Fiduciary Income Tax Update

By Ellis H. Pretlow, Esq.

The Tax Cuts and Jobs Act of 2017 (the "TCJA") is the most sweeping tax legislation since the Tax Reform Act of 1986, and innumerable articles have been published about the impact of the legislation on the corporate, individual, and transfer tax systems.[1] Less has been published about the effect on the fiduciary income taxation of trusts and estates.

Perhaps this lack of commentary is because between 2001 and 2013, there were an average annual 1.35 million 1041s filed with the Internal Revenue Service,[2] while there were over 150 million 1040s filed in 2016 alone.[3] However, for many individual filers, Schedule K-1s coming from a trust or estate may have a great impact on their individual tax returns, or tax paid by an estate or trust may diminish assets otherwise available for beneficiaries of an estate or trust. Especially in the context of estate and trust administration, the changes to fiduciary income taxation deserve a more careful analysis.

The taxable income of an estate or trust is generally computed in the same manner as an individual under the Internal Revenue Code (the "Code") except where specifically stated otherwise.[4] The TCJA did little to change the tallying and computation of gross income, which is usually realized by a trust or estate as dividends, interest, rents, royalties, and income from partnerships or other pass through entities. The TCJA did, however, greatly change the face of the 1041 in its allowance and utilization of deductions.

Changes in Fiduciary Income Tax

The biggest impact of the TCJA on individuals has been the abolishment of miscellaneous itemized deductions.[5] For individuals, that means the loss of unreimbursed work expenses, investment expenses, and tax preparation fees; however, with most taxpayers predicted to take advantage of the new higher standardized deduction in 2018, the loss should not be felt as harshly.[6] Historically, one of the largest and recurring expenses for trusts and estates are investment advisor fees, and the loss of the deduction for such fees utilized by most trusts and estates, and especially those trusts with a high level of investable assets, will be felt in the calculation of taxable income on fiduciary income tax returns.

Because of poorly worded legislation in the TCJA, initially there was fear and speculation in the tax law community that new Code section 67(g) abolished all deductions available in Code section 67, including trusts and estate administration expenses and most notably fiduciary fees. However, on July 13, 2018, the IRS issued Notice 2018-61[7] stating that it intended to issue regulations clarifying that the TCJA did not impact Code section 67(e), which allows for "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 trust or estate."[8]

IRS Notice 2018-61 also addressed another impact of new Code section 67(g): an individual beneficiary's inability to take advantage of excess deductions passed to them by an estate or trust in its final year.[9] In past years, these excess deductions were taken as miscellaneous itemized deductions on the individual's 1040,[10] and now that miscellaneous itemized deductions for individuals have been abolished, the IRS clarified its position that these deductions are no longer available to individual beneficiaries.[11]

These excess deductions are especially prevalent in the final year of an estate in which substantial distributions may have already been made and so the estate's administrative fees may exceed income generated by the assets remaining in the estate. The IRS requested comment on this subject in section 4 of Notice 2018-61, and among others, the American Institute of CPAs has responded with a letter calling for regulations clarifying that the TCJA did not impact an individual's ability to take advantage of these excess deductions and utilize them on an individual return.[12] If and until such regulations are issued, however, tax preparers must follow the IRS issued guidance that disallows beneficiaries to take

advantage of these deductions on their individual 1040s. One way to combat the practical impact of the loss of these excess deductions is for the personal representative to consider generating gains in the last taxable year of the estate or trust to take advantage of the deductions rather than lose their benefit on the close of the estate or trust.

Like individuals, trusts and estates are now limited to a combined $10,000 annual deduction for state and local real property taxes, personal property taxes, and state and local income taxes.[13] This limitation, however, does not apply to taxes paid by an estate or trust in carrying on a trade or business described in Code section 212.[14]

Finally, like individuals, trusts and estates now are able to take advantage of the newly enacted Code section 199A deduction to deduct twenty percent (20%) of the entity's net qualified business income and pass on that benefit to its individual beneficiaries.[15] The 199A deduction's calculation is complex and beyond the scope of this article, but it does provide an opportunity to employ tax savings techniques in the estate and trust planning realm to greatly benefit individual beneficiaries who are recipients of qualified business income.

NAI versus DNI

Because of the loss and limitation of deductions historically allowed in the fiduciary income tax context, there is now a greater schism between how net accounting income ("NAI") is calculated under state law and how distributable net income ("DNI") is calculated under federal law, which could create unanticipated consequences to individual beneficiaries of trusts and estates.

Under federal law, a trust or estate is entitled to an income distribution deduction ("IDD") that is equal to the lesser of NAI or DNI.[16] A Trust's NAI is calculated using the principles of the Virginia Uniform Principal and Income Act ("VUPIA"),[17] and DNI is a federal tax law concept.[18] Generally, all appropriate administrative expenses are allowed in calculating DNI, but under the VUPIA only some expenses, or a portion of such expenses, are allocated to income and reflected in the trust's calculation of NAI. Because of this departure in calculation, most trusts have different NAI and DNI numbers.

NAI continues to be calculated the same in 2018 as it was in 2017, but now DNI is calculated differently because of the limitation and losses of deductions discussed above. In a simple trust, this will impact the trust beneficiaries in that they will have a higher amount of taxable income reported to them on the Schedule K-1 from a trust. Below is a chart illustrating an example of a simple trust with one beneficiary and the tax effects of 2017 and 2018.

In a complex trust in which no distributions are made during the year, a typical trust will have higher

Simple Trust Example

	Item of Tax	**2017**	**2018**
1	Gross Income (not including any tax-exempt income)	$100,000	$100,000
2	Taxes Paid allocated to Principal	$15,000	$15,000
3	**Deduction for Taxes Paid**	**$15,000**	**$10,000**
4	Investment Advisor Fees	$5,000	$5,000
5	**Deduction for Investment Advisor Fees (subject to 2% floor)**	**$4,614**	**0**
6	NAI (Line 1 minus 1/2 of Line 4)	$97,500	$97,500
7	**DNI** (Line 1 minus Line 3 minus Line 5)	**$80,386**	**$90,000**
8	**Income Distribution Deduction (lesser of NAI or DNI)**	**$80,386**	**$90,000**
9	**Taxable Income reported on Beneficiary's Schedule K-1**	**$80,386**	**$90,000**

Complex Trust Example

	Item of Tax	2017	2018
1	Gross Income (not including any tax-exempt income)	$100,000	$100,000
2	Taxes Paid allocated to Principal	$15,000	$15,000
3	**Deduction for Taxes Paid**	**$15,000**	**$10,000**
4	Investment Advisor Fees	$5,000	$5,000
5	**Deduction for Investment Advisor Fees (subject to 2% floor)**	**$3,002**	**0**
6	NAI (Line 1 minus 1/2 of Line 4)	$97,500	$97,500
7	**DNI** (Line 1 minus Line 3 minus Line 5)	**$81,998**	**$90,000**
8	**Income Distribution Deduction (lesser of NAI or DNI)**	**$81,998**	**$90,000**
9	**Taxable Income**	**$81,898**	**$89,900**
10	**Tentative Tax Due (not including NIIT)**	**$15,373**	**$16,955**

taxable income (and thus pay more tax) because of the limitations and losses of deductions discussed above. Below is a chart summarizing a complex trust that made no distributions during 2017 or 2018 and the difference in taxation in 2017 and 2018.

These examples are very simplified to attempt to concisely demonstrate the differences between basic taxation of trusts in 2017 and 2018, but with the introduction of the qualified business income deduction and the other complicated facts that affect each individual trust such as tax-exempt income, bond premium amortization adjustments, and complicated partnership K-1s, the tax effects of the TCJA can become more exaggerated and may depart greatly from what we have become accustomed to in past years. ⚜

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(Endnotes)

1. Pub. L. No. 115-97
2. https://www.irs.gov/pub/irs-soi/13EstatesAndTrustsOneSheet.pdf
3. https://www.irs.gov/pub/irs-soi/16inintaxreturns.pdf
4. I.R.C. § 641(b).
5. *See* I.R.C. § 67(g)
6. *See* I.R.C. § 67.
7. I.R.S. Notice 2018-61, 2018 I.R.B. 278
8. I.R.C. § 67(e)(1).
9. *Supra* n. 6
10. I.R.C. § 642(h)(2); Treas. Reg. § 1.642(h)-2.
11. *See* JCT Gen. Explanation of Pub. L. 115-97 (including "excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the items that can no longer be claimed as an itemized deduction under I.R.C. § 67(g)). *Id*. at Part V(E).
12. https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20181031-comment-letter-on-notice-2018-61.pdf
13. I.R.C. § 164(b)(6)
14. I.R.C. § 164(a)
15. I.R.C. § 199A
16. I.R.C. § 651
17. Va. Code Ann. 64.2-1000 *et seq*.
18. I.R.C. § 643 ⚜