



October 31, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
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Washington, DC 20224

Mr. William M. Paul
Acting Chief Counsel
Internal Revenue Service
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Ms. Holly Porter
Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
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RE: Notice 2018-61 Concerning a Beneficiary's Ability to Claim Excess Deductions Pursuant to Section 642(h)

Dear Messrs. Kautter, Rettig, and Paul and Ms. Porter:

The American Institute of CPAs (AICPA) respectfully submits comments in response to [Notice 2018-61](#) concerning a beneficiary's ability to claim excess deductions allowed to the beneficiary upon the termination of a trust or estate under section 642(h)(2).¹ Notice 2018-61 also states that the Department of Treasury (Treasury) and the Internal Revenue Service (IRS) will issue regulations to clarify that estates and non-grantor trusts may continue to deduct expenses described at section 67(e)(1). In addition, the Notice states that Treasury and IRS will continue to consider expenses listed in section 67(b)(1)-(12) and section 67(e) as not miscellaneous itemized deductions, and the deduction of those expenses is not affected by new section 67(g). We appreciate your attention to this matter and clarifying it through regulations. The Treasury and IRS explanation of these expenses in Notice 2018-61, prior to the issuance of regulations, is helpful and appreciated.

Our comments below address your request in section 4 of Notice 2018-61 regarding a beneficiary's ability to claim excess deductions pursuant to section 642(h).

Background

Under section 642(h)(2), the beneficiaries succeeding to the property of a terminated trust or estate are allowed a deduction, in accordance with regulations prescribed by the Secretary, for the amount

¹ All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.

The Honorable David J. Kautter
The Honorable Charles P. Rettig
Mr. William M. Paul
Ms. Holly Porter
October 31, 2018
Page 2 of 5

that certain deductions of the trust or estate in its final year exceed the entity's gross income. Treasury Reg. § 1.642(h)-2(a) provides that the excess deductions are allowed to the beneficiary only in computing taxable income.

Prior to 2018, according to the instructions for Form 1041, U.S. Income Tax Return for Estates and Trusts, the beneficiary treated these excess expenses as miscellaneous itemized deductions.

Section 67(g) was added to the Internal Revenue Code (Code) by [Pub. L. No. 115-97](#) (commonly referred to as the Tax Cuts and Jobs Act (TCJA)). Section 67(g) provides that miscellaneous itemized deductions are not deductible for the years 2018 through 2025.

Notice 2018-61 requests comments on the effect of section 67(g) on the ability of the beneficiary to deduct the excess deductions under section 642(h)(2).

Recommendation

The AICPA recommends that Treasury and the IRS issue regulations clarifying that excess deductions are not miscellaneous itemized deductions subject to section 67(g) and are fully deductible by beneficiaries succeeding to the property of a terminated non-grantor trust or estate under the authority of section 642(h)(2). To the extent that section 642(h)(2) excess deductions are attributable to expenses described in section 67(e)(1), Treasury and IRS should provide that these section 67(e)(1) related excess deductions are deductible by the beneficiary in determining the beneficiary's adjusted gross income. The guidance should provide that all other section 642(h)(2) excess deductions are deductible by the beneficiary in determining the beneficiary's taxable income.

In addition, Treasury and IRS should clarify that expenses that are miscellaneous itemized deductions paid during an estate's fiscal tax year starting before January 1, 2018 are deductible by the estate as miscellaneous itemized deductions even though some of those expenses are paid in 2018.

Analysis

Section 642(h)(2) provides special rules for deductions in the last taxable year of an estate or trust. Specifically, on the termination of an estate or trust, the excess of deductions over the gross income for the last taxable year is allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. These deductions do not include the deductions allowed under section 642(b) (relating to the personal exemption) or section 642(c) (relating to charitable contributions).

The excess deduction is allowed in accordance with regulations prescribed by the Secretary. These deductions are referred to in this letter as "excess deductions."

The Honorable David J. Kautter
The Honorable Charles P. Rettig
Mr. William M. Paul
Ms. Holly Porter
October 31, 2018
Page 3 of 5

Treasury Reg. § 1.642(h)-2(a) provides that the excess deductions are allowed as a deduction to the beneficiary succeeding to the property of the estate or trust only in computing taxable income, and the beneficiary must take the excess deductions into account in computing the beneficiary's items of tax preference. The only guidance on how the beneficiary takes these excess deductions into account is found in the instructions for Form 1041. Page 40 of the 2017 Instructions for Form 1041 provides that the beneficiary's share of excess deductions is entered on Form 1041, Schedule K-1 in Box 11 using Code A. Form 1041 Schedule K-1 instructions provide that the beneficiary treats these excess deductions as miscellaneous itemized deductions on the individual's Schedule A, Line 23. No other guidance regarding the treatment of excess deductions exists.

The excess deductions in the final year of the trust or estate may include several types of expenses. Expenses can include interest deductible under section 163, taxes deductible under section 164 (subject to the \$10,000 limitation for tax years 2018 through 2025), costs paid or incurred in connection with the administration of the estate or trust and which the estate or trust would not have incurred if the property were not held in such estate or trust (referred to as "section 67(e)(1) expenses"). In addition, for tax years other than 2018 through 2025, the trust or estate may have miscellaneous itemized deductions defined in section 67(b).

Treasury and IRS have authority to issue the recommend guidance. Section 642(h)(2) provides the authority for the beneficiary to claim a deduction for the excess deductions. Congress authorized the Secretary through regulations to implement the deduction.

An update to the regulations is long overdue. The current regulations state that the excess deductions are allowed as a deduction in computing the beneficiary's taxable income. These regulations date back to 1956 (TD 6217, 12/19/56) and were never updated for statutory changes that have occurred in the intervening 60 years. Specifically, in Pub. L. No. 99-514 (the Tax Reform Act of 1986), Congress placed a limit on the deductibility of miscellaneous itemized deductions, providing that they were deductible only to the extent that they exceeded 2 percent of the taxpayer's adjusted gross income (AGI). Trusts and estates were provided a special rule for a certain category of expenses, the section 67(e)(1) expenses. These 67(e)(1) expenses are not subject to the 2 percent floor on miscellaneous itemized deductions and are deductible in determining the trust or estate's AGI. Thus, these expenses are "above the line" deductions for the trust or estate. Because these expenses are deductible in determining the trust or estate's AGI, Treasury and the IRS should also treat them as deductible in determining the AGI of the beneficiaries who succeed to the property of the terminated trust or estate. The changes made by the TCJA afford the opportunity to update Treas. Reg. § 1.642(h)-2 to implement the changes made by the 1986 Act.

Most of the excess deductions of a terminating trust or estate are section 67(e)(1) expenses. The major expenses included in section 67(e)(1) expenses are fiduciaries' commissions, attorneys' fees, and accountants' fees, to the extent they are not allocable to investment advice or other types of miscellaneous itemized deductions under Treas. Reg. § 1.67-4(c). Many of these expenses are

The Honorable David J. Kautter
The Honorable Charles P. Rettig
Mr. William M. Paul
Ms. Holly Porter
October 31, 2018
Page 4 of 5

paid in the final year of the trust or estate. Payment of these expenses in the final year is particularly true of estates, which in some jurisdictions must receive approval from the probate court before paying executors' commissions and attorneys' and accountants' fees. The approval is not typically received until shortly before the estate terminates. A probate estate is allowed to terminate after all the bills are paid and the court approves the expenses. In that final year, the estate usually does not have enough income to absorb these major expenses, and thus, they become part of the excess deductions that the beneficiaries can deduct. Treasury and the IRS should allow the beneficiaries to deduct these expenses in the same manner that the trust or estate is allowed to deduct them, i.e., as "above the line" deductions in determining AGI.

Treasury and the IRS should treat the remaining section 642(h)(2) excess deductions as a lump sum deductible by the beneficiaries in determining their taxable income. For the years 2018 through 2025, miscellaneous itemized deductions are not deductible by trusts or estates (with the exception of expenses paid by a terminating estate that has a fiscal tax year starting before January 1, 2018). The statute's effective date includes an exception, providing that expenses paid by a fiscal year estate for the year beginning before January 1, 2018 are deductible. The remaining section 642(h)(2) excess deductions during those years will generally not include any expenses that are miscellaneous itemized deductions. The TCJA limitations imposed on the interest and tax deductions are applied at the estate or trust level (with the exception of no TCJA limits on taxes paid by a terminating estate that has a fiscal year starting before January 1, 2018). As a result, there is no need to separate the excess deductions into their component parts for testing again at the beneficiary level.

The intent of section 642(h)(2) is to allow the beneficiaries to deduct the excess deductions that the trust or estate cannot use in its final year. Nothing in the TCJA changed that provision. Congress authorized the Secretary to implement this deduction through regulations. Our recommendation implements the deduction allowed to the beneficiaries by section 642(h)(2), and to the extent of the section 67(e)(1) expenses, our recommendation is consistent with the special treatment afforded these expenses since 1986.

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The AICPA is the world's largest member association representing the CPA profession, with more than 431,000 members in 137 countries and territories, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments. If you would like to discuss these issues further, please contact Peggy Ugent, Chair, AICPA Trust, Estate, and Gift Technical Resource Panel, at (512) 983-8285 or peggyugent@gsrjlaw.com; Eileen Sherr, Senior Manager – AICPA

The Honorable David J. Kautter
The Honorable Charles P. Rettig
Mr. William M. Paul
Ms. Holly Porter
October 31, 2018
Page 5 of 5

Tax Policy & Advocacy, at (202) 434-9256 or Eileen.Sherr@aicpa-cima.com; or me at (408) 924-3508 or Annette.Nellen@sjsu.edu.

Sincerely,

A handwritten signature in black ink, appearing to read "Annette Nellen". The signature is fluid and cursive, with the first name "Annette" written in a larger, more prominent script than the last name "Nellen".

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Ms. Catherine Veihmeyer Hughes, Attorney-Advisor, Department of the Treasury
Mr. Bradford R. Poston, Special Counsel to the Associate Chief Counsel, Office of the Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Ms. Adrienne M. Mikolashek, Branch Chief, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Ms. Meghan M. Howard, Attorney, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service