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.

Jul. 13, 2020

The Department of the Treasury and the Internal Revenue Service (IRS) issued proposed regulations to provide guidance resulting from changes to miscellaneous itemized deductions enacted under the Tax Cuts and Jobs Act (TCJA) and the beneficiaries' treatment of excess deductions of trust and estates. In response, the American Institute of CPAs (AICPA) released comments addressing the provisions concerning excess deductions of a terminating trust or estate and supplementing previously submitted comments on the issue.

Section 642(h)(2) provides special rules for deductions in the last taxable year of an

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 provide a correction 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 individual income tax return.

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. The AICPA recommends the final regulations clarify this point.

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