Chapman and Cutler LLP

Chapman Client Alert

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Will Trustees Fees Still Be Deductible? How Tax Reform Impacts Trusts and Estates

Overlooked in the many discussions about the new tax laws are the consequences on trusts[1] and estates and the high likelihood trusts and their beneficiaries will see larger income tax bills for the next seven years. This Alert will focus on how the tax changes will impact trusts and estates, identify some of the significant uncertainties and provide some recommendations for fiduciaries (see last page).

The Tax Act

On December 20, the House and the Senate passed the bill formerly known as the Tax Cut and Jobs Tax Act of 2017 (the "Act"), which the President signed into law on December 22. Most of the provisions of the Act applicable to trusts and estates are only in place for tax years 2018 through 2025. Because of the speed the Act passed through Congress and the multiple changes made, the impact of the Act is still being assessed.

The Treasury Department will be very busy, likely for the next several years, providing guidance, rulings and temporary regulations. The Act creates a number of uncertainties that Treasury (or the tax courts) will need to address. This is especially true for trusts and estates.

Elimination of Deductions

As has been widely discussed, the Act eliminates or minimizes many deductions for individuals. Trusts and estates are subject to the same income reporting and deduction rules as individuals, with a few exceptions. As such, trusts and estates will have fewer deductions. While the elimination of many deductions for individuals may be off-set by changes to the individual income tax rates and the increase in the standard deduction for individuals, those off-sets do not apply to trusts and estates. Trusts and estates do not have a standard deduction and the tax rate changes for trusts and estates are very minimal. As a result, the taxes paid by trusts and estates will likely increase, as will the taxable income that flows through to the beneficiary.

Which Deductions are Eliminated?

There are two significant deduction eliminations in the Act that have an unclear application to trusts and estates. The first is the elimination on all miscellaneous itemized deductions under Code §67. Code §67 imposes a 2% limit (2% floor) on all miscellaneous itemized deductions and defines miscellaneous itemized deductions as all itemized deductions except for a few specifically enumerated deductions (which include interest, taxes, casualty/theft losses, charitable contributions and certain estate taxes). Section 67(e) provides an exception *to the 2% floor when computing the adjusted gross income of a trust or estate*, if the deduction is for costs which would not have been incurred if the property were not held in a trust or estate (we will refer to these as "fiduciary specific expenses"). New Section 67(g) simply sates that "*no miscellaneous itemized deduction shall be allowed*" for tax years 2018–2025.

The question is whether Section 67(e)'s exclusion of fiduciary specific expenses means those types of expenses are not miscellaneous itemized deductions. If so, then trusts and estates can still benefit from a number of deductions that individuals cannot. If, however, Section 67(e)'s exclusion of fiduciary specific expenses is just to the application of the 2% floor, but not an exclusion from the definition of what are miscellaneous itemized deductions, then all of the same deductions that are eliminated for individuals will also be eliminated for trusts and estates.

The second deduction elimination that is unclear is the cap on the deduction for state and local taxes. The Act caps the deduction for all state and local taxes, such as real estate taxes, income taxes and personal property taxes, at $10,000 total. However, the Act provides three exceptions to this cap:
(1) foreign taxes claimed in lieu of foreign tax credit,
(2) personal and real property taxes that are incurred in a trade

1 In this Alert, the focus on trusts will be on so-called "complex" and "simple" trusts, which report income and deductions at the trust level. For "grantor" trusts, which simply pass through all items of income and deduction to the grantor or owner of the trust, the tax consequences will depend on who the owner is (individual or entity). Other Client Alerts will discuss the tax impact on individuals, corporations and pass-through entities.

or business (i.e., those taxes that are deductible on Schedule C, Schedule E or Schedule F) and (3) personal and real property taxes incurred for an activity described in Code § 212, which relates to expenses for the production of income. Generally, the "activities" that relate to the production of income include managing investments in federally taxable securities. Because many trusts and estates hold assets for investment (and ultimate distribution) to beneficiaries, the cap on the deduction for state and local taxes may have limited impact on trusts and estates who do pay personal taxes or real property taxes. If all of the "activities" of a trust can be characterized as for the production of taxable income, then under this exception, the state personal and real property taxes paid by the trust in states like Illinois that impose personal property tax should still be still deductible.

Below is a chart with a summary of many deductions that trusts and estate claim and how those deductions may change as a result of the Act.

Clearly Deductible	May or May Not Be Deductible	Not Deductible
State income/property taxes on trust/estate owned assets up to $10,000	Trustee/Executor fees related to administration	Investment management fees/commissions
State personal and real property taxes on trust/estate owned trade or business	Tax prep fee for 1041	Trustee/Executor fees related to investment management
Interest (rules and limits are same as before)	Legal fees related to administration of trust/estate	Personal casualty and theft loss not resulting from Presidentially-declared disasters
Estate taxes for income in respect of decedent	State personal and real property taxes over $10,000 on "federally taxable investments"	Safe deposit box rental
Personal casualty and theft loss from Presidentially-designated disasters	Administrative fees (appraisals, accountings, etc.)	IRA fees billed separately
Charitable distributions for amounts specifically payable or allocable to charity by will/trust/governing instrument		State income and property taxes over $10,000 not related to trade/business or "federally taxable investments"
Amortized bond premiums and OID		
Depreciation/depletion expenses		
Net operating losses from trade or business (carried forward and capped at 90% of taxable income until 2022, then capped at 80% of taxable income)		

The position that the $10,000 cap on state and local taxes does not apply to personal and real property taxes paid on federally-taxable investments seems pretty clear from the face of the Act. However, Treasury may take a narrow view of what it takes to be an "activity described in Section 212." The question of whether fiduciary-specific expenses, such as trustees and executor's fees, are still deductible is likely a policy decision that Treasury will have to make. The language of the Code, as amended by the Act, is just not clear. Until there is clarification from Treasury, there will be uncertainty as to how the elimination of miscellaneous itemized deductions will apply to trusts and estates.

Potential Impact If Deductions Disallowed

If Treasury takes the position that Code § 67(e)'s exception does not change the definition of miscellaneous itemized deductions or provide an exception from the elimination of these deductions for trusts and estates, it will have a significant impact on many trusts and estates. For trusts and estates that pay trustee/executor fees, it will eliminate a significant deduction. Below are some of the likely consequences:

- The accounting rules for trusts vs. the taxable income rule for trusts will have greater differences.
- Distributable net income (DNI) is likely to be higher than trust or fiduciary accounting income (TAI) because a portion of the trustee's fees are typically deducted from TAI, but would not be deducted from DNI.

- For trusts that distribute all TAI to a beneficiary, a portion of all taxable income (interest, dividend, tax-exempt) will be subject to tax at the trust level, not the beneficiary level.
- The beneficiary will see a higher amount of reportable, taxable income on his/her K-1 even if distributions do not change.
- Because tax rates for trusts changed very little, but tax rates for most individuals are going down, the disparity between a trust's tax rate vs. a beneficiary's tax rate is likely greater under the Act.

Recommendations

With the change in the Act effective next year (the 2018 tax year) there are a few items for fiduciaries of trusts/estates to consider:

- If there are unpaid administrative costs and fees, pay them before the tax year-end to avoid the uncertainty as to how Treasury will apply the rules under Code § 67.
- If there is a *known* administrative expense (expense for appraisal, accounting, legal services), consider providing a retainer or up-front payment for those services before the tax year-end.
- Consider whether there is a benefit to paying any balance due on state income taxes or property taxes prior to the tax year-end.
- If contemplating a distribution to a beneficiary, consider (both from the trust side and the beneficiary side) whether it's better for the distribution to occur in tax year 2017 or 2018.
    - For trusts/estates on a calendar year, distributions made between January 1 and March 5, 2018 may be eligible for the "65 day" election to treat the distribution as a 2017 distribution, rather than 2018 distribution. This time period may provide some planning opportunities to pick the tax year, and tax consequences for pending distributions.
    - Distribution may be better in 2018, if a trust's tax rate will be higher in 2018 than in 2017, but a beneficiary's tax rate stays relatively the same, or is in fact lower in 2018.

For More Information

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