



June 16, 2020

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

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Holly Porter
Associate Chief Counsel
Passthrough & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

RE: Comments on Proposed Regulations ([REG-113295-18](#)) Regarding a Beneficiary's Ability to Claim Excess Deductions Pursuant to Section 642(h)

Dear Messrs. Kautter and Desmond, and Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) in issuing proposed regulations ([REG-113295-18](#), published May 11, 2020) to provide guidance related to Internal Revenue Code ("Code") sections 67(e), 67(g), and 642(h)(2)¹ as a result of changes to miscellaneous itemized deductions enacted under [Pub. L. No. 115-97](#), commonly referred to as the Tax Cuts and Jobs Act (TCJA) and the beneficiaries' treatment of excess deductions of trusts and estates. Our comments address the provisions concerning excess deductions of a terminating trust or estate and supplement our previously submitted comments on this issue in response to [Notice 2018-61](#).²

We appreciate that Treasury and the IRS adopted our suggestion to update the regulations to take into account the statutory changes made during the more than 60 years since the regulations under section 642(h) were issued. We also appreciate that the proposed regulations adopt our suggestion that allows the beneficiary to treat the portion of the excess deductions attributable to expenses described in section 67(e) as a deduction when computing the beneficiary's adjusted gross income.

¹ Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.

² AICPA Comment Letter "Notice 2018-61 Concerning a Beneficiary's Ability to Claim Excess Deductions," submitted [October 31, 2018](#).

Background

The proposed regulations clarify that deductions described in section 67(e) are not miscellaneous itemized deductions and therefore remain deductible in determining the adjusted gross income of an estate or non-grantor trust during the taxable years in which the deduction for miscellaneous itemized deductions is suspended under section 67(g). The proposed regulations also provide guidance on 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).

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

Prop. Reg. § 1.642(h)-2(b)(1) provides that each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary succeeding to the property of an estate or trust, its character while in the estate or trust. Specifically, each deduction falls into one of three categories: allowable in arriving at adjusted gross income, a non-miscellaneous itemized deduction, or a miscellaneous itemized deduction. (Expenses categorized as miscellaneous itemized deductions under section 67(g) are not deductible and do not separately pass out to beneficiaries for 2018-2025.) The proposed regulations also provide that an item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code and the trustee must separately state the deduction if a limitation may apply to it.

Recommendations

We suggest that:

1. By retaining their character in the hands of the beneficiary, the excess deductions are deductible in determining the beneficiary's net investment income.
2. The category of expenses described as non-miscellaneous itemized deductions are fully deductible by the beneficiary and not subject to a second level of limitation because they already passed any limitations at the estate or trust level.
3. Treasury and IRS correct Example 2 in Prop. Reg. § 1.642(h)-5(b) to take into account that the real estate taxes on rental property are part of a business activity that generally generates a passive activity loss rather than passing through to the beneficiary as taxes.
4. The Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., provide separate lines for each type of excess deduction and guidance on where the beneficiary should report the items on the beneficiary's Form 1040, U.S. Individual Income Tax Return.

Analysis

The proposed regulations provide that the excess deductions retain the character they had at the trust or estate level when they are passed through to the beneficiary. By retaining their character in the hands of the beneficiary, some excess deductions are deductible in computing the beneficiary's adjusted gross income, and some excess deductions are deductible in computing the beneficiary's taxable income. All these expenses, however, are deductible in determining the net investment income of a trust or estate. Thus, these expenses should remain deductible in the hands of the beneficiary in determining the beneficiary's net investment income. We suggest that the final regulations clarify this point.

As stated in our prior comments, we continue to believe that there is no need to break down the non-miscellaneous itemized deductions into their component parts and to subject them to further limitations at the beneficiary's level. The limitation imposed by the TCJA on the deductibility of state and local taxes and the interest limitation were already applied at the estate or trust level in computing the amount of the excess deductions. As a result, it is unnecessary to separate the excess deductions into their component parts for testing again at the beneficiary level. For example, if a terminating trust has \$25,000 of state income tax, the deduction is limited to \$10,000. If the \$10,000 deduction for state income tax is part of the excess deductions passed through to the beneficiary, Treasury and the IRS should allow the beneficiary to deduct the entire amount because the limitation of section 164(b)(6)(B) was already applied at the trust level.

Example 2 includes a rental real estate activity with rental income of \$2,000 and real estate taxes on the rental property of \$3,500 in the year the estate terminates. The example treats the real estate taxes as a separate deductible non-miscellaneous item apart from the real estate rental business. The real estate taxes are an expense of the real estate rental business and are deductible in determining the loss from the business for the year.

The \$1,500 loss from the business is likely a passive loss subject to the passive activity loss rules of section 469. If the rental real estate is distributed to a beneficiary upon the termination of the estate, the passive activity loss of \$1,500 for the year plus any other passive activity losses for that property are added to the basis of the property under section 469(j)(12)(A).

If the final year of the estate ends less than two years after the decedent's death and the decedent actively participated in rental real estate activities prior to death, the loss is not a passive activity loss under section 469(i)(4). Similarly, if the rental real estate is sold by the estate prior to its termination, then the loss from the rental real estate is a loss that is not from a passive activity under section 469(g)(1)(A). As a result, the \$1,500 net operating loss carryover is passed through to the beneficiary under section 642(h)(1) and is reported as a loss on the beneficiary's Form 1040, Schedule E. We recommend revisions to the example to incorporate these possible outcomes.

If the goal of Example 2 is to illustrate state and local taxes passing through to the beneficiary, then the example should include state income taxes rather than real estate taxes on rental real estate. To provide clarity for taxpayers and practitioners, we suggest Schedule K-1 (Form 1041), Part III, Line 11 provide a separate code for each of the three categories of excess deductions and page 2

contain instructions as to where each category of excess deductions is reported on the beneficiary's Form 1040.

The AICPA is the world's largest member association representing the accounting profession with more than 429,000 members in the United States and worldwide, 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 and welcome the opportunity to discuss these issues further. If you have any questions, please contact Eileen Sherr, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9256 or Eileen.Sherr@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,

A handwritten signature in blue ink that reads "Christopher W. Hesse". The signature is fluid and cursive, with a stylized flourish at the end.

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles Rettig, Commissioner, Internal Revenue Service
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Ms. Catherine Veihmeyer Hughes, Estate and Gift Tax Attorney Adviser, Office of Tax Legislative Counsel, Office of Tax Policy, 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
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