations confirm, the information concerning excess deductions must be reported to the beneficiaries when a trust or an estate terminates. Deduction items must be separately stated when, in the beneficiary's hands, the deduction would be limited under the Code. The Preamble states that the Treasury Department and the IRS "plan to update the instructions for Form 1041, Schedule K-1 (Form 1041) and Form 1040…for 2020 and subsequent tax years to provide for the reporting of excess deductions that are section 67(e) expenses or non-miscellaneous itemized deductions."

Because excess deductions retain their nature in a beneficiary's hands, any individual-level tax limitations still apply. Thus, for example, if an excess deduction results from state and local taxes (SALT) that a non-grantor trust or estate pays, is still limited at the beneficiary's level to the $10,000 maximum amount under the TCJA. The Final Regulations addressed this issue, but the Treasury determined that it lacked the authority to exempt a beneficiary from the SALT limitation.

The Preamble also notes that beneficiaries subject to tax in states that don't conform to I.R.C. §67(g) may need access to miscellaneous itemized deduction excess deduction information for state tax purposes. This burden apparently rests with the fiduciary of the estate/trust and the pertinent state taxing authority. The IRS declined to modify federal income tax forms to require or accommodate the collection of this information because it is a state tax issue and not a federal one.

The Final Regulations clarify that a beneficiary cannot carry back a net operating loss carryover that is passed out of a trust/estate in its final year. *Treas. Reg. §1.642(h)-5(a), Ex. 1.* A net operating loss carryover from an estate/trust can only be carried forward by the beneficiary.

Applicability

The Final Regulations apply to tax years beginning after their publication in the Federal Register. They do not apply to all open tax years. Thus, it is not possible to file an amended return to take advantage of the position of the Final Regulations with respect to excess deductions for a tax year predating the effective date of the Final Regulations.

Conclusion

The Proposed and Final Regulations are, in general, taxpayer friendly. Tax planning will likely focus on the allocation of deductions in accordance with classes of income over which the fiduciary can exercise discretion (amounts allowed in arriving at AGI; non-miscellaneous itemized deductions; and miscellaneous itemized deductions). To the extent that the fiduciary can have excess deductions on termination of an estate or non-grantor trust reduce AGI, that is likely to produce the best tax result for the beneficiary or beneficiaries (with consideration given, of course, to possible TCJA-imposed limitations). Given the compressed tax brackets applicable to trusts and estates, the position taken in the Proposed and Final Regulations on deduction items and the flexibility given to fiduciaries is welcome news.