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June 22, 2020

Ms. Margaret Burow
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CC:PA:LPD:PR (REG-113295-18), Room 5203
Internal Revenue Service
P.O. Box 7604 Ben Franklin Station
Washington, DC 20044

Submitted electronically at www.regulations.gov

Re: Treasury Notice 85 Fed. Reg. 27693 (5/11/20): Comments on Proposed Regulations on Income Tax Regulations (26 CFR part 1) under sections 67 and 642 of the Internal Revenue Code

Dear Ms. Burow,

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit the enclosed comments pursuant to Treasury Notice 85 Fed. Reg. 27693, published in the Federal Register on May 11, 2020. ACTEC commends Treasury and the IRS for their efforts in drafting such a well-organized package of proposed regulations, and we appreciate the opportunity to comment on the proposed regulations. ACTEC's comments focus primarily on the application of the proposed regulations to trusts and estates.

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.

If you or your staff would like to discuss the comments, please contact Gregory Gadarian who led the task force that put together the comments, at (520) 529-2242 or greg@gadarianlaw.com, Don Kozusko, Chair of the ACTEC Washington Affairs Committee, at (202) 457-7211 or dkozusko@kozlaw.com, or Deborah McKinnon, ACTEC Executive Director, at (202) 684-8460 or domckinnon@actec.org.

Respectfully submitted,

Stephen R. Akers, President

Attachments

Comments of The American College of Trust and Estate Counsel ("ACTEC") on Proposed Regulations under Sections 67(g) and 642(h)

Treasury Notice 85 Fed. Reg. 27693 (05/11/20) requested comments on proposed regulations issued under sections 67(g) and 642(h) of the Internal Revenue Code.[1] The American College of Trust and Estate Counsel (ACTEC) is pleased to submit these comments on the proposed regulations.

The proposed regulations clarify the effect of section 67(g) on the deductibility of expenses described in sections 67(b) and (e) and § 1.67-4 that are incurred by estates and non-grantor trusts.[2] The proposed regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income that are carried out to the beneficiaries on the termination of an estate or non-grantor trust under section 642(h).

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]

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

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[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 refer to non-grantor trusts.

[3] *See*, *e.g.*, § 1.67-1T. The phrase "above-the-line" refers to a line that used to exist on the Form 1040 U.S. Income Individual Income Tax Return. Below what used to be that line, individual income tax filers have a choice of claiming either itemized deductions or the standard deduction; and above what used to be that line, all individual income tax filers compute their adjusted gross income. The standard deduction available to estates and trusts is zero; thus, there has never been a comparable line on the Form 1041 U.S. Income Tax Return for Estates and Trusts. Section 63(c)(6).

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 itemized deductions on the return of the beneficiary.

Treasury Reg. § 1.642(h)-2(a) addresses excess deductions other than net operating loss and capital loss carryovers. This regulation currently 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 regulation further provides that the deduction is allowed only in computing taxable income and must be taken into account in computing a beneficiary's items of tax preference. In addition, § 1.642(h)-2(a) provides that the section 642(h)(2) excess deduction "is not allowed in computing adjusted gross income." Consequently, under section 67(b), which was enacted after § 1.642(h)-2(a) was issued, the section 642(h)(2) excess deduction was classified as a miscellaneous itemized deduction. Thus, the regulation effectively caused the excess deductions to become nondeductible under section 67(g).

PROPOSED REGULATIONS

Proposed § 1.67–4 Costs paid or incurred by estates or non-grantor trusts.

The proposed regulations amend § 1.67–4 to confirm that section 67(g) does not deny an estate or non-grantor trust (including the S portion of an electing small business trust)[4] a deduction for expenses described in section 67(e)(1) and (2) because such deductions are allowable in arriving at adjusted gross income and are not miscellaneous itemized deductions under section 67(b).[5] ACTEC agrees with this change.

Proposed § 1.642(h)–5(b), Example 2. Computations under section 642(h)(2).

The proposed regulations add two new examples under § 1.642(h)–5(b). ACTEC believes that these examples are very helpful, but there are a few potential issues with Example 2, as proposed, which could be resolved with some minor modifications. First, Example 2 assumes that the real estate taxes on rental property in excess of rental income are deductible. Whether such excess real estate taxes are deductible, however, depends on the facts. In particular, section 469 would disallow a deduction for any amount in

[4] Treasury Reg. § 1.641(c)-1(j) provides that, when an electing small business trust ("ESBT") terminates, if the S portion has a net operating loss under section 172, a capital loss carryover under section 1212, or deductions in excess of gross income, then any such loss, carryover, or excess deductions are allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates. Now that section 641(c)(2)(E) provides that ESBT charitable contributions are deductible under section 170 instead of section 642(c), they appear to be included as an excess deduction, unlike all other trust charitable deductions. When section 641(c)(2)(E) was adopted, neither the legislative history nor the explanation of the staff of the Joint Committee on Taxation addresses whether this result was intended.

[5] ACTEC notes that, although discussion of the alternative minimum tax is outside the scope of these proposed regulations, a natural consequence of proposed § 1.67-4(a)(1)(ii) is to also allow such deductions for purposes of the alternative minimum tax.

excess of rental income unless the decedent (or perhaps the executor) actively participated in the real estate activity in the year of death or if the executor did so after death, neither of which is addressed in the fact scenario.[6]

Next, Example 2 characterizes the real estate taxes on rental property at issue as itemized deductions. However, real estate taxes that are attributable to property held for rent are not itemized deductions, but are allowed in computing adjusted gross income. Section 62(a)(4) provides that "ordinary and necessary expenses paid or incurred during the taxable year…for the management, conservation, or maintenance of property held for the production of income" under section 212(2) that "are attributable to property held for the production of rents" are deductible as above-the-line deductions in arriving at adjusted gross income, not as below-the-line itemized deductions.

Finally, Example 2 does not address how the executor may exercise discretion to allocate excess deductions among items of trust income.

Accordingly, ACTEC recommends that Treasury consider revising Example 2 in the final regulations to address the aforementioned issues. The following proposal for a revised Example 2 does the following: (1) reduces the amount of real estate taxes on rental property deductible under section 62(a) to $2,000; (2) adds a new itemized deduction of $1,500 for real estate taxes on decedent's personal residence; and (3) allocates the real estate taxes on decedent's personal residence to fully offset items of income in the exercise of the executor's discretion pursuant to § 1.652(b)–3(b) and (d).[7] The proposed changes are indicated by underlined additions and bracketed deletions.

> (b) *Example 2. Computations under section 642(h)(2)*—(1) *Facts*. D dies in 2019 leaving an estate of which the residuary legatees are E (75%) and F (25%). The estate's income and deductions in its final year are as follows:

TABLE 4 TO PARAGRAPH (b)(1)

Income		
Dividends	$3,000	
Taxable Interest	500	
Rents	2,000	
Capital Gain	1,000	
Total Income		6,500

TABLE 5 TO PARAGRAPH (b)(1)

Deductions		
Section 67(e) deductions:		
Probate fees		1,500

[6] If the facts in Example 2 are unchanged so that the estate retains a net loss from rental real estate, then additional facts and analysis would be necessary to address (1) whether the loss is deductible under section 469(c)(7) or (i)(4), and (2) the effect, if any, of *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014), on whether the executor qualifies as a real estate professional and the estate may benefit from the active participation rule based on the executor's work.

[7] The proposed revisions to Example 2 follow the format for calculating distributable net income provided in § 1.652(c)-4(f). See also *Baker v. Commissioner*, 59 T.C.M. 10 (1990), footnote 8.

Estate tax preparation fees	8,000	
Legal fees	4,500	
Total Section 67(e) deductions	14,000	
Section 62(a) [~~Itemized~~] deductions:		
Real estate taxes on rental property	2,000 [~~3,500~~]	
Itemized deductions:		
Real estate taxes on Decedent's personal residence	1,500	
Total deductions		17,500

(2) *Determination of character*. Pursuant to § 1.642(h)–2(b)(2), the character and amount of the excess deductions is determined by allocating the deductions among the estate's items of income as provided under § 1.652(b)–3. Under § 1.652(b)–3(a), $2,000 of real estate taxes on rental property is allocated to the $2,000 of rental income. In the exercise of the executor's discretion pursuant to § 1.652(b)–3(b) and (d), D's executor allocates $1,500 of itemized deductions to $1,500 of income and $3,000 [~~$4,500~~] of section 67(e) deductions to the remaining $3,000 [~~$4,500~~] of income. As a result, the excess deductions on termination of the estate are $11,000, consisting of $11,000 [~~$9,500~~] of section 67(e) deductions and $0 [~~$1,500~~] of itemized deductions.

(3) *Allocations among beneficiaries*. Pursuant to § 1.642(h)–4, the excess deductions are allocated in accordance with E's (75 percent) and F's (25 percent) interests in the residuary estate. E's share of the excess deductions is $8,250, consisting of $8,250 [~~$7,125~~] of section 67(e) deductions and $0 [~~$1,125~~] of real estate taxes. F's share of the excess deductions is $2,750, consisting of $2,750 [~~$2,375~~] of section 67(e) deductions and $0 [~~$375~~] of real estate taxes.

(4) *Alternative allocation of expenses*. [~~The~~]If the executor had not allocated the real estate taxes on decedent's personal residence to the income of the trust in the exercise of the executor's discretion pursuant to § 1.652(b)–3(b) and (d), then the real estate taxes on decedent's personal residence [~~rental property must~~] would be required to be separately stated as itemized deductions, as provided in § 1.642(h)–2(b)(1).