



4830-01-p

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-113295-18]

RIN 1545-BO87

Effect of Section 67(g) on Trusts and Estates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations clarifying that the following deductions allowed to an estate or non-grantor trust are not miscellaneous itemized deductions: costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust, the personal exemption of an estate or non-grantor trust, the distribution deduction for trusts distributing current income, and the distribution deduction for estates and trusts accumulating income. Therefore, these deductions are not affected by the suspension of the deductibility of miscellaneous itemized deductions for taxable years beginning after December 31, 2017, and before January 1, 2026. The proposed regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or non-grantor trust. These proposed regulations affect estates, non-grantor trusts (including the S portion of an electing small business trust), and their beneficiaries.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-113295-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LPD:PR (REG-113295-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Margaret Burow, (202) 317-5279; concerning submissions of comments and/or requests for a public hearing, Regina Johnson, (202) 317-5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 67 and 642 of the Internal Revenue Code (Code).

I. Section 67(g)

Section 67(g) was added to the Code on December 22, 2017, by section 11045(a) of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2088 (2017) (Act). Section 67(g) prohibits individual taxpayers from claiming miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026.

For purposes of subtitle A of the Code, an individual's adjusted gross income is defined in section 62(a) as gross income minus the deductions listed in section 62(a)(1) through (21). Individuals then may subtract itemized deductions from adjusted gross income to arrive at taxable income. See section 63(a). Section 63(d) defines itemized deductions as deductions allowable under chapter 1 of subtitle A of the Code, other than (1) deductions allowable in arriving at adjusted gross income, (2) deductions for personal exemptions provided by section 151, and (3) the deduction under section 199A. A subset of these itemized deductions, identified as miscellaneous itemized deductions, are subject to special rules. Prior to the Act, miscellaneous itemized deductions were allowable for any taxable year only if the sum of such deductions exceeded two percent of adjusted gross income. See section 67(a). Section 67(b) defines miscellaneous itemized deductions as itemized deductions other than those listed in section 67(b)(1) through (12).

II. Section 67(e)

Section 67(e) provides that an estate or trust computes its adjusted gross income

in the same manner as that of an individual, except that the following additional deductions are treated as allowable in arriving at adjusted gross income: (1) the deductions 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 estate or trust, and (2) deductions allowable under section 642(b) (concerning the personal exemption of an estate or non-grantor trust), section 651 (concerning the deduction for trusts distributing current income), and section 661 (concerning the deduction for trusts accumulating income). Accordingly, section 67(e) removes the deductions in section 67(e)(1) and (2) from the definition of itemized deductions under section 63(d), and thus from the definition of miscellaneous itemized deductions under section 67(b), and treats them as deductions allowable in arriving at adjusted gross income under section 62(a). Section 67(e) further provides regulatory authority to make appropriate adjustments in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

On July 13, 2018, the Treasury Department and the IRS issued Notice 2018-61, 2018-31 I.R.B. 278, announcing that proposed regulations would be issued concerning the effect of section 67(g) on the deductibility of certain expenses described in section 67(b) and (e) incurred by estates and non-grantor trusts. The notice states that regulations would clarify that expenses described in section 67(e) remain deductible in determining the adjusted gross income of an estate or non-grantor trust during the taxable years in which section 67(g) applies.

III. Section 642(h)

Section 642(h) provides that if, on the termination of an estate or trust, the estate or trust 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 the personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction, in accordance with the regulations prescribed by the Secretary of the Treasury or his delegate, to the beneficiaries succeeding to the property of the estate or trust.

Net operating loss and capital loss carryovers under section 642(h)(1) are used to compute adjusted gross income on the return of a beneficiary, formerly referred to as an above-the-line deduction. See §1.642(h)-1. The excess deduction under section 642(h)(2) is not, however, used to compute adjusted gross income on the return of a beneficiary. Instead, §1.642(h)-2(a) provides that the section 642(h)(2) excess deduction is “allowed only in computing taxable income and must be taken into account in computing the items of tax preference of beneficiaries; it is not allowed in computing adjusted gross income.” As a result, under the existing regulations, excess deductions on termination of an estate or trust are treated as a single miscellaneous itemized deduction (section 642(h)(2) excess deduction) of the beneficiary subject to disallowance under section 67(g). See also sections 63(d) and 67(b).

The section 642(h)(2) excess deduction may be comprised of several types of deductions including: (1) those deductions allowable in arriving at adjusted gross income under sections 62 and 67(e); (2) itemized deductions under section 63(d) allowable in computing taxable income; and (3) miscellaneous itemized deductions currently disallowed under section 67(g). See section 67(b). Notice 2018-61 explained

that the Treasury Department and the IRS were studying whether section 67(e) deductions, as well as other deductions not subject to the limitations imposed by sections 67(a) and (g) in the hands of the estate or trust, should continue to be treated as miscellaneous itemized deductions when included as a section 642(h)(2) excess deduction.

Notice 2018-61 requested comments regarding the effect of section 67(g) on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction on the termination of an estate or trust considering section 642(h) and §1.642(h)-2(a) and expressed the intent to address this issue in regulations. The Treasury Department and the IRS requested comments regarding whether the separate deductions comprising the section 642(h)(2) excess deduction, such as section 67(e) deductions, should be analyzed separately when applying section 67.

The Treasury Department and the IRS received comments addressing issues concerning section 67(e), as well as excess deductions on termination of an estate or trust under section 642(h), as discussed in more detail in the Explanation of Provisions section of this preamble. All comments were considered and are available for public inspection. The Treasury Department and the IRS continue to study issues related to sections 67 and 642 that are beyond the scope of these proposed regulations and may discuss those comments in future guidance.

Explanation of Provisions

I. Section 1.67-4

Commenters agreed with the statements in Notice 2018-61 that deductions described in section 67(e)(1) and (2) are not miscellaneous itemized deductions subject

to disallowance by section 67(g) and asked that the language in §1.67-4 be amended to clarify this position. This document contains proposed regulations amending §1.67-4 to clarify that section 67(g) does not deny an estate or non-grantor trust (including the S portion of an electing small business trust) 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).

One commenter asked that the regulations address the treatment of expenses and deductions described in section 67(e)(1) and (2) in determining an estate or non-grantor trust's income for alternative minimum tax (AMT) purposes. The commenter requested that regulations provide that such expenses and deductions continue to be deductible for AMT purposes. The treatment of expenses and deductions described in section 67(e) for purposes of determining AMT is outside the scope of these proposed regulations concerning the effects of section 67(g); therefore, these proposed regulations do not address the AMT.

II. Regulations Under Section 642(h)

A. Character and Amount of the Excess Deductions

Commenters opined that the Treasury Department and the IRS have and should exercise their regulatory authority not to treat the section 642(h)(2) excess deduction as a single miscellaneous itemized deduction. Commenters noted that the regulations under §1.642(h)-2 were written before the concept of miscellaneous itemized deductions was added to the Code and need to be updated.

In response to the request for comments in Notice 2018-61 concerning analysis of the separate deductions that comprise the section 642(h)(2) excess deduction,

commenters stated that the Treasury Department and the IRS should provide regulations for the segregation of the section 642(h)(2) excess deduction into its components to determine the character, computation, and deductibility of costs. One commenter said that failure to provide for such segregation could result in either the prolonged administration of estates or trusts, or the sale of assets, to fully utilize deductible costs at the estate or trust level. Another commenter stated that the portion of the section 642(h)(2) excess deduction that qualifies as section 67(e)(1) expenses should remain deductible in arriving at a beneficiary's adjusted gross income and that the remaining section 642(h)(2) excess deduction should be treated as a single itemized deduction, which would avoid having to further separate out the individual costs comprising the excess deduction to determine deductibility at the beneficiary level. Other commenters proposed treating the section 642(h)(2) excess deduction as allowable in full in arriving at the beneficiary's adjusted gross income similar to the treatment of a section 67(e) deduction.

Another commenter requested more specific guidance on the character of the excess deductions. The commenter recommended that the fiduciary be required to separate deductions into at least three categories: (1) deductions allowed in arriving at adjusted gross income, (2) non-miscellaneous itemized deductions, and (3) miscellaneous itemized deductions. This commenter stated that the character of the deductions should not change when succeeded to by the beneficiaries on termination of the estate or trust. Further, the commenter suggested that regulations require that deductions subject to limitation when claimed by a beneficiary be separately identified (for example, the limitation on state and local property and income tax deductions under

section 164(b)(6)). The commenter also requested guidance on how each item of deduction offsets items of income of the estate or trust in the final year of administration for purposes of determining the character of the excess deductions. The character of the excess deductions will vary based on how an executor or trustee allocates deductions against the income of the estate or trust. The same commenter suggested that the rules under §1.652(b)-3, which are used for determining the character of distributable net income to beneficiaries under sections 652 and 662, be used as a model to determine how deductions are allocated to offset income in the final year of administration of the estate or trust for purposes of determining the character of the section 642(h)(2) excess deduction.

The Treasury Department and the IRS adopt the more specific suggestion from commenters of preserving the tax character of the three categories of expenses, rather than the suggestion of grouping all non-section 67(e) expenses together, to allow for such expenses to be separately stated and to facilitate reporting to beneficiaries. Thus, under these proposed regulations, each deduction comprising the section 642(h)(2) excess deduction retains its separate character, specifically: as an amount allowed in arriving at adjusted gross income; a non-miscellaneous itemized deduction; or a miscellaneous itemized deduction. The character of these deductions does not change when succeeded to by a beneficiary on termination of the estate or trust. Further, these proposed regulations require that the fiduciary separately state (that is, separately identify) deductions that may be limited when claimed by the beneficiary as provided in the instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts and the Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credit, etc.

The proposed regulations adopt the suggestion that the principles under §1.652(b)-3 be used to allocate each item of deduction among the classes of income in the year of termination for purposes of determining the character and amount of the excess deductions under section 642(h)(2). Section 1.652(b)-3(a) provides that deductions directly attributable to one class of income are allocated to that income. Any remaining deductions that are not directly attributable to a specific class of income, as well as any deductions that exceed the amount of directly attributable income, may be allocated to any item of income (including capital gains), but a portion must be allocated to tax-exempt income, if any. See §1.652(b)-3(b) and (d). The proposed regulations provide that the character and amount of each deduction remaining after application of §1.652(b)-3 comprises the excess deductions available to the beneficiaries succeeding to the property as provided under section 642(h)(2).

These proposed regulations incorporate a new example to illustrate the rule for determining the character of excess deductions in proposed §1.642(h)-2. The proposed regulations also update the current example in §1.642(h)-5 to account for changes in the Code since this example was last modified on June 16, 1965, in T.D. 6828, 1965-2 C.B. 264.

B. Allocation of the Excess Deduction Among Beneficiaries

One commenter requested guidance on allocating the excess deductions among multiple beneficiaries and suggested that the allocation could be made generally, in proportion to the entire amount of deductions, or specifically, based on the burden the beneficiary bears as to each deduction. The commenter noted, however, that a specific allocation may increase fiduciary reporting and IRS administrative burdens and may not

be worth the added complexity.

Existing regulations under §1.642(h)-4 provide that carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust proportionately according to the share of each in the burden of the loss or deduction. A person who qualifies as a beneficiary succeeding to the property of an estate or trust with respect to one amount and who does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which the beneficiary qualifies. These proposed regulations do not change the allocation method among beneficiaries set forth in §1.642(h)-4.

One commenter asked that the Treasury Department and the IRS address the treatment of suspended deductions on the termination of a trust, such as those under section 163(d) for investment interest, and asked that such suspended deductions be treated in the same manner as the excess deduction under section 642(h). While the Treasury Department and the IRS acknowledge the comment, addressing suspended deductions under section 163(d) and other Code sections is beyond the scope of these proposed regulations.

Proposed Applicability Date

These proposed regulations apply to taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**. However, estates, non-grantor trusts, and their beneficiaries may rely on these proposed regulations under section 67 for taxable years beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the **Federal**

Register. Taxpayers may also rely on the proposed regulations under section 642(h) for taxable years of beneficiaries beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the **Federal Register** in which an estate or trust terminates.

One commenter asked that the Treasury Department and the IRS clarify that expenses incurred during an estate's fiscal year beginning before January 1, 2018, which properly are characterized as miscellaneous itemized deductions, remain deductible as such even if some of the costs were paid after January 1, 2018. Section 67(g) applies to taxable years beginning after December 31, 2017; therefore section 67(g) would not apply to an estate's or trust's taxable years beginning before that date.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. Therefore, a regulatory impact assessment is not required.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal in that it requires fiduciaries of estates and trusts to provide information already maintained and reported to the IRS on Form 1041, on the Schedule K-1 (Form 1041) issued to beneficiaries. Moreover, it should take an estate or trust no more than 2 hours to satisfy the information requirement in these regulations. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for

Advocacy of the Small Business Administration for comment on its impact on small businesses.

Paperwork Reduction Act

The collection of information related to these proposed regulations under section 642(h) is reported on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., and has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and approved by the Office of Management and Budget under control number 1545-0092. Comments concerning the collection of information and the accuracy of estimated average annual burden and suggestions for reducing this burden should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the burden associated with this collection of information must be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

The collection of information in these proposed regulations is in proposed §1.642(h)-2(b)(1). The IRS requires this information to ensure that excess deductions on an estate's or trust's termination that are subject to additional applicable limitations retain their character when taken into account by beneficiaries on their returns. The respondents will be estates, trusts and their fiduciaries.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Comments and Requests for Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “**ADDRESSES**” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these proposed regulations is Margaret Burow of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS, however, participated in their development.

Statement of Availability of IRS Documents

The IRS notice cited in this document is published in the Internal Revenue Bulletin and available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry for §1.67-4 and an entry for §§1.642(h)-2 and 1.642(h)-5 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.67-4 also issued under 26 U.S.C. 67(e).

* * * * *

Sections 1.642(h)-2 and 1.642(h)-5 also issued under 26 U.S.C. 642(h).

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Par. 2. Section 1.67-4 is amended by revising paragraph (a) and the heading of paragraph (d) and adding a sentence at the end of paragraph (d) to read as follows:

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

(a) In general--(1) Section 67(e) deductions. (i) An estate or trust (including the S portion of an electing small business trust) not described in §1.67-2T(g)(1)(i) (a non-

grantor trust) shall compute its adjusted gross income in the same manner as an individual, except that the following deductions (Section 67(e) deductions) are allowed in arriving at adjusted gross income:

(A) Costs that are paid or incurred in connection with the administration of the estate or trust, which would not have been incurred if the property were not held in such estate or trust; and

(B) Deductions allowable under section 642(b) (relating to the personal exemption) and sections 651 and 661 (relating to distributions).

(ii) Section 67(e) deductions are not itemized deductions under section 63(d) and are not miscellaneous itemized deductions under section 67(b). Therefore, section 67(e) deductions are not disallowed under section 67(g).

(2) Deductions subject to 2-percent floor. A cost is not a section 67(e) deduction and thus is subject to both the 2-percent floor in section 67(a) and section 67(g) to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust (including the S portion of an electing small business trust), and commonly or customarily would be incurred by a hypothetical individual holding the same property.

* * * * *

(d) *Applicability date.* * * * Paragraph (a) of this section applies to taxable years beginning after [date these regulations are published as final in the **Federal Register**].

Par. 3. Section 1.642(h)-2 is amended by:

1. Revising paragraph (a).

2. Redesignating paragraph (b) as paragraph (d) and adding a heading for newly redesignated paragraph (d).

3. Redesignating paragraph (c) as paragraph (e) and adding a heading for newly redesignated paragraph (e).

4. Adding new paragraphs (b), (c), and (f).

The revisions and additions read as follows:

§1.642(h)-2 Excess deductions on termination of an estate or trust.

(a) In general. If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to the personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess deductions are allowed under section 642(h)(2) as items of deduction to the beneficiaries succeeding to the property of the estate or trust.

(b) Character and amount of excess deductions--(1) Character. The character and amount of the excess deductions on termination of an estate or trust will be determined as provided in this paragraph (b). Each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust. An item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041, U.S. Income Tax Return for

Estates and Trusts and the Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credit, etc., or successor forms.

(2) Amount. The amount of the excess deductions in the final year is determined as follows:

(i) Each deduction directly attributable to a class of income is allocated in accordance with the provisions in §1.652(b)-3(a);

(ii) To the extent of any remaining income after application of paragraph (b)(2)(i) of this section, deductions are allocated in accordance with the provisions in §1.652(b)-3(b) and (d); and

(iii) Deductions remaining after the application of paragraph (b)(2)(i) and (ii) of this section comprise the excess deductions on termination of the estate or trust. These deductions are allocated to the beneficiaries succeeding to the property of the estate or trust in accordance with §1.642(h)-4.

(c) Year of termination--(1) In general. The deductions provided for in paragraph (a) of this section are allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year.

(2) Example. Assume that a trust distributes all its assets to B and terminates on December 31, Year X. As of that date, it has excess deductions of \$18,000, all characterized as allowable in arriving at adjusted gross income under section 67(e). B, who reports on the calendar year basis, could claim the \$18,000 as a deduction allowable in arriving at B's adjusted gross income for Year X. However, if the deduction (when added to B's other deductions) exceeds B's gross income, the excess may not be carried over to any year subsequent to Year X.

(d) Net operating loss carryovers. * * *

(e) Items included in net operating loss or capital loss carryovers. * * *

(f) Applicability date. Paragraphs (a) and (b) of this section apply to taxable years beginning after [date these regulations are published as final in the Federal Register].

Par. 4. Section 1.642(h)-5 is revised to read as follows:

§1.642(h)-5 Examples.

The following examples illustrate the application of section 642(h).

(a) Example 1. Computations under section 642(h) when an estate has a net operating loss--(1) Facts. On January 31, 2020, A dies leaving a will that provides for the distribution of all of A's estate equally to B and an existing trust for C. The period of administration of the estate terminates on December 31, 2020, at which time all the property of the estate is distributed to B and the trust. For tax purposes, B and the trust report income on a calendar year basis. During the period of administration, the estate has the following items of income and deductions:

Table 1 to Paragraph (a)(1)

<u>Income</u>	
Taxable interest.....	\$2,500
Business income	<u>3,000</u>
Total income	<u>5,500</u>

Table 2 to Paragraph (a)(1)

<u>Deductions</u>	
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses not allocable to business income that would not have been incurred if property had not been held in a trust or estate (section 67(e) deductions)	<u>9,800</u>
Total deductions	14,800

(2) Computation of net operating loss. (i) Under section 642(h)(1), B and the trust are each allocated \$1,000 of the \$2,000 unused net operating loss carryover of the terminated estate in the taxable year, with the allowance of any net operating loss and loss carryover to B and the trust determined under section 172. The amount of the net operating loss carryover is computed as follows:

Table 3 to Paragraph (a)(2)(i)

Gross income		\$5,500
Total deductions	14,800	
Less adjustment under section 172(d)(4) (allowable non-business expenses (\$9,800) limited to non-business income (\$2,500))	<u>7,300</u>	
Deductions as adjusted		<u>7,500</u>
Net operating loss		2,000

(ii) Neither B nor the trust can carry back any of the net operating loss of A's estate made available to them under section 642(h)(1).

(3) Section 642(h)(2) excess deductions. The \$7,300 of deductions not taken into account in determining the net operating loss of the estate are excess deductions on termination of the estate under section 642(h)(2). Under §1.642(h)-2(b)(1), such deductions retain their character as section 67(e) deductions. Under §1.642(h)-4, B and the trust each are allocated \$3,650 of excess deductions based on B's and the trust's respective shares of the burden of each cost.

(4) Consequences for C. The net operating loss carryovers and excess deductions are not allowable directly to C, the trust beneficiary. To the extent the distributable net income of the trust is reduced by the carryovers and excess deductions, however, C may receive an indirect benefit from the carryovers and excess deductions.

(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)

<u>Income</u>		
Dividends.....	\$3,000	
Taxable Interest.....	500	
Rents.....	2,000	
Capital Gain.....	<u>1,000</u>	
Total Income.....		6,500

Table 5 to Paragraph (b)(1)

<u>Deductions</u>		
Section 67(e) deductions:		
Probate fees.....	1,500	
Estate tax preparation fees.....	8,000	
Legal fees.....	<u>4,500</u>	
Total Section 67(e) deductions.....	14,000	
Itemized deductions:		
Real estate taxes on rental property.....	3,500	
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 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 \$4,500 of section 67(e) deductions to the remaining \$4,500 of income. As a result, the excess deductions on termination of the estate are \$11,000, consisting of \$9,500 of section 67(e) deductions and \$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 \$7,125 of section 67(e) deductions and \$1,125 of real estate taxes. F's share of the excess deductions is \$2,750, consisting of \$2,375 of section 67(e) deductions and \$375 of real estate taxes. The real estate taxes on rental property must be separately stated as provided in §1.642(h)-2(b)(1).

(c) Applicability date. This section is applicable to taxable years beginning after [date these regulations are published as final in the **Federal Register**].

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2020-09801 Filed: 5/7/2020 4:15 pm; Publication Date: 5/11/2020]