

Deductibility of Trust and Estate Expenses

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The IRS has issued final regulations under section 67 regarding the application of the 2% floor on miscellaneous itemized deductions to non-grantor trusts and estates. Here is what you need to know to comply with the new rules.

Non-grantor trusts and estates may deduct certain miscellaneous itemized deductions only to the extent they exceed 2% of adjusted gross income. The stakes are high: If an expense is subject to the 2% floor, the benefit of the deduction will be reduced or eliminated entirely, resulting in a higher income tax bill. Determining which expenses are subject to the 2% floor, therefore, is critically important.

The long-awaited regulationsⁱ may require professional fiduciaries to change their practices to comply with the new rules. A key issue that will require special attention is the treatment of “bundled” fees (fees that include both costs that are subject to the 2% floor and those that are not), which must now be allocated between the component parts.

2% Floor

Generally, miscellaneous itemized deductions are allowed only to the extent that the aggregate of the deductions for any taxable year exceeds 2% of adjusted gross income.ⁱⁱ Section 67(e) applies this rule to non-grantor trusts and estates with one key modification: Costs paid or incurred in connection with the administration of a trust or estate “which would not have been incurred if the property were not held in such trust or estate” are deductible without regard to the 2% floor.

Whether a cost is subject to the 2% floor depends on the nature of the expense. For instance, trustee fees are deductible in full because these fees are by definition incurred only when assets are held in trust. Other types of fiduciary expenses – most notably, investment advisory fees – can be subject to the 2% floor. Indeed, much of the litigation about the boundaries of the 2% floor rule, including the Supreme Court’s decision in *Knight v. Comm’r*,ⁱⁱⁱ centers on the deductibility of investment expenses.

Circuit Split

Prior to the *Knight* decision, the courts had been divided on the legal standard for deducting investment expenses. In 1993, the Sixth Circuit held that a non-grantor trust or estate could deduct investment advisory fees in full.^{iv} In contrast, the Federal Circuit (in 2001) and the Fourth Circuit (in 2003) reasoned that section 67 requires an inquiry as to whether an expense is customarily or commonly incurred outside of a trust or estate.^v Since investment advisory fees are frequently incurred by individuals, the courts held that investment fees incurred by a non-grantor trust or estate were subject to the 2% floor.

In 2006, the Second Circuit adopted yet another reading of the statute.^{vi} It held that section 67 allows a full deduction only for those costs that could not have been incurred by an individual property owner, with the result that investment advisory fees were subject to the 2% floor.

In 2007, the IRS issued proposed regulations under section 67 that followed the strict standard adopted by the Second Circuit and allowed a full deduction only for costs unique to an estate or trust – meaning costs that could not have been incurred by an individual owner.

Importantly, the 2007 proposed regulations included an anti-avoidance rule designed to prevent taxpayers from bundling fees that are subject to the 2% floor with fees that are not subject to the 2% floor into a single deductible charge. Under the proposed rule, fiduciaries would be required to allocate bundled fees between the component parts using any reasonable method. This unbundling concept has been retained and expanded in the final regulations.

The Knight Case

The 2007 proposed regulations were quickly made obsolete by the Supreme Court's decision in *Knight* (on appeal from the Second Circuit case).

In *Knight*, the trustee of a trust paid about \$22,000 in investment advisory fees and deducted this expense in full on the trust's income tax return. On audit, the IRS took the position that the deduction was subject to the 2% floor.

The Supreme Court adopted the reasoning of the Fourth and Federal Circuits. Specifically, the Court held that the key test for deductibility under section 67 is whether it would be "uncommon (or unusual, or unlikely)" for a cost incurred by a trust or estate to be incurred by a hypothetical individual owner. A cost that would not be commonly incurred by an individual is fully deductible, while a cost that would be commonly or customarily incurred by an individual is subject to the 2% floor.

Based on this standard, the Court held that investment advisory fees paid by a trust are subject to the 2% floor because it is not unusual or uncommon for an individual owner to pay for investment advice.

The Court emphasized, however, that some investment advisory fees incurred by a trust may be fully deductible if, for example, "an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts." In addition, the Court reasoned that it is possible for a trust to have an unusual investment objective, or that a trust may require a specialized balancing of the interests of various parties (beyond the usual balancing of income and remainder beneficiaries' interests, however). In that case, the incremental cost of such specialized investment advice would not be subject to the 2% floor.

IRS Response

In response to *Knight*, the IRS issued interim guidance announcing that the Service expected to publish final regulations that would be consistent with the Supreme Court's analysis. Since the final regulations would be effective only prospectively, however, the IRS permitted fiduciaries to continue deducting bundled fees without regard to the 2% floor until the final regulations were issued.^{vii}

In 2011, the 2007 proposed regulations were withdrawn as inconsistent with *Knight*, and the IRS issued another round of proposed regulations. The 2011 proposed regulations provided that an expense would be subject to the 2% floor to the extent it commonly or customarily would be incurred by a hypothetical individual holding the same property.

2014 Final Regulations

In May 2014, the 2011 proposed regulations were issued in final form with relatively minor modifications. The key aspects include:

- *General standard.* The final regulations retain the "commonly or customarily" test for deductibility first put forth in the 2011 proposed regulations. Under this test, a miscellaneous itemized deduction of an estate or non-grantor trust is subject to the 2% floor if the expense commonly or customarily would be incurred by a hypothetical individual holding the same property.

The final regulations expressly provide that expenses subject to the 2% floor include certain ownership costs, tax preparation fees, investment advisory fees, and appraisal fees.

- *Ownership costs.* Ownership costs subject to the 2% floor include expenses incurred simply by reason of being the owner of the property. For example, a custody fee charged for holding securities would likely be characterized as an ownership cost.
- *Tax preparation fees.* The final regulations supply an exclusive list of tax return preparation costs that are not subject to the 2% floor. Fully deductible expenses include the cost of preparing estate and GST (but not gift) tax returns, fiduciary income tax returns and the decedent's final individual income tax return. The cost of preparing all other tax returns is subject to the 2% floor.
- *Investment advisory fees.* Generally, investment advisory fees are subject to the 2% floor. However, consistent with *Knight*, the final regulations provide that certain incremental costs of investment advice beyond the amount normally charged to an individual investor are not subject to the 2% floor. Likewise, the cost of providing specialized advice relating to an unusual investment objective or the need for customized balancing of the interests of various parties is

fully deductible, to the extent the cost of this specialized advice exceeds the cost charged to a hypothetical individual. In other words, the fact that investment advice is highly specialized does not alone make the cost deductible; the fee must also exceed the fee charged to an individual client.

- *Appraisal fees.* The final regulations expressly provide that certain appraisal fees are not subject to the 2% floor. Specifically, the cost of appraisals for determining the value of assets as of the decedent's date of death, for purposes of making distributions from a trust or estate, or to prepare the trust's or estate's tax returns (including GST tax returns) is fully deductible. The cost of all other appraisals is subject to the 2% floor.
- *Fiduciary expenses.* The final regulations contain a new provision intended to confirm that certain specific fiduciary expenses are not subject to the 2% floor. These include probate court fees and costs, fiduciary bond premiums, costs of providing legal notices, and costs related to fiduciary accounts.

Treatment of Bundled Fees

Importantly, the final regulations retain the requirement to allocate bundled fees between costs that are subject to the 2% floor and those that are not. Although the rule is simple in concept, complying with it will be difficult in practice.

- *Non-hourly fees.* A key exception to the "unbundling" requirement is that bundled fees not computed on an hourly basis must be allocated only between investment advice and all other services. The investment portion is subject to the 2% floor, while the entire remaining balance is fully deductible.

This exception is favorable from an administrative point of view, because it allows professional fiduciaries (whose fees are typically calculated as a percentage of assets under management) to avoid breaking out their charges into many separate components representing all the different types of services they provide. Indeed, several large corporate trustees have already taken advantage of this rule by adopting fee schedules with two separately stated fee components, one for investment management and one for all other fiduciary services.

- *Separate payments.* The final regulations contain two exceptions for payments that may not be allocated as part of a bundled fee and must be analyzed separately. First, any payments made from the bundled fee to third parties that would have been subject to the 2% floor if paid directly by the trust or estate are subject to the 2% floor. For example, if a trustee charges a single fee for administering a trust and hires an outside investment advisor whose fees are paid by the trustee out of its own compensation, the separate investment advisory fee will be subject to the 2% floor. The separate fee may, however, be deductible to the extent it includes specialized advice not required for individuals.

Second, any payments separately assessed by the fiduciary in addition to the usual bundled fee are subject to the 2% floor (again, to the extent the charges for the additional services are commonly or customarily incurred by an individual).

- *Reasonable method of allocation.* The final regulations retain the flexibility (from the 2007 proposed regulations) of allowing fiduciaries to allocate bundled fees between the component parts using any reasonable method. The IRS believes that this rule will help mitigate the administrative burden of complying with the unbundling requirement.

The final regulations contain a non-exclusive list of factors that may be considered in determining whether an allocation is reasonable. The factors are: (1) the percentage of the value of the trust subject to investment advice; (2) whether a third party advisor would have charged a comparable fee for similar advisory services; and (3) the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

Note that the final regulations do not provide any safe harbor method for allocating bundled fees. As a practical matter, this means that fiduciaries will need to exercise their judgment in developing a reasonable method of allocation. The IRS reserved the right, however, to provide safe harbors in future guidance.

Practical Implications for Fiduciaries

The final regulations will have a substantial impact on professional fiduciaries, who must evaluate whether their current practices (especially regarding fee allocation and unbundling) satisfy the new rules. Fiduciaries should focus on three key areas:

- 1. Develop a reasonable unbundling method.* Guidance on what constitutes a reasonable method of allocating bundled fees is sparse. Here are several practical suggestions:
 - Determine the amount of time dedicated to investment and non-investment tasks. One way to do this is to review prior time records or begin recording time going forward. If this is not practical, consider using sampling techniques to identify client relationships with a representative mix of services to develop a reasonable allocation that could be applied to similar clients.
 - Benchmark how your fees compare to other professional fiduciaries and investment advisors in your market segment. If your bundled fees are higher than the fees charged by “pure” investment advisors, it may be possible to allocate a greater portion of your bundled fee to non-investment (and therefore fully deductible) fiduciary advice. Likewise, if you provide substantial non-investment services as part of the overall client relationship, consider allocating a greater portion of the bundled fee to those value-added services.
 - Identify investment and non-investment fees on your schedule of fees separately, to make it easier for clients and their accountants to prepare fiduciary income tax returns. Also consider developing separate fee schedules for individual and trust clients. Finally, consider charging some trust clients an additional trust-only investment fee, which should be deductible in full.
- 2. Look for unique situations.* From a practical perspective, it is easier to implement a unified allocation method across all client relationships. Don’t forget, however, to keep an eye out for trusts with truly unique investment objectives, such as trusts that will last a very long time (for example, a dynasty trust or a perpetual charitable foundation). Arguably, an extremely long-term investment horizon is well beyond the investment objective of a hypothetical individual owner, and any additional charges (in excess of what is charged to an individual investor) for implementing a special investment program should not be subject to the 2% floor.
- 3. Manage transition issues.* The final regulations apply to taxable years beginning on or after May 9, 2014. This means that calendar year trusts and estates, and many fiscal year entities, may continue to deduct bundled fees in full on the 2014 return and will have considerable time to react to the new regulations. Taxpayers whose fiscal years begin on or after May 9, 2014, however, will need to comply much sooner. This includes existing fiscal year estates and newly created non-grantor trusts and estates.

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Endnotes

ⁱ Treas. Reg. § 1.67-4.

ⁱⁱ § 67(a).

ⁱⁱⁱ *Knight v. Comm’r*, 552 U.S. 181 (2008).

^{iv} *O’Neill v. Comm’r*, 994 F.2d 302 (6th Cir. 1993).

^v *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001); *Scott v. U.S.*, 328 F.3d 132 (4th Cir. 2003).

^{vi} *Rudkin v. Comm’r*, 467 F.3d 149 (2d Cir. 2006).

^{vii} Notice 2008-32 (effective for tax years beginning before January 1, 2008); Notice 2008-116 (extension through January 1, 2009); Notice 2010-32 (extension through January 1, 2010); Notice 2011-37 (extension through the publication of final regulations in the Federal Register).