

## Change in Treatment of Excess Deductions

IRS has issued regulations (TD 9918) addressing a change in the treatment of “Excess Deductions on Termination” of an Estate or Trust. This regulation package is a follow up of Notice 2018-61. On October 21<sup>st</sup>, IRS also released the draft instructions for the 2020 Schedule K-1 (Form 1041). These instructions follow the regulations and show how IRS wants the “excess deductions” reported on the beneficiary’s tax return. Here is the new reporting of these “excess deductions”. The new regulations apply to tax years beginning after October 19, 2020, but they can be applied to any tax year beginning after December 31, 2017.

The treatment of Excess Deductions on termination of a trust or estate is different from the treatment we had prior to 2018. Prior to 2018 the Excess Deductions were claimed by the beneficiary as a “2% Miscellaneous Itemized Deduction.” As everyone knows items, the “2%” items are no longer deductible for tax years 2018-2025. In Notice 2018-61 IRS reconsidered where these Excess Deductions should be claimed and proposed breaking the expenses down into their individual categories and claiming them as either 1) an adjustment to income, or 2) as Itemized Deductions.

According to the draft instructions, there are now new codes to Box 11 of the 2020 Schedule K-1, Form 1041.

**BOX 11, CODE A** – This portion of the Excess Deductions are those costs of administering the estate/trust that would not have been incurred if the property were not held in the estate/trust. This includes expenses such as fiduciary fees, attorney fees, accounting fees, and court costs of administration. This amount is claimed on the beneficiary’s return as an adjustment to income on Schedule 1 (Form 1040), Part II, Line 22, with a margin entry of “ED67(e)”.

**BOX 11, CODE B** – This portion of the Excess Deductions are allowed to be claimed as itemized deductions on the beneficiary’s return. This portion are the excess deductions on the Form 1041 that would have been itemized deductions if paid by an individual. The most common item is probably taxes, although this item could include other itemized deduction type of items such as interest expense and charitable contributions. These expenses should be entered in their proper location on the Schedule A: real estate taxes added to the total real estate taxes claimed on Schedule A, state and local income taxes added to the total state and local income taxes claimed on Schedule A, etc. If the beneficiary is subject to the limitations, such as the SALT limit of \$10,000, these excess deduction items are also part of those limitations. The breakdown will be provided by the Fiduciary on the Schedule K-1.

Side note – The Notice, regulations, and draft instructions do NOT change the denial of expenses that fall into the “2% Miscellaneous Itemized Deduction” category. They simply direct us to claim the “excess deductions” based on their character inside the estate/trust.

Any expense that is directly related to a type of income is allocated to that particular income. Any remaining expenses are allocated on a pro-rata to total expenses.

**BOX 11, OTHER CODES** – The other codes for box 11 have been moved one letter down in the alphabet, so be careful when reading the Schedule K1. The verbiage on page 3 of the draft instructions for Box 11, Codes C & D, still refer to these lines as Codes B & C. IRS will likely correct the verbiage in the final instructions.

You can find the draft forms, including the instructions for Schedule K-1 (Form 1041), by going to [irs.gov/pub/](https://irs.gov/pub/) and clicking on [irs-dft](#). Clicking on top of each column will sort the links based on that column's listing. For example, clicking on the DATE column will sort the items by date, NAME column will sort by name, etc.

Note – These Codes are different from the Codes on the 2019 version of the Schedule K-1, Form 1041, which had ONE Excess Deduction amount. This is important because fiscal year estates or trusts that began in 2019 will be using the 2019 Schedule K-1 and not the 2020 Schedule K-1. The preparer of the 2019/2020 Schedule K-1, Form 1041 should include a breakdown of the Box 11, Code A, Excess Deductions for the benefit of the beneficiary. Otherwise the beneficiary may be calling during tax season and asking for a breakdown.

Also, when inputting the 2019 Schedule K-1, you will need to make sure the entries you input are for the correct items. For example, the 2019 Schedule K-1 uses Code B for Short-term capital loss carryover, while the 2020 Schedule K-1 Code B stands for the ED67(e) deductions.

**2018-2019 RETURNS** – Notice 2018-61 contained the proposed regulation and stated we could apply it to 2018 & 2019 returns. The final regulations state we can follow the proposed regulations or the final regulations for tax years 2018 & 2019. So if you didn't apply these rules on the beneficiary's original return AND have a breakdown of the Excess Deductions, you can amend to claim the expenses as outlined in these final regulations.

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