Which Expenses are Still "Miscellaneous Itemized Deductions" on the Fiduciary Income Tax Return?: Revisiting Internal Revenue Code Sect. 67(g)

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One of the most important aspects in any estate or trust administration is income tax. Thus, it is imperative to understand which expenses are deductible. But, unlike individuals, income taxation deductions for estates and non-grantor trusts are considerably different and it is imperative to understand the nuances if you are hoping to minimize tax liability. Consequently, the IRS's most recent release of final regulations on September 21, 2020 concerning Miscellaneous Itemized Deductions stresses the importance of revisiting which expenses are still deductible post Section 67(g).

Before diving into the unique rules for deductions allotted to estates and non-grantor trusts, it is critical to first be aware of the compressed income tax brackets that make income inside estates and non-grantor trusts unattractive. Unlike individual income tax brackets where significant income is required to reach the top brackets, it only takes $12,950.00[1] to reach the top tax bracket for an estate or non-grantor trust.[2] Accordingly, ever since the compressed tax brackets came into being, practitioners have been seeking ways to "push" income to the beneficiaries and/or maximize available deductions. Nevertheless, in order to maximize available deductions–and therefore minimize income being taxed at higher rates–it is key to understand the types of deductions estates and non-grantor trusts are allowed.

While there are similar deductions allotted to estates and non-grantor trusts as there are for individuals[3], there are very important differences to note. First, estates and non-grantor trusts are not permitted to utilize the Standard Deduction.[4] Instead, estates and non-grantor trusts must itemize their deductions. One important section of the Code in itemizing expenses is commonly seen as the "catch-all" deduction–"Miscellaneous Itemized Deductions." Section 67(b) defines Miscellaneous Itemized Deductions as itemized deductions *other than* those listed in Section 67(b)(1) through (12). It is a catch-all, which is why the Service seeks to limit its use. One way it has done this is with Section 67(a), which limits Miscellaneous Itemized Deductions to the extent the aggregate exceeds 2% of adjusted gross income. Section 67(a) is commonly referred to as the "2% Floor" or the "2% Floor on Miscellaneous Itemized Deductions." This so-called 2% Floor, however, does not always necessarily apply to expenses incurred as part of the administration of an estate or non-grantor trust. Such expenses are instead subject to Section 67(e), which allows such deductions–regardless of whether their aggregate exceeds the 2% Floor–provided such expenses would not have been incurred but for the estate or trust administration. In essence, Section 67(e) "reclassifies" any expense that would have formerly been defined as a "Miscellaneous Itemized Expense" as a "Unique Expense," thereby allowing such deduction in full. Section 67(e)'s exception to the 2% Floor was confirmed in 26 CFR Section 1.67-4 (otherwise known as the "*Knight* Regulations"[5]). While the *Knight* Regulations were important when they became effective in 2014, their importance has elevated even more so after The Tax Cuts and Jobs Acts of 2017 ("TCJA").

Section 67(g) was added to the Code by the TCJA December 22, 2017 and basically forbids Miscellaneous Itemized Deductions for any taxable year beginning December 31, 2017, with a sunset of January 1, 2026. With such a clear ban on Miscellaneous Itemized Deductions, the *Knight* Regulations' power to reclassify expenses from Miscellaneous Itemized Deductions to Unique Expenses has since become much more valuable. If expenses are reclassified, they can escape the ban imposed by Section 67(g) and instead are fully deductible. Thus, it is much more important today in determining which expenses fit within the purview of the *Knight* Regulations as Unique Expenses so as to ensure deductibility.

For a deduction to be reclassified as a Unique Expense, such deduction must pass Section 67(e)'s (and the *Knight* Regulations') "but for" test. Would this expense still be incurred if there were not an estate or non-grantor trust administration? If the answer is yes (the expense would still have been incurred), then the Code (and the Regulations) is clear: such expense is a Miscellaneous Itemized Expense and thus <u>not</u> deductible under Section 67(g) per the TCJA. On the other hand, if the answer were no (the expense would not have been incurred unless the estate or non-grantor trust were being administered), the Section 67(e) (and *Knight* Regulations) reclassify the expense as a Unique Expense, which is deductible. One clear example (as discussed in the *Knight* Regulations) is whether the fiduciary may deduct the cost of a real estate appraisal. If the appraisal was performed for the purpose of establishing the date of death value or to determine the value for the purpose of making distributions, the Regulations clearly allow such appraisals to be fully deductible. On the other hand, if the appraisal was for any other purpose (including, for example, insurance), such appraisal expense would be a Miscellaneous Itemized Expense and would therefore <u>not</u> be deductible at all under Section 67(g). While the Regulations offer clear lines of distinction, practitioners know all too well that the lines, especially with regard to expenses with mixed purpose, can all too often be blurred. It is thus imperative that careful attention be applied when considering the deductibility of such mixed expenses.

On September 21, 2020, the IRS released final regulations, which both adopt the *Knight* Regulations without modification and offer further guidance on deductions for estates and non-grantor trusts. These recently released final regulations offer help in clarifying whether certain deductions are considered Miscellaneous Itemized Deductions under Section 67(e)(1) and (g). With Section 67(g)'s clear ban on Miscellaneous Itemized Deductions, practitioners must ensure, perhaps now more than ever, that expenses will meet the Section 67(e) "but for" test. In the event the expenses do not, the compressed brackets are not the kind of place clients will want to keep income.

References

1 Adjusted for inflation.

2 I.R.C. 1(e).

3 I.R.C. Sect. 641(b).

4 I.R.C. Sect. 63(c)(6)(D).

5 *Knight v. Commissioner*, 552 U.S. 181 (2008).

This article provides an overview and summary of the matters described therein. It is not intended to be and should not be construed as legal advice on the particular subject.

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