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& Wealth Management

Blanche Lark Christerson
Managing Director, Senior Wealth Planning Strategist

Tax Topics

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Final regs issued on deductible expenses for trusts and estates

On May 9th, the IRS issued long-awaited final regulations regarding which expenses a trust or an estate can fully deduct, and which ones are subject to the "2% floor." Before getting into what this means, some background may be helpful.

Taxable income. "Non-grantor trusts" (the trusts referred to in this piece) can be created during the grantor's lifetime or at the grantor's death; estates come into being at an individual's death. Both entities are generally subject to the same income tax rules, and are responsible for paying their own income taxes. Like individuals, these entities calculate their taxable income by adding up all income, and subtracting deductions and the relevant exemption. While this sounds straightforward enough, the advent of "miscellaneous itemized deductions" in the 1986 Tax Reform Act spawned litigation. For trusts, the issue has been whether the fee a trustee pays to an outside investment advisor is fully deductible, or is a miscellaneous expense that can only be deducted to the extent it exceeds 2% of a trust's "adjusted gross income" (the 2% floor mentioned above). Courts were divided on the matter, although most sided with the IRS and the 2% floor limitation. When *Knight v. Commissioner* came along, the Supreme Court agreed to hear the case to resolve this split in judicial authority; it, too, sided with the IRS. What were the facts in *Knight*?

Knight. Michael Knight was the trustee of the Rudkin Testamentary Trust, which was established in 1967, under the will of Henry Rudkin (Rudkin's family helped found Pepperidge Farm, the food products company that was sold to Campbell Soup Company in the early 1960's; the trust was initially funded with proceeds of this sale). Knight hired a company to manage the trust's investments; during 2000, Knight paid the firm over $22,000 for its services, and fully deducted the expense on the trust's 2000 income tax return; in late December 2003, the IRS issued a deficiency notice for about $4,400 because it said the expense was subject to the 2% floor.

Knight took his case to the Tax Court, and lost in 2005 (124 T.C. 304). He appealed to the Second Circuit Court of Appeals, and lost again in 2006 (467 F.3d 149). He appealed to the Supreme Court and lost yet

again on January 16, 2008 (552 U.S. 181). The case turned on the meaning of the following italicized language from Sec. 67(e) of the Internal Revenue Code:

> …the adjusted gross income of a trust…shall be computed in the same manner as in the case of an individual, except that…the deductions for costs which are paid or incurred in connection with the administration of the…trust and *which would not have been incurred if the property were not held in such trust*…shall be treated as allowable [and not subject to the 2% floor]. [Italics added.]

Knight argued that his fiduciary duties as trustee effectively required him to obtain professional investment advice, something that was optional if he were simply handling his own money; because these investment advisory fees were therefore a necessary and "involuntary" component of trust administration, they should be fully deductible. The IRS argued that because individuals regularly pay investment advisory fees, these costs did not satisfy the statutory requirement of "would not have been incurred" if the property hadn't been held in trust, and were therefore subject to the 2% floor.

In holding for the IRS, the Supreme Court agreed that individuals commonly incur investment advisory fees, but that it was nevertheless conceivable that

> a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.

In other words, although investment advisory fees were generally subject to the 2% floor, there could be circumstances when they would not be.

IRS actions. After the Supreme Court's decision, the IRS issued interim guidance four times on *Knight* and 67(e), as it wrestled with how to implement the Court's holding. In September 2011, the IRS issued proposed regulations on the topic (REG-128224-06), and on May 9th, issued final regulations (T.D. 9664), which hew closely to the proposed regs.

The final regs. These final regs are effective for tax years beginning on or after May 9th, and therefore apply immediately to the estates of decedents dying after May 8th, and to new trusts created after this date; existing trusts will generally be subject to these rules as of January 1, 2015. Here are some highlights:

"Commonly" or "customarily" incurred. In analyzing whether a given trust or estate expense is subject to the 2% floor because a hypothetical individual owning the same property would "commonly" or "customarily" incur that same expense, what matters is the *type* of product or service to which the expense relates, rather than a description of it. To wit:

- **Ownership costs.** Ownership costs are chargeable to a property owner by virtue of being the property owner. Thus, because a hypothetical individual could be charged with costs such as condominium fees, insurance premiums, maintenance and lawn services, these expenses are subject to the 2% floor. Expenses for real estate taxes or "ordinary and necessary" trade or business expenses are not subject to the 2% floor, however, and are generally fully deductible.

  Comment. Insurance premiums, and maintenance and lawn services costs are typically deductible when they relate to an estate's administration – as in, the property owner has died, and the decedent's personal representative is safeguarding the property prior to selling it or distributing it to heirs; otherwise, such expenses are generally not deductible.

- **Tax preparation fees.** The only tax preparation fees that will be fully deductible are those relating to all estate and generation-skipping transfer tax returns, income tax returns for the estate or trust (known as "fiduciary" income tax returns), and the decedent's final income tax return. Any other tax return preparation fees (such as for gift tax returns) are subject to the 2% floor.

  Comment. Executors often need to file gift tax returns for decedents: the decedent might have made a taxable gift in the year of death, or simply may not have filed gift tax returns when she should have. The point is that gift tax returns that are filed in conjunction with administering a decedent's estate seem analogous to a decedent's final income tax return, and arguably should be fully deductible.

- **Investment advisory fees.** Investment advisory fees are subject to the 2% floor, although certain "incremental" costs would not be. An incremental cost is a special charge added solely because the advice pertains to a trust (or an estate), the trust or estate has unusual investment objectives, or more is required than the usual balancing of interests between current and future beneficiaries.

  Comment. Although the language regarding incremental costs is presumably there to take account of the Supreme Court's statement to this effect in *Knight* (see the quoted passage above), it is difficult to envision what costs might actually fall into this bucket.

- **Appraisal fees.** Appraisal fees are fully deductible if they are incurred to determine the fair market value of a decedent's estate or to determine value for purposes of making distributions, or "as otherwise required" to properly prepare the estate's or trust's tax returns or a generation-skipping transfer tax return; appraisal fees for other purposes, such as insurance, are subject to the 2% floor.

- **Certain fiduciary expenses.** Fiduciary expenses that are not commonly or customarily incurred by individuals are fully deductible. Such expenses include probate court fees and costs, fiduciary bond premiums, legal publication costs of notices to creditors or heirs, the cost of death certificates, and costs related to fiduciary accounts.

  Comment. The costs listed above typically relate to administering a decedent's estate and *not* to ongoing trust administration.

"Bundled" fees. If a trust or an estate pays a single fee (such as a fiduciary's commission, attorney's fee or accountant's fee), and that fee covers costs that are subject to *both* the 2% floor and those that are not, the fee must be allocated between these two types of costs. If, however, the bundled fee is *not* computed on an hourly basis, it is fully deductible, *except for* the investment advisory portion of the fee, which must be broken out, and is subject to the 2% floor. Out-of-pocket expenses are treated as separate from the bundled fee. Payments made to third parties from the bundled fee will be subject to the 2% floor if those payments would have been subject to the floor if the trust or estate had paid the provider directly; in addition, separately charged expenses that individuals commonly or customarily incur will also be subject to the 2% floor.

- **"Reasonable method."** The fiduciary may use any "reasonable method" to unbundle the bundled fee between costs that are subject to the 2% floor, and those that are not. The same "reasonable method" may be used to determine the investment advisory portion of the non-hourly bundled fee. Facts that may be considered in determining whether an allocation is reasonable include the percentage of the principal subject to investment advice, whether a third party would have charged a comparable fee for similar advisory services and "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."

Comment. Unbundling is a big deal and chiefly affects "corporate fiduciaries" – namely, banks and trust companies that serve as executors and trustees and typically charge a single all-inclusive fee for their services. Although a portion of this fee certainly does represent investment advisory services, how to make the appropriate allocation for a given trust or estate is difficult, since there is no "one size fits all" approach. Given the immediate effective date of these regs, however, corporate fiduciaries have very little time to figure this out. Although the preamble to the regs suggests that the IRS may eventually issue "safe harbor" guidance on unbundling, the Service seems to be taking a wait-and-see approach on this – as in, let's first see how the affected parties actually deal with this requirement.

To sum up. The IRS's position regarding the deductibility of fees for investment advisory services reflects their view that "similarly situated" taxpayers should receive similar treatment: in other words, if an individual can't fully deduct these expenses, why should a trust or an estate be any different? The answer, perhaps, gets down to this: while the tax computations for trusts and estates and individuals may be similar, the standard of behavior that applies to individuals and fiduciaries is very different. Individuals, for example, can stuff their money under a mattress if they wish; fiduciaries, of course, cannot: they are bound by an overarching responsibility – and attendant liability – that infuses their every action.

June 7520 rate

The IRS has released the June 2014 applicable federal rates. The June 7520 rate is 2.2%, down 0.20% (20 basis points) from May's 2.4% 7520 rate. The June mid-term rates are also slightly down: 1.91% (annual), 1.90% (semiannual and quarterly), and 1.89% (monthly). The May mid-term rates were: 1.93% (annual), 1.92% (semiannual and quarterly), and 1.91% (monthly).

Blanche Lark Christerson is a managing director at Deutsche Asset & Wealth Management in New York City, and can be reached at blanche.christerson@db.com.