

New IRC Section 67(g) and Form 1041 Trust Deduction Rules Post-Tax Reform

WEDNESDAY, AUGUST 8, 2018, 1:00-2:50 pm Eastern

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New Section 67(g) – Form 1041 Trust Deduction Rules Post TCJA of 2017

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Agenda

- History and background of administration fees
- Final Section 67(e) regulations
- Changes made by the TCJA of 2017 – Section 67(g) and disallowance of “miscellaneous itemized deductions” for years 2018 to 2025
- Analysis of Section 62, 63 and 67 to determine what are “miscellaneous itemized deductions”
- What’s deductible in years 2018-2025
- What’s not deductible in years 2018-2025
- What you may not have thought of

Introduction

- New Section 67(g) disallows “miscellaneous itemized deductions” for years 2018-2025
- This affects estates and trusts as well as individuals
- We must determine what estate and trust expenses are “miscellaneous itemized deductions”
- To do so, we must review Sections 62, 63 and 67 of the Internal Revenue Code
- In addition, we must be familiar with the final Section 67(e) regulations
- The results may be surprising

Administration Expenses on 1041 – Subject to 2% Floor?

- Administration expenses subject to the 2% floor if they “commonly or customarily would be incurred by a hypothetical individual holding the same property”
- Investment advisory fees appear to be what the IRS is concerned about

Misc. Itemized Deduction – 2% Floor

- ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?
 - O’Neill – Sixth Circuit – NO
 - Mellon – Federal Circuit – YES
 - Scott – Fourth Circuit – YES
 - Rudkin – Second Circuit – YES
 - Appealed to United States Supreme Court as Knight

Misc. Itemized Deduction – 2% Floor

- KNIGHT v. COMMISSIONER 127 S. CT. 782 (2008)
 - §67(e) excepts from the 2% floor only those costs that it would be uncommon (or unusual or unlikely) for an individual to incur.
 - Specifically disavows the “could not have been incurred by an individual” language of the Second Circuit in Rudkin and the IRS proposed regulations

Misc. Itemized Deduction – 2% Floor

- ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?
 - May 9, 2014 – IRS issues final regulations under §67 providing guidance on which costs by estates and nongrantor trusts are subject to the 2% floor
 - Administration expenses subject to the 2% floor if they “commonly or customarily would be incurred by a hypothetical individual holding the same property”
 - Costs subject to 2% floor determined by type of services provided rather than on taxpayer’s characterization or labels of services
 - Final Regs would not allow taxpayers to circumvent 2% floor by bundling investment advisory fees and trustee fees together
 - If bundled, taxpayer must use a reasonable method to allocate a single fee between the two types of costs
 - Final Regs provides a nonexclusive list of services that are exempt or nonexempt from the 2% floor

Misc. Itemized Deduction – 2% Floor

- ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?
 - Five categories of expenses:
 - Ownership costs
 - Tax preparation fees
 - Appraisal fees
 - Certain fiduciary expenses
 - Investment advisory fees

Misc. Itemized Deduction – 2% Floor

- ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?
 - Services NOT commonly incurred by individuals i.e. not subject to 2% floor under Final Regs.:
 - Fiduciary accountings
 - Judicial or quasi-judicial filings as part of estate or trust administration
 - Fiduciary income tax, estate, GST tax returns and decedent's final income tax return
 - Division or distribution of income or corpus to or among beneficiaries
 - Trust or will contest or construction
 - Fiduciary bond premiums
 - Communications with beneficiaries regarding estate or trust matters
 - Appraisal fees incurred to determine value of assets for estate tax or distribution purposes

Misc. Itemized Deduction – 2% Floor

- ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?
 - Services commonly incurred by individual i.e. subject to 2% floor under Final Regs.:
 - Custody or management of property
 - Advice on investing for total return
 - Gift tax returns
 - Defense of claims by creditors of the decedent or grantor
 - Purchase, sale, maintenance, repair, insurance or management of nontrade or business property

Misc. Itemized Deduction – 2% Floor

- Expenses commonly or customarily incurred by hypothetical individual include:
 - Cost incurred in defense of claim against the estate, the decedent, or non-grantor trust that is unrelated to the existence, validity or administration of the estate or trust
 - “Ownership costs” associated with a particular assets such as a condo fee, insurance premiums, maintenance and lawn services, automobile registration and insurance costs
 - Cost of individual and gift tax returns, tax return for a sole proprietorship or a retirement plan
 - Fees for investment advice
 - Exception: “Special” investment advice attributable to an unusual investment objective or need is not subject to the 2% floor.
 - Incorporates language from the Knight decision.

Misc. Itemized Deduction – 2% Floor

- Final regs retain requirement for bundled fees to be unbundled i.e. separate those subject to the 2% floor from those not subject to the 2% floor
 - Use any reasonable method
 - Fee not computed hourly, such as trustee's fees, need only be unbundled for the portion related to investment advice
 - Query: what about investments in mutual funds (where the fee is deducted inside the fund before the distribution to the shareholder) or a commission based broker (where the commission is netted against the income)

- Regs apply to taxable years beginning on or after the date the regs are finalized i.e. for tax year 2015

Misc. Itemized Deduction – 2% Floor

Why Do We Care?

Facts: \$100,000 income, \$100,000 expenses subject to 2% floor

		Regular Tax	AMT
Income		100,000	100,000
Misc. Deductions	100,000		
2% of AGI	<u>(2,000)</u>	<u>(98,000)</u>	<u>(0)</u>
Net Income		2,000	100,000
Exemption		<u>(100)</u>	<u>(18,662)*</u>
Taxable Income		1,900	81,338
Tax		285	21,148**

*23,800 AMT exemption reduced to 18,662 due to phase out of AMTI over 79,450.

** 26% AMT tax rate

Misc. Itemized Deduction – 2% Floor

Why Do We Care?

- Significance:
 - 2% floor rule has minimal impact on regular tax BUT there can be substantial AMT consequences
 - If trust distributions exceed trust's taxable income, the miscellaneous deductions subject to the 2% floor will be an adjustment that must be added back in computing the beneficiary's AMT.
 - If distributions are less than regular tax DNI, the AMT tax preferences stay with the trust.
 - If distributions are more than regular tax DNI, some AMT tax preferences carry out to the beneficiary
 - Planning point: distribute more than regular tax DNI but less than AMTI – this will split the tax preferences between the trust and the beneficiaries – each taxpayer has its own AMT exemption.

Changes Made to Trusts and Estates by TCJA of 2017

- Goal: find how TCJA of 2017 affects the income taxation of estates and trusts.
- Generally, new Section 67(g) disallows miscellaneous itemized deductions for taxable years beginning after December 31, 2017 and before January 1, 2026.
- We have to figure out what those deductions are that are disallowed for years 2018 to 2025.
- This involves an analysis of Sections 62, 63 and 67 of the Internal Revenue Code.

Section 67(g) – Suspension for Taxable Years 2018 Through 2025

(g) Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

Section 641(b) - Calculation of trust taxable income

(b) Computation and Payment. The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.

Section 641(b) - Translated

- The same rules that apply to individuals in computing taxable income also apply to computing the taxable income of an estate or trust unless stated otherwise.

Calculation of trust taxable income

Gross income
Less: Adjustments to gross income i.e., above the line deductions
 Less: Section 67(e) deductions unique to a trust
Less: Miscellaneous itemized deductions subject to 2% floor
 Less: Income distribution deduction
 Less: Exemption
Taxable income

Types of deductions available to trusts

- Adjustments to gross income
 - Section 67(e) deductions unique to an estate or trust

- Itemized deductions
 - Section 67(b) deductions - not miscellaneous deductions

 - Miscellaneous deductions subject to 2% floor
 - Section 67(g) suspends these deductions for the years 2018 to 2025

Section 62 – Adjusted Gross Income

- Section 62 defines adjusted gross income of an individual as gross income less a laundry list of deductions, including, among others:
 - Section 162 trade or business expenses;
 - Capital losses and Section 1231 losses;
 - Deductions related to rental and royalty income held for the production of income, allowed by section 161-199A, section 212, and section 611
- These are so-called “above the line” deductions and are not miscellaneous itemized deductions.

Section 63(d) – Itemized Deductions

(d) Itemized Deductions. For purposes of this subtitle, the term “itemized deductions” means the deductions allowable under this chapter **other than –**

- (1) the deductions allowable in arriving at adjusted gross income,
- (2) The deduction for personal exemptions provided by section 151, and
- (3) The deduction provided in section 199A.

Section 63(d) – Translated

- Section 67(d) says that deductions allowable in determining adjusted gross income (so-called “above the line” deductions) are excluded from the definition of itemized deductions.

- Thus, the following deductions are not subject to Section 67(g) suspension for years 2018-2025:
 - Section 162 trade or business expenses;

 - Capital losses and Section 1231 losses;

 - Deductions related to rental and royalty income held for the production of income, allowed by section 161-199A, section 212, and section 611

 - The Section 199A deduction

Section 67(a) – General Rule

(a) General Rule – In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

Section 67(a) – Translated

- Miscellaneous itemized deductions are allowable only to the extent they exceeds 2% of the estate or trust's adjusted gross income.

Section 67(b) – Definition of miscellaneous itemized deductions

- (b) Miscellaneous Itemized Deductions – For purposes of this section, the term “miscellaneous itemized deductions” means the itemized deductions **other than** –
- (1) **the deduction under section 163 (relating to interest),**
 - (2) **the deduction under section 164 (relating to taxes),**
 - (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
 - (4) **the deductions under** section 170 (relating to charitable, etc., contributions and gifts) and **section 642(c) relating to amounts paid or permanently set aside for a charitable purpose),**
 - (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
 - (6) any deduction allowable for impairment-related work expenses,

Section 67(b) – Definition of miscellaneous itemized deductions

(b) Miscellaneous Itemized Deductions – For purposes of this section, the term “miscellaneous deductions” means the itemized deductions **other than** –

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale.

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under a claim of right),

(10) the deduction under section 73(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium),

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

Section 67(b) - Translated

- Only itemized deductions not included in the above list are potentially subject to the Section 67(a) limitation i.e., limited to the amount in excess of 2% of the estate or trust's adjusted gross income

- This excludes the items above highlighted in blue:
 - Interest

 - Taxes – although otherwise limited to \$10,000 under TCJA of 2017 for years 2018 to 2025

 - Section 691(c) deduction – income tax deduction for estate tax attributable to IRD

 - Charitable deduction under Section 642(c)

Section 67(e) – Determination of Adjusted Gross Income in Case of Estates and Trusts

(e) Determination of Adjusted Gross Income in Case of Estates and Trusts. For purposes of this section the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, **except that-**

(1) the deduction 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 such trust or estate, and

(2) the deductions allowable under sections 642(b), 651, and 661,

shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

Section 67(e) - Translated

- Section 67(e) allows the section 651 and 661 income distribution deduction and the section 642(b) personal exemption in computing the adjusted gross income of an estate or trust.
 - Thus, the Section 67(a) limitation does not apply to income distribution deduction or the personal exemption.
 - Section 67(a) limitation also does not apply to expenses that individuals do not normally incur i.e., expense “unique” to an estate or trust
 - Section 67(a) limitation applies if the cost “is included in the definition of miscellaneous itemized deductions under section 67(b) . . . and commonly or customarily would be incurred by a hypothetical individual holding the same property.” Reg. 1.67-4(a).

What's Deductible – 2018 - 2025

- Deductible as adjustments to gross income per Section 62:
 - Section 162 trade or business expenses;
 - Capital losses and Section 1231 losses;
 - Deductions related to rental and royalty income held for the production of income, allowed by section 161-199A, section 212, and section 611
 - Note: Section 212(1) expenses related to the production or collection of income and Section 212(3) expenses related to the determination, collection, or refund of a tax (unless connected with an estate tax, generation skipping tax or fiduciary tax i.e., expenses “unique” to a trust or estate) are subject to Section 67(g) as a miscellaneous itemized deduction
- These are so-called “above the line” deductions and are not miscellaneous itemized deductions.

What's Deductible – 2018 - 2025

- Deductible as adjustments to gross income per Section 62:
 - Section 642(h)(1) net operating losses and capital loss carryovers in the year of termination of an estate or trust.
 - NOLs are carried forward only and capped at 90% of taxable income under 2022, then capped at 80% of taxable income
 - Both items are adjustments to gross income under Section 62 and therefore are not miscellaneous itemized deductions

What's Deductible – 2018 - 2025

- Deductions not commonly incurred by individuals:
 - Costs associated with estate tax returns, generation skipping tax returns, fiduciary income tax returns, the decedent's final income tax return but not costs associated with gift tax returns;
 - Fiduciary fees not associated with investment advice (unless for extraordinary services);
 - Appraisal fees incurred to prepare and administer an estate or trust
 - Probate fees, fiduciary bond premiums, legal notices, fiduciary accountings
 - Personal exemption of estate or trust - \$100, \$300, \$600, depending on status of entity
 - Income distribution deduction allowed under Sections 651 and 661

What's Deductible – 2018 - 2025

- Items excluded from the definition of miscellaneous itemized deductions:
 - Interest
 - Taxes – limited by TCJA to \$10,000 for years 2018 to 2025
 - Section 642(c) fiduciary income tax charitable deduction
 - Section 691(c) income tax deduction for federal estate tax attributable to income in respect of a decedent

What's Deductible – 2018 - 2025

- Items excluded from the definition of miscellaneous itemized deductions:
 - Interest
 - Taxes – limited by TCJA to \$10,000 for years 2018 to 2025
 - Section 642(c) fiduciary income tax charitable deduction
 - Section 691(c) deduction for federal estate tax attributable to income in respect of a decedent

What's Not Deductible – 2018 - 2025

- Items that constitute miscellaneous itemized deductions:
 - ❑ Investment advisory fees (except for extraordinary expenses);
 - ❑ Appraisal fees incurred other than in the taxation or administration of an estate or trust;
 - ❑ Property ownership costs not deductible as a trade or business expense;
 - ❑ Section 212(1) expenses related to the production or collection of income and Section 212(3) expenses related to the determination, collection, or refund of a tax (unless connected with an estate tax, generation skipping tax or fiduciary tax i.e., expenses “unique” to a trust or estate);
 - ❑ Miscellaneous itemized deductions from partnerships and S corporations

What's Not Deductible – 2018 - 2025

- Items that constitute miscellaneous itemized deductions:
 - Section 642(h)(1) excess deductions of an estate or trust
 - The regulations treat excess deductions as miscellaneous itemized deductions to the individuals entitled to that item.
 - Thus, Section 67(g) would not allow an individual to deduct the excess deductions for those excess deductions reported in the years 2018 to 2025.

Surprising Results – 2018 - 2025

- Alternative minimum tax
 - Miscellaneous itemized deductions will not be an adjustment for AMT purposes from 2018 to 2025 for an estate or trust.

Surprising Results – 2018 - 2025

- A simple trust may have taxable income as a result of Section 67(e)
- This will occur if the trust has deductible expenses, allocable to trust accounting income and nondeductible expenses, also allocable to trust accounting income.
- The DNI of the trust will be greater than the trust accounting income.
- The income distribution deduction for the trust will be limited to the lower trust accounting income, leaving undistributed DNI in the trust.
- The undistributed DNI will be accumulated in the trust and taxed to the simple trust.

Surprising Results – 2018 - 2025

- ❑ **Example:**
- ❑ Trust is a simple trust, required to pay its trust accounting income to John.
- ❑ In 2018 the trust has ordinary income from interest and dividends in the amount of \$50,000.
- ❑ The trust paid expenses for probate fees, a judicial accounting and preparation of the fiduciary income tax return in the amount of \$10,000, all allocable to trust accounting income. These expenses are fully deductible as they are not miscellaneous itemized deductions.
- ❑ The trust also paid expenses in the amount of \$20,000, allocable to trust accounting income, to maintain a house owned by the trust. None of the \$20,000 expenses are deductible as they constitute ownership costs and are miscellaneous deductions, not deductible under Section 67(g).

Surprising Results – 2018 - 2025

- ❑ **Example:**
- ❑ The DNI of the trust is \$40,000 (\$50,000 income less \$10,000 allowable deductions).
- ❑ The trust accounting income is \$20,000 (\$50,000 income less \$10,000 deductible expenses less \$20,000 nondeductible expenses).
- ❑ John receives trust accounting income of \$20,000.
- ❑ The distribution deduction to the trust is \$20,000, the lesser of trust accounting income (\$20,000) or DNI (\$40,000).
- ❑ The trust is taxed on \$19,700 (\$50,000 income less \$10,000 deductible expenses less \$20,000 distribution deduction less \$300 exemption).

Conclusion

- New Section 67(g) disallows miscellaneous itemized deductions for years 2018-2025
- This affects estates and trusts
- We must determine what estate and trust expenses are “miscellaneous itemized deductions”
- To do so, we must review Sections 62, 63 and 67 of the Internal Revenue Code
- In addition, we must be familiar with the final Section 67(e) regulations
- The results may be surprising

Thank You!