



THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

McPherson Building
901 15th Street, NW, Suite 525
Washington, DC 20005
(202) 684-8460 • Fax (202) 684-8459
www.actec.org

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Honolulu, Hawaii

February 19, 2019

Notice.Comments@irsccounsel.treas.gov
Internal Revenue Service
CC:PA:LPD:RU (Notice 2018-61), Room 5203
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Re: Notice 2018-61: Comments regarding the effect of new section 67(g) of the Internal Revenue Code on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction upon termination of a trust or estate

Dear Ladies and Gentlemen,

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit comments pursuant to Notice 2018-61, effective July 13, 2018. The Notice requests comments on issues relating to section 642(h)(2) and §1.642(h)-2(a) in light of new section 67(g).

ACTEC is a professional organization of approximately 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

ACTEC's comments and recommendations on the ability of the beneficiary of an estate or trust to deduct amounts comprising section 642(h)(2) excess deductions upon termination of the entity are set forth in the attached memorandum.

If you or your staff would like to discuss the comments, please contact Greg V. Gadarian, who led the task force that put together the comments, at (520) 529-2242 or greg@gadarianlaw.com, Beth Shapiro Kaufman, Chair of the ACTEC Washington Affairs Committee, at (202) 862-5062 or bkaufman@capdale.com, or Deborah McKinnon, ACTEC Executive Director, at (202) 684-8460 or domckinnon@actec.org.

Respectfully submitted,

Charles D. Fox IV, President

Attachments

**COMMENTS OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL
ON ISSUES RELATING TO SECTION 642(h)(2) AND TREAS. REG. § 1.642(h)-2(a) IN LIGHT
OF NEW SECTION 67(g)**

The American College of Trust and Estate Counsel (ACTEC) is pleased to submit these comments in response to Notice 2018-61, 2018-31, I.R.B. 278, which became effective on July 13, 2018.

The Notice requests comments regarding the effect of new section 67(g) of the Internal Revenue Code¹, as enacted on December 22, 2017, by P.L. 115-97 (the 2017 Act), on the ability of the beneficiary of an estate or trust to deduct amounts comprising section 642(h)(2) excess deductions upon termination of the entity.

Notice 2018-61 also states that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue regulations providing clarification of the effect of section 67(g) on the deductibility of certain expenses described in sections 67(b) and (e) and Treas. Reg. § 1.67-4 that are incurred by estates and non-grantor trusts.²

BACKGROUND

Code Section 67(g)

Section 11045 of the 2017 Act added section 67(g) to the Code. It provides that, notwithstanding section 67(a), no miscellaneous itemized deductions shall be allowed to any individual taxpayer for any taxable year beginning after December 31, 2017, and before January 1, 2026. For other taxable years—i.e., those beginning on or before December 31, 2017, or on or after January 1, 2026—section 67(a) allows miscellaneous itemized deductions only to the extent that they exceed two percent of an individual's adjusted gross income.

Code Section 67(e)

Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or a trust is determined in the same manner as for an individual, except that expenses described in section 67(e)(1) and deductions pursuant to sections 642(b), 651, and 661 are allowable as deductions in arriving at adjusted gross income. Thus, section 67(e) removes the expenses described in section 67(e)(1) from the category of itemized deductions (and thus also from the subset of miscellaneous itemized deductions) and instead treats them as deductions allowed in determining adjusted gross income under section 62(a). Deductions allowed in determining adjusted gross income are commonly referred to, in the case of an individual, as “above-the-line” deductions.³

Notice 2018-61 states that the Treasury Department and the IRS believe that the suspension by section 67(g) of the deductibility of miscellaneous itemized deductions does not affect the deductibility of payments described in section 67(e)(1). The Notice further states that an expense that commonly or customarily would be incurred by an individual (including the appropriate portion of a fiduciary's bundled fee) is not a payment

¹ Unless otherwise stated, references herein to “section(s)” or to “Code” are to the Internal Revenue Code of 1986, as amended. References herein to “§” are to relevant sections of the Treasury regulations.

² The terms “trust” and “trusts” as used herein refers to non-grantor trusts.

³ See, e.g., Treas. Reg. § 1.67-1T. The epithet “above-the-line” refers to a line – actually now a page break – on the Form 1040 U.S. Income Individual Income Tax Return. Below that line, individual income tax filers have a choice of claiming either itemized deductions or the standard deduction; above that line, all individual income tax filers compute their adjusted gross income. The standard deduction available to estates and trusts is zero; thus, there is no comparable line or page break on the Form 1041 U.S. Income Tax Return for Estates and Trusts. Section 63(c)(6).

described in section 67(e)(1) and, therefore, is affected by section 67(g) and is not deductible by an estate or a trust during the suspension of the deductions previously subject to the limitations of section 67(a).

Code Section 642(h)

Section 642(h) applies to the termination of an estate or trust that has: (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212; or (2) for the last taxable year of the estate or trust, deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income for such year. In such cases, the carryover or excess deductions are allowed as deductions (in accordance with regulations prescribed by the Secretary) to the beneficiaries succeeding to the property of the estate or trust.

Treasury Reg. § 1.642(h)-1(b) provides, in part, that the “net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust.” Therefore, any net operating and capital loss carryovers are taken into account in computing a beneficiary’s taxable income and alternative minimum tax. By section 62(a)(1) and 62(a)(3), respectively, these deductions are allowed in computing an individual beneficiary’s adjusted gross income and are not miscellaneous itemized deductions on the return of the beneficiary.

Treasury Reg. § 1.642(h)-2(a) deals with excess deductions other than net operating loss and capital loss carryovers. This regulation provides that the excess is allowed under section 642(h)(2) as a deduction to those beneficiaries who succeed to the property of the estate or trust. The deduction is allowed only in computing taxable income and must be taken into account in computing a beneficiary’s items of tax preference. Treasury Reg. § 1.642(h)-2(a) further provides that the section 642(h)(2) excess deduction “is not allowed in computing adjusted gross income.” Consequently, under section 67(b) (described below), which was enacted after Treasury Reg. § 1.642(h)-2(a) was issued, the section 642(h)(2) excess deduction is classified as a miscellaneous itemized deduction. Thus, the regulation effectively causes the excess to become nondeductible under section 67(g).

Notice 2018-61 indicates that the Treasury Department and the IRS are considering whether the treatment of the section 642(h)(2) excess as a miscellaneous itemized deduction remains appropriate. In particular, the Notice states that the Treasury Department and the IRS are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of an estate or a trust, should continue to be treated as miscellaneous itemized deductions when they are included in the section 642(h)(2) excess deduction. Notice 2018-61 further states that the Treasury Department and the IRS intend to issue regulations regarding the section 642(h)(2) excess deduction.

Finally, the Notice requests comments regarding the effect of section 67(g) on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction upon the termination of an estate or a trust in light of section 642(h) and Treas. Reg. § 1.642(h)-2(a). In particular, the Treasury Department and the IRS request comments concerning the separate amounts comprising the section 642(h)(2) excess deduction, such as any amounts that are section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the estate or trust. The question raised in the Notice is whether those amounts should be separately analyzed for purposes of determining the extent to which they are deductible in the hands of the beneficiaries, or whether they should continue to be treated in the aggregate as a single miscellaneous itemized deduction that is currently nondeductible under section 67(g).

RECOMMENDATIONS

Code Section 67(e)

ACTEC believes that Notice 2018-61 correctly states the law in concluding that the expenses and deductions described in section 67(e)(1) and (2) continue to be deductible and are not affected by section 67(g). ACTEC also believes that any confusion regarding the treatment of such expenses and deductions could be addressed by amending the first sentence of Treas. Reg. § 1.67-4(a).⁴

In addition, ACTEC recommends that the Treasury Department and the IRS address the treatment of expenses and deductions described in section 67(e)(1) and (2) for purposes of determining a trust's or estate's alternative minimum taxable income. By way of background, section 56(b)(1)(A)(i) provides that miscellaneous itemized deductions, as defined in section 67(b), are not allowed as deductions in determining alternative minimum taxable income. Section 67(e) treats certain expenses and deductions as allowable in computing adjusted gross income, and thus removes those expenses and deductions from the class of miscellaneous itemized deductions described in section 67(b). This rule, however, as Notice 2018-61 observes, applies only "for purposes of this section," i.e., section 67. It does not, by its terms, cause expenses or deductions to avoid treatment as miscellaneous itemized deductions for purposes of any other section of the Code.

Form 1041, Schedule I uses "adjusted total income" as the starting point for the computation of alternative minimum taxable income.⁵ Adjusted total income allows deductions allowable under section 67(e)(1) but does not allow a deduction for miscellaneous itemized deductions for 2017 and subsequent tax years. ACTEC believes that this approach is correct, and that Congress intended, by cross-referencing section 67(b) in section 56(b)(1)(A)(i) to incorporate the rule of section 67(e) into the definition of miscellaneous itemized deductions for purposes of computing alternative minimum taxable income. To allay all doubt, however, ACTEC recommends that Treasury and the IRS publicly confirm that a trust's or estate's expenses and deductions described in section 67(e)(1) and (2) continue to be deductible for alternative minimum tax purposes.

Code section 642(h)

History and current law. Section 642(h) was enacted in 1954. There was no comparable provision under prior law. The committee report accompanying enactment states:

Under subsection (d) [now section 642(h)] any unused net operating loss carryover, capital loss carryover, or deductions in excess of gross income (other than deductions for distributions allowed under section 661 or the deduction for personal exemption under section 642(b)) upon the termination of an estate or trust are made available, in accordance with regulations, to the

⁴ Treas. Reg. § 1.67-4(a) states that "section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust." The confusion regarding the treatment of such expenses under section 67(g) could be avoided if the regulation were amended to read "section 67(e) provides that costs paid or incurred in connection with the administration of an estate or a non-grantor trust that would not have been incurred if the property were not held in such estate or trust shall be treated as allowable in arriving at adjusted gross income."

⁵ Line 1 of Schedule I starts with Line 17 of the Form 1041. Line 17 reflects the trust's adjusted total income. The computation of adjust total income specifically allows deductions for attorney fees and other expenses described in section 67(e)(1). Specifically, Lines 12-15a allow the deductions described in section 67(e) for purposes of computing adjusted total income. Thus, the alternative minimum tax takes into account expenses described in section 67(e)(1).

beneficiaries or remaindermen succeeding to the property. Under existing law, these unused loss carryovers are lost when the estate or trust terminates (Cf. Charles Neave, 17 T. C. 1237).⁶

As discussed, Treasury Reg. § 1.642(h)-2(a) treats any deductions (other than net operating loss carryovers and capital loss carryovers) in excess of gross income as a single deduction allowed to the beneficiaries, but only in computing beneficiaries' taxable incomes and not as a deduction allowed in computing adjusted gross income. As result, under section 67(b), a section 642(h)(2) excess deduction is treated as a miscellaneous itemized deduction that is currently nondeductible under section 67(g).

Categories of trust and estate expenses. Expenses incurred by estates and trusts generally fall into one of four categories, which are defined by general tax principles as well as the specific rules of sections 62(a), 63(a), 67(b), and 67(e)(1). The categories are generally described in Notice 2018-61 and are examined below.

First, some expenses, even if incurred by an estate or trust, are not deductible for income tax purposes. Examples include expenses incurred to maintain a residence owned by a trust for the personal use of a beneficiary⁷ and deductions disallowed for income tax purposes because they were instead allowed as estate tax deductions.⁸

Second, some expenses are allowed in computing a trust's or estate's adjusted gross income. Under section 62(a), expenses allowed in computing adjusted gross income include: section 162 trade or business expenses; losses arising from the sale or exchange of property; section 212 deductions attributable to the production of rents and royalties; penalties for early withdrawals of savings accounts and certificates of deposits; and section 194 reforestation expenses.⁹ In addition, by section 67(e)(1), costs incurred in the administration of an estate or trust that are not commonly or customarily incurred by an individual holding the same property are also allowed (for purposes of section 67) in computing a trust's or estate's adjusted gross income. Examples of such costs include those relating to: the preparation of all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns; costs of appraisals and probate court fees and costs; fiduciary bond premiums; costs for publication of legal notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts. See Treas. Reg. § 1.67-4. Deductions for these costs, because they are allowed in computing adjusted gross income, escape classification as itemized deductions and are not subject to the section 67(a) limitation or the section 67(g) suspension.

Third, section 63(d) defines a category of deductions known as "itemized deductions." Itemized deductions are deductions other than (1) those allowed in computing adjusted gross income, (2) the deduction for qualified business income under section 199A, and (2) the deduction for personal exemptions under section 151.¹⁰ Examples of itemized deductions include: the section 163 interest deduction; the

⁶ H. Rept. No. 1337, 83d Cong., 2d Sess., at A201. See also S. Rep. No. 83-1622, at 4714-16 (1954), indicating that "under existing law these unused carryovers and excess deductions are *wasted* when the estate or trust terminates."

⁷ See *Alfred I. Dupont Testamentary Trust, et al. v. C.I.R.*, 514 F.2d 917 (5th Cir. 1975), *aff'g* 62 T.C. 36 (1974) (disallowing deduction for residential maintenance expenses under section 212); *Alfred I. Dupont Testamentary Trust, et al. v. C.I.R.*, 66 T.C. 761 (1976) (disallowing deduction for residential maintenance expenses under sections 651 and 661), *aff'd* 574 F.2d 1332 (5th Cir. 1978).

⁸ Section 642(g).

⁹ As noted above, in the case of individuals, these are referred to as "above-the-line" deductions.

¹⁰ The 2017 Act suspends personal exemptions for taxable years beginning after December 31, 2017, and after January 1, 2026. Section 151(d)(5). As discussed in the text, certain itemized, classified as "miscellaneous itemized deductions," are suspended for taxable years beginning after December 31,

section 164 deduction for state and local taxes (subject to the applicable limitations); the section 170 and section 642(c) charitable contribution deductions; the section 213 medical expense deduction; the section 691(c) deduction for estate taxes attributable to income in respect of a decedent (IRD); and the section 171 deduction for amortizable bond premiums. In the case of an individual, the effect of classifying a deduction as an itemized deduction (assuming that it is not a miscellaneous itemized deduction, as described below), is to give the individual filer a choice, under section 63, between claiming itemized deductions or the standard deduction.¹¹ Trusts or estates, by contrast, are not allowed the standard deduction.¹² In the case of a trust or estate, therefore, the effect of classifying a deduction as “itemized” is much more limited.¹³

Finally, section 67(b) defines a subset of itemized deductions known as “miscellaneous itemized deductions.” Miscellaneous itemized deductions are defined negatively as those itemized deductions that are not included on a favored list of itemized deductions. IRS Publication 529 lists numerous examples of miscellaneous itemized deductions. Notable examples include an individual’s tax preparation fees and expenses incurred to produce or collect income (if not allowed in computing adjusted gross income, such as fees or expenses incurred to produce rental or royalty income). As discussed, section 67(e)(1) provides a rule, unique to estates and trusts, that allows a cost to escape treatment as a miscellaneous itemized deduction if it was incurred in administration and is not commonly or customarily incurred by individuals holding the same property.

For taxable years beginning before January 1, 2018 and after December 31, 2025, section 67(a) allows deductions for miscellaneous itemized deductions only to the extent that they exceed, in the aggregate, two percent of adjusted gross income. For taxable years beginning after December 31, 2017, or before January 1, 2026, miscellaneous itemized deductions are suspended by section 67(g). That is, all section 67(b) deductions that previously were subject to the section 67(a) limitation now are entirely denied.

Costs in final year of administration. In its final year of administration, an estate or a trust may have deductions that exceed the gross income of the estate or trust. The excess (except to the extent attributable for the section 642(b) personal exemption, the section 642(c) charitable deduction, or net operating or capital loss) is treated as a section 642(h)(2) deduction to the beneficiaries succeeding to the property of the estate or trust. For example, in its final year of administration an estate or trust may have: section 162 trade or business expenses; deductions under section 163 (interest deduction), section 164 (state and local taxes), section 691(c) estate taxes attributable to income in respect of a decedent, and section 171 (amortizable bond premiums). All of these items are specifically excluded from the definition of miscellaneous deductions under section 67(b).

In addition, an estate or trust may have deductions for expenses that are paid or incurred in connection with the administration of the estate or trust but that are not commonly incurred by individuals. For example,

2017, and before January 1, 2026, and, for other taxable years, are only allowed to the extent that they exceed two percent of adjusted gross income

¹¹ For taxable years beginning prior to January 1, 2018, or after December 31, 2025, itemized deductions, in the case of an individual, are also subject a limitation, commonly known as the “Pease” limitation, under section 68. The Pease limitation does not in any years apply to trusts and estates. Section 68(e).

¹² Section 63(c)(6).

¹³ Indeed, for taxable years beginning after December 31, 2017, and before January 1, 2026, trusts and estates are indifferent to whether a deduction is allowed in computing adjusted gross income or is instead merely an itemized deduction. For taxable years beginning prior to January 1, 2018, or after December 31, 2025, by contrast, a deduction allowed in computing adjusted gross income reduces the amount of the two percent “haircut” under section 67(a), whereas an itemized deduction does not have that favorable effect. Classification of a deduction as itemized can also reduce the amount of a trust’s or estate’s casualty loss deduction under section 165 in years prior to January 1, 2018, or after December 31, 2025. Section 165(h)(2).

a terminating estate or trust may incur costs for final accounting, tax preparation, and probate fees. These costs, at the trust or estate level, are allowed as deductions under section 67(e)(1).

Despite the fact that costs may be deductible by an estate or trust, either as non-miscellaneous itemized deductions or as deductions allowed in computing adjusted gross income, Treasury Reg. § 1.642(h)-2 aggregates the costs comprising the excess in the year of the estate's or trust's termination, and treats the aggregate excess as a single itemized deduction. The Treasury Regulations specifically provide the "deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income."¹⁴ The Treasury Regulation in effect bundles the excess deductions and treats the aggregated deduction as a miscellaneous itemized deduction in the hands of the beneficiaries. The Regulation was promulgated in 1956¹⁵ prior to the enactment of the limitation on the deductibility of miscellaneous itemized deductions in 1986¹⁶ and does not address the fact that the excess costs, when bundled together as a single deduction that passes out to the beneficiaries, is treated not only as an itemized deduction but as a miscellaneous itemized deduction subject to the section 67(a) limitation and/or section 67(g) suspension.

Authority to separately state items of expense. Notice 2018-61 requests comments regarding whether the separate categories of items which comprise the section 642(h)(2) excess deduction, specifically including any amounts that are not miscellaneous itemized deductions in the hands of the estate or trust, should be separately analyzed and capped or denied at the beneficiary level when the excess deduction is carried out to the beneficiaries under section 642(h)(2). ACTEC believes the Treasury Department and the IRS have the authority to separate these deductible items.

The legislative history of the 2017 Act states that present law and IRS guidance (IRS Publication 529, "Miscellaneous Deductions") provide examples of items that may be deducted as miscellaneous itemized deductions under present law. This non-exhaustive list includes excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust. Although ACTEC believes that IRS Publication 529 correctly applies current law by classifying the section 642(h)(2) excess deduction as miscellaneous, ACTEC also believes that present law is an unintended artifact of Treasury Reg. § 1.642(h)-2 having been written long before the concept of "miscellaneous itemized deduction" was known. The description of present law does not, therefore, preclude the Treasury Department and the IRS from exercising its regulatory authority in order to separate the section 642(h)(2) excess deduction into its components. On the contrary, it would be appropriate for the Treasury Department to exercise its authority, as the treatment of the section 642(h)(2) excess deduction as a miscellaneous itemized deduction disregards the reality that the excess may be composed of a variety of expenses, many of which are either deductible in the hands of the trust or estate, or would be deductible in the hands of the successive beneficiaries, or both.

Further, section 642(h) provides that the excess "shall be allowed as a deduction, *in accordance with regulations prescribed by the Secretary*, to the beneficiaries succeeding to the property of the estate or trust (emphasis added)." The italicized language confers broad regulatory authority under which the Treasury Department may issue regulations not only regarding the manner in which the section 642(h) deductions are allowed but also regarding how the deductions are computed and characterized. Nothing in the 2017 Act overrides this broad grant of regulatory authority; on the contrary, Congress implicitly confirmed that the Treasury Department may continue to issue rules determining how the section 642(h)(2) excess is computed and characterized, including in light of section 67(g). Thus, ACTEC agrees that the Treasury Department and the IRS have the authority to separately state these deductible items and provide different treatment for separate amounts comprising section 642(h)(2) excess.

¹⁴ Treas. Reg. § 1.642(h)-2(a).

¹⁵ T.D. 6217, 12-19-56, 21 F.R. 10212, December 20, 1956; amended by T.D. 7564, 9-11-78.

¹⁶ H.R. 3838, 99th Congress; Public Law 99-514.

Finally, ACTEC believes practical considerations make it appropriate for the Treasury Department and the IRS to exercise their authority to separate these items rather than to treat all such items as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction. In particular, if the excess continues, as under current law, to be treated as a miscellaneous itemized deduction in the hands of the beneficiaries, then fiduciaries might feel compelled to prolong administration of an estate or a trust, or sell assets, to fully utilize deductible expenses at the trust or estate level.¹⁷

Separation of the excess: computational issues in general. To provide adequate guidance to taxpayers, regulations separating the section 642(h)(2) excess into its components would need to address a number of technical computational issues. Specifically, they must address (1) the character of the section 642(h)(2) excess in the hands of the beneficiaries, including the extent to which the costs comprising the section 642(h)(2) excess are deductible when carried out to the beneficiaries; (2) how the amounts entering into the section 642(h)(2) excess are determined, particularly when they are offset by items of income in the final year; and (3) how the costs comprising the section 642(h)(2) excess are allocated among multiple beneficiaries.¹⁸ These issues are discussed below.

Character of excess deduction in the hands of the beneficiaries. The first technical issue that the regulations should address is the character of the costs that are carried out to the beneficiaries in the final year of administration. Considering the purpose of section 642(h), as described in the legislative history cited above, ACTEC believes that the character of the excess should not change when the deduction passes through to the beneficiaries upon termination of an estate or a trust. In particular, if deductions for costs would not be capped or disallowed as miscellaneous itemized deductions in the hands of the estate or trust, then they should not be capped or disallowed in the hands of those beneficiaries. Further, itemized deductions, which, as discussed above, have little effect on the computation of the taxable income of an estate or trust, should retain their character when carried out to individual beneficiaries, who may either claim them as itemized deductions or elect to claim the standard deduction.

More specifically, ACTEC recommends that regulations first require the fiduciary to divide any excess deduction in the final year of administration into separate amounts. At a minimum, the excess should be divided into at least three categories: (1) amounts allowed in computing adjusted gross income; (2) non-miscellaneous itemized deductions (as defined by sections 63(d) and 67(b), but not including deductions allowed in computing adjusted gross income under section 67(e)); and (3) miscellaneous itemized deductions. The regulations should then provide that these amounts are carried out, without change in character, to the beneficiaries succeeding to the section 642(h)(2) excess deduction.

Thus, if an expense was allowed in computing the trust's or estate's adjusted gross income (for example, an expense of producing rental income or a fiduciary accounting expense), it should be allowed in computing the succeeding beneficiary's adjusted gross income; if an expense was a non-miscellaneous

¹⁷ To be sure, excess deductions in a year in which an estate does not terminate are not allowed to beneficiaries or carried over to future years. On the contrary, they are wasted absent a provision of the Code (such as for net operating losses or capital losses) permitting them to be carried over to another year. The apparent anomaly of the section 642(h)(2) excess deduction, which is allowed only in years of termination can perhaps be explained by the fact that administration expenses, such as those incurred for final accounting and commissions, are typically larger in the year of termination than in other years. In most years, the risk of wasted deduction is minimal. In the final year, by contrast, a failure of the section 642(h)(2) to permit deductions of excess termination expenses is more likely to cause distortion in the form of prolonged administration or sales of assets to increase gross income.

¹⁸ For an earlier discussion of these issues, see *Select Treasury Guidance Projects: What To Expect*, by Austin W. Bramwell and Beth Shapiro Kaufman at 38-40, presented at American College of Trusts & Estates Counsel Fall Meeting, October 26, 2018 (available from authors on request).

itemized deduction (for example, a payment of state income tax), it should be allowed as an itemized deduction to the succeeding beneficiary; and if an expense was a miscellaneous itemized deduction (for example, an investment advisory fee), it should be treated as miscellaneous itemized deduction in the hands of the beneficiaries and thus disallowed under section 67(g) for tax years beginning before January 1, 2026.

In addition, if an amount is subject to a deduction limitation rule, regulations should further provide it must be separately identified. For example, because the deduction for state or local property or income taxes is limited under section 164(b)(6), any payment of such taxes entering into the section 642(h)(2) excess should be separately identified. Likewise, because the deduction for interest is limited by various rules under section 163 (such as in the case of investment interest and qualified residence interest), any payment of interest entering into the section 642(h)(2) excess should be separately identified. Regulations could include a “catch-all” provision requiring a separate statement of any costs that could result in a different income tax liability, when separately stated, when carried out to the beneficiaries under section 642(h)(2).¹⁹

Under the foregoing approach, if a trust is the beneficiary succeeding to the property of an estate or another trust, any items that were section 67(e)(1) deductions would continue to be treated as such by the trust succeeding to the property. In other words, they would continue to be treated as allowed in computing the succeeding trust’s adjusted gross income and therefore would be deductible. Indeed, the entire section 642(h)(2) excess, to the extent it would be deductible by the terminating estate or trust, would continue to be deductible if an irrevocable trust is the beneficiary succeeding to the property of the estate or trust, subject to general deduction limitation rules. For example, the excess deduction may include interest deductible under section 163 and state and local taxes deductible under section 164 (subject to the \$10,000 limitation). These items, which would be coded as non-miscellaneous itemized deductions in the hands of an individual beneficiary, would be deductible in the hands of a trust which is the beneficiary succeeding to the property of an estate or another trust, subject to the limitations of section 163 or section 164.

If instead an individual is the beneficiary succeeding to the property of an estate or trust, an expense which is a section 67(e)(1) administration expense at the trust and estate level should continue to be treated as an item allowable in arriving at the individual’s adjusted gross income. For example, the cost of preparing a fiduciary income tax return is deductible to an estate or trust under section 67(e)(1), whereas the cost of preparing an individual income tax return is a miscellaneous itemized deduction that is currently not deductible under section 67(g). Despite the difference in treatment of tax return preparation expenses incurred by fiduciaries versus individuals, ACTEC believes that, if a cost is deductible against adjusted gross income at the estate or trust level, it should likewise be deductible to an individual beneficiary. Treating the cost as a non-deductible miscellaneous itemized deduction in the hands of an individual beneficiary would, as noted, result in fiduciaries feeling compelled to prolong administration of an estate or a trust, or sell assets, to fully utilize any deductions. To reduce distortion and disparities in treatment, ACTEC believes that the cost should have the same treatment in the hands of the beneficiary as in the hands of the estate or trust.

Allocation of costs to items of income in final year. A second technical computational question is how the items entering into the section 642(h)(2) deduction are determined. In particular, any separation regulations must address how such items of deduction are to be allocated among items of income in the final year of administration. The deductions carried out to beneficiaries under Treasury’s proposal to separate the section 642(h)(2) excess into its components will vary depending on how costs are allocated among items of income in the final year.

Suppose, for example, that in the final year a trust has \$10,000 of taxable interest income, and pays \$10,000 for final accounting expenses and \$10,000 in real estate taxes on property not held for investment. The total excess deduction is \$10,000 (i.e., \$10,000 + \$10,000 - \$10,000). If the trustee can allocate all the

¹⁹ Cf. Section 702(a)(7); Treas. Reg. § 1.702-1(a)(8).

real estate taxes to the interest income, then the beneficiary will have a \$10,000 accounting cost carried out, which Treasury and the IRS might decide should be allowed in computing the beneficiary's AGI, given that it would be allowed in computing the trust's AGI. If instead the trustee allocates, or is forced to allocate, the accounting expense to the interest income, then the beneficiary will have a real estate tax carried out, which might not be deductible in the hands of the beneficiary thanks to the new limitation under section 164(b)(6).

After considering the foregoing issues, ACTEC believes that the rules of Treas. Reg. § 1.652(b)-3, which determine the character of distributable net income that is carried out to beneficiaries under sections 652 and 662, can be used as a model for determining how expenses in a final year should be allocated against income in a final year for purposes of determining the character of the section 642(h)(2) excess deduction.²⁰ That is, the Treasury Department and the IRS should consider adopting the following rules: (1) Costs directly attributable to one class of income are allocated thereto (with any excess subject to the last of the following rules, except if it is attributable to tax-exempt income); (2) A portion of costs not directly attributable to one class of income must be allocated to tax-exempt income pursuant to the rules of section 265; (3) The balance of costs not directly attributable to a specific class of income may be allocated to any item of income in the discretion of the fiduciary.²¹

Allocation of costs among multiple beneficiaries. A final computational issue is how the costs entering into the section 642(h)(2) deduction should be allocated among multiple beneficiaries. Treas. Reg. § 1.642(h)-4 currently provides the section 642(h) excess is allocated among the beneficiaries succeeding to the property of an estate or trust according to the share of each in the burden of the loss or deductions. Thus, for example, if a pecuniary bequest has abated, the legatee of the bequest succeeds to the section 642(h) deductions to the extent of the abatement.

ACTEC believes that the allocation can either be specific to each item comprising the excess or can be on a general basis. For the reasons set forth below, ACTEC believes that an allocation should be among the beneficiaries as a whole.

The current regulation on allocation of the excess deduction assumes that, as provided in Reg. § 1.642(h)-2(a), the section 642(h)(2) excess consists of a single deduction in the hands of the beneficiaries. Once the section 642(h)(2) excess is separated into its components, it would be possible to rewrite Treas. Reg. § 1.642(h)-4 to require at a higher level of specificity in order to support deductibility. That is, the Treasury Department and the IRS could propose a rule that each separate cost entering into the section 642(h)(2) excess is separately allocated among multiple beneficiaries on the basis on which each beneficiary bears the burden of the separate cost. Different costs under this approach would potentially be allocated differently. Examples of such costs are (1) expenses incurred in the production of rental income, which are charged to income under state law, (2) trust termination commissions or fees, which are charged to principal under state law, and (3) fiduciary accounting expenses, which are charged half to principal and half to income. Regulations issued by the Treasury Department and the IRS could provide that, in this circumstance, the rental income expenses must be allocated to the beneficiary entitled to income in the final year, the trust termination commissions or fees must be allocated to the beneficiary entitled to principal, and the accounting expenses must be evenly divided.

ACTEC believes that the foregoing approach would be needlessly cumbersome. Calculating a separate allocation for each cost would increase the reporting burdens of fiduciaries and the administrative burdens

²⁰ Treas. Reg. § 1.652(b)-3 permits the fiduciary to choose how items of deductions are allocated among items of income, other than deductions that are directly attributable to a specific class of income or a portion of deductions that must be allocated to nontaxable income.

²¹ See, e.g., Treas. Reg. § 1.652(c)-4(f) and *Baker v. Commissioner*, 59 T.C.M. (CCH) 10, 15 n. 8 (1990) (amount of each class of income distributable to the beneficiary is computed by allocating deductions included in computing DNI).

on the IRS. Rather than allocating each cost separately, ACTEC suggests that, as under current law, the section 642(h)(2) excess be allocated among multiple beneficiaries as a whole. The items comprising the excess can then be allocated among the beneficiaries in the same proportion as the whole excess. In this fashion, the fiduciary need only make a single allocation among multiple beneficiaries, which dictates how the costs comprising the excess are allocated. While rules that would achieve greater precision are possible, ACTEC in this case believes that it is not worth the added complexity and burden.²²

Suspended deductions. Finally, ACTEC recommends that the Treasury Department and the IRS address the treatment of suspended deductions on the termination of a trust. Suspended deductions include investment interest under section 163(d).²³ The treatment of suspended passive activity losses is already addressed in section 469(j)(12). Other suspended deductions such as section 163(d) investment interest did not exist in 1954 when section 642(h) was enacted and guidance is needed in the case of such deductions. ACTEC recommends that such suspended deductions be treated in the same manner as excess deductions.

²² Subchapter J frequently opts for uniformity over precision. For example, income beneficiaries receive the entire benefit of section 212 deductions, insofar as they reduce distributable net income, despite that the expenses giving rise to the deduction may be allocated, in whole or in part, to principal for fiduciary accounting purposes. Where the after-tax results are inequitable, state law often permits the fiduciary or local probate court to make an equitable adjustment.

²³ Other deductions are described in Abbin and Schafer, Income Taxation of Fiduciaries and Beneficiaries, § 417 (2018).