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Practitioners Weigh In On 2 Percent Floor Debate

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ACTEC breaks ranks on a key issue by supporting a mandatory unbundling requirement for fiduciary fees and commissions

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With the Internal Revenue Service on the verge of issuing final regulations, more than 17 professional organizations and legal commentators have taken a stand in the ongoing debate on the extent to which trusts and estates can deduct certain costs without regard to the 2 percent of adjusted gross income floor, and whether fiduciary fees and commissions must be unbundled. Stakes are high: For banks and trustees, it could mean reorganizing how they do business. For trusts, estates and their beneficiaries, it could mean a substantial tax hit.

The American College of Trust and Estate Counsel (ACTEC), the American Bankers Association, the American Bar Association Section of Real Property, Trust and Estate Law and various other prominent organizations and figures in the trust and estates field responded to an IRS request and submitted comments on proposed Treasury Regulations Section 1.67-4 and Notice 2008-32. Specifically, the proposed regs address the exception to the 2 percent of adjusted gross income floor (the 2 percent floor) on miscellaneous itemized deductions (MIDs) for certain costs that are paid or incurred in connection with the administration of an estate or a trust, and which would not have been incurred if the property were not held in such estate or trust. Depending upon the facts and circumstances of a particular trust or estate, the costs could be significant because expenses subject to the 2 percent floor may be effectively nondeductible as a result of the alternative minimum tax.

On Jan. 16, 2008, the Supreme Court issued a decision in *Knight* v. *Commissioner,* finding that costs paid to an investment advisor by a non-grantor trust generally are subject to the 2 percent floor. In light of *Knight,* the Service issued Notice 2008-32 providing taxpayers with interim guidance. That notice also held in abeyance a requirement imposed by previously issued proposed regulations that fiduciary fees be unbundled for taxable years beginning Jan. 1, 2008, to distinguish between those costs that are unique to trusts and estates (which would not be subject to the 2 percent

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floor) and those that are not unique (which would be subject to the floor).

The notice also requested comments concerning certain aspects of the proposed regulations – including the use of safe harbors and reasonable estimates for allocation purposes by fiduciaries for unbundling fiduciary fees.

The Response

Most comments agreed on a number of issues. But there was a striking lack of consensus on the single most important point: whether bundled fees should be unbundled so that deductible and non-deductible fees could be teased apart.

Most argued against the proposed regs' unbundling requirement. Only ACTEC accepted the premise that unbundling was a given. Indeed, the group supported mandatory unbundling—subject to *de minimis* exceptions and safe harbors. ACTEC did not couch its argument (as other organizations did) as an alternative line of analysis that would apply only if the Service were unwilling to abandon its unbundling requirement.

It may be that ACTEC is simply more resigned to the idea than the others. But its submission appears to put a positive spin on unbundling.

ACTEC's stance surprised and concerned many in the trusts and estates, banking and accounting communities, who worry that the IRS will interpret it as meaning that taxpayers and their advisors are not unified in their opposition to unbundling.

Here's how the various commentators came down on key points:

- **Unbundling of single fees and commissions**–With the notable exception of ACTEC, commentators sharply opposed the Service's position in the proposed regs and the notice that bundled fiduciary fees should be unbundled. The comments generally regarded the unbundling requirement to be inconsistent with both the language of Internal Revenue Code Section 67(e)–which does not authorize the Service to "look through" a fiduciary's fees or commissions to determine their underlying classification–and each of the four federal court of appeals decisions that have construed Section 67(e).[1] As the U.S. Court of Appeals for the Second Circuit succinctly put it: "[F]ees paid to trustees' ... are fully deductible."[2]

The objectors also uniformly expressed concern about the burden that unbundling would impose upon fiduciaries.[3] A number of the commentators observed that creating such extra work sharply contradicts the uncontroverted congressional intent in enacting the 2 percent floor of Section 67(e): to simplify recordkeeping for taxpayers.[4] Indeed, several commentators refused to address alternative lines of analysis on the grounds that an unbundling regime would be nearly impossible for fiduciaries to administer.[5]

The loner on this issue, ACTEC, suggested a framework to implement it. A possible framework, ACTEC said, is contained in the *Hubert* regulations set forth by Treas. Regs. Section 20.2056(b)-4. These regs bifurcated "transmission expenses" from "management expenses" in determining whether costs of administering estates charged to the marital share will reduce the estate tax marital deduction. This approach, ACTEC claimed, can be applied under Section 67(e) to establish presumptions, subject to certain exceptions and safe harbors. Under ACTEC's proposal, expenses relating to the transmission of property would generally be fully deductible without regard

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to the 2 percent floor, because they are relatively unique to trusts and estates. In contrast, expenses relating to the management of property would generally be subject to the 2 percent floor. This *Hubert* regime would apply so long as both the transmission and management portions of the bundled fiduciary fee are not insignificant.

As ACTEC explained it: “Application of the *Hubert* regulations in this context suggests that such expenses should be unbundled. To avoid undue administrative complexity and burden to the IRS and the taxpayer, we suggest that such unbundling of a fee composed of expenses subject to the Two Percent Floor and expenses not subject to the Two Percent Floor is appropriate only where both components of the fee are not insignificant. To illustrate, even if a portion of an investment advisory fee is attributable to some unique investment goal or special balancing of interests, if such portion is not significant, the entire fee would be subject to the Two Percent Floor. In such case, unbundling would be permitted only if the fiduciary establishes that there was a significant incremental charge for the fee relating to a unique investment goal or balancing.”[6]

▪ **Fact-based allocations to unbundle fiduciary fees–**If the Service does institute an unbundling requirement, what then? Commentators disagreed about whether it would be helpful for fiduciaries to demonstrate, without regard to any safe harbor, the portion of their fiduciary fee that individuals would not commonly incur.

Those who favor a fact-based allocation generally assert that a trust or estate should be allowed to deduct without regard to the 2 percent floor the portion of its bundled fiduciary fee that individuals would not normally incur (as determined based upon the fiduciary's books and records and using any reasonable method of allocation that the fiduciary may select.) The fiduciary's determination then could take into account the exceptions set forth near the end of the Supreme Court's decision in *Knight,* including for special additional charges that are applicable only to fiduciary accounts, and the incremental cost of expert advice beyond what individuals normally would incur.[7]

Those who opposed a fact-based allocation did so on the basis that it would be extremely impractical to generate the data needed to support the fiduciaries' allocations between unique and non-unique costs.[8]

▪ **The use of safe harbors–** Most (but not all) of the commentators favored allowing fiduciaries to claim safe harbor amounts that would be deductible without regard to the 2 percent floor. Proposed safe harbor amounts included:

(1) the amount of the total trustees' commissions (or total executor commissions) that would be allowable for the taxable year under the applicable state law (whether by statute, or pursuant to local custom and practice) governing individual trustee commissions (or individual executor commissions, as the case may be);[9]

(2) a specified percentage of the fiduciary commissions (such as 50 percent), to be determined by the Service;[10] and

(3) the amount of the allocations to fully deductible costs based upon the fiduciary's generally applicable fee schedule that is publicly available.

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In addition, a few commentators proposed establishing *de minimis* exceptions whereby trusts or estates holding principal valued below a specified dollar amount (such as the applicable exclusion amount for federal estate tax purposes) would be exempt from the 2 percent floor.[11] Also, the American Bar Association Section of Real Property, Trust and Estate Law proposed exemptions from the 2 percent floor for (1) directed and delegated fiduciary fees, (2) fees of trustees that retain separate and independent investment management, and (3) fees of non-professional fiduciaries.[12]

Not all urged the Service to adopt safe harbors. Notably, the American Bankers Association argued against safe harbors, saying that they would impose an undue burden. Trustees, in accordance with their fiduciary obligations, would be obligated to determine every year whether a fact-based computation would produce a greater income tax deduction than the applicable safe harbor amount.

▪ **Other changes to conform the proposed regs to the Supreme Court's decision in *Knight*–**There was consensus among the commentators about the obvious need for the Service to update the proposed regulations to take into account the intervening decision of the Supreme Court in *Knight.* Necessary updates include:

(1) clarifying that Section 67(e)(1) excepts from the 2 percent floor those costs that individuals would not commonly incur.[13] According to the Supreme Court, the question of whether a trust- or estate-related expense is fully deductible turns on a prediction about what would happen if the property were held by an individual rather than a trust or estate. Thus, the critical question is: Would an individual normally incur the costs that a trust or estate is paying?[14]

(2) clarifying, in accordance with the language appearing near the end of *Knight,* that the 2 percent floor won't apply to (a) special additional charges that are applicable only to fiduciaries or fiduciary accounts,[15] and (b) the incremental cost of expert advice beyond what would normally be required for individuals.[16]

Given the significance of *Knight,* which was issued after the proposed regs came out, the commentators' consensus is that instead of the IRS going straight to final regulations, it should issue a second round of proposed regulations (or alternatively, temporary regulations in conjunction with new proposed regulations) to ensure that all of *Knight's* requirements have been fully addressed.

▪ **Penalty protection for taxpayers and tax practitioners–**The New York City Bar Association proposed that the Service provide safe harbor relief from penalties for both taxpayers and tax practitioners given the difficulty in determining whether an individual would commonly incur a particular expense that has been incurred by a trust or estate. According to the City Bar, this safe harbor can be achieved by clarifying that neither taxpayers nor tax practitioners will be subject to penalties relating to Section 67(e) unless there is no reasonable basis for the taxpayer's position.

▪ **The effective date of final regulations under Section 67(e)–**Several commentators expressed concern about when the final regulations would become effective. The proposed regs say they will "be effective for payments made

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after the date final regulations are published in the *Federal Register.*"[17] To prevent taxpayers from being unduly burdened with potentially having to apply two different sets of rules for bundled fiduciary fees and other costs that are paid or incurred during the same taxable year, these commentators requested that the final regs apply only to taxable years beginning on or after the later of Jan. 1, 2009, or the year following the year in which final regs are issued.[18]

All Together Now

The comments on the proposed regulations under Section 67(e) are diverse. Although there was a general consensus on a number of points, ACTEC's divergence on the threshold issue of whether to oppose unbundling is striking. Clearly, there's something to be said for a think-tank approach and fostering creativity in tax policy. But, at the end of the day, we in the profession may well view this comment period as a squandered opportunity to present a unified opposition to the unbundling of fiduciary fees.

Endnotes:

1 *William L. Rudkin Testamentary Trust v. C.I.R.,* 467 F.3d 149 (2d Cir. 2006); *Scott v. United States,* 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. United States,* 265 F.3d 1275 (Fed. Cir. 2001); *O'Neill v. Commissioner,* 994 F.2d 302 (6th Cir.1993).

2 *Rudkin, supra* note 1 at p.156 (emphasis added) (quoting *Scott supra* note 1 at p.140).

3 The information systems of many institutional trustees are not currently equipped to accommodate unbundling trustees' commissions into unique and non-unique costs. Substantial additional expenditures would be required to generate the information needed in a form that is suitable to make this determination. Unfortunately, trust beneficiaries will often bear the ultimate cost of both the additional complexity and the lost income tax deduction.

4 The comments can all be found at *wwwtaxanalysts.com,* a subscription service. See Statement of Richard B. Covey (annexed to joint Comments of U.S. Trust, Bank of America Private Wealth Management and U.S. Trust Company of Delaware).

5 *See* Comments of the American Bankers Ass'n; Comments of the New York Bankers Ass'n. Both the American Bankers Ass'n and the New York Bankers Ass'n also questioned whether the Internal Revenue Service has given the public adequate time to comment on the actual proposal under consideration as required by the Administrative Procedure Act in light of the Supreme Court's intervening decision in *Knight.*

6 Comments of the American College of Trust and Estate Counsel (ACTEC).

7. *See* Comments of the New York City Bar Ass'n.

8. *See* Comments of the American Bankers Ass'n; Comments of the New York Bankers Ass'n.

9 The methodology for determining this safe harbor amount would vary from state to state. The computation of this amount could depend upon such matters as the value of the assets held in trust, and the amount of trust principal paid out to beneficiaries during the taxable year.

10 *See* Comments of the American Institute of Certified Public Accountants; Comments of the New York City Bar Ass'n; Comments of William H. Forsyth, Jr. of Bessemer Trust. Both Richard B. Covey and the New York City Bar Ass'n also proposed that executors (including for this purpose trustees of revocable trusts that are subject to an Internal Revenue Code Section 645 election) be assigned a higher safe harbor percentage than trustees because an executor's duties will more frequently focus upon the collection of assets and the distribution of property to beneficiaries, as opposed to long-term investment management.

11 *See* Comments of the American Bar Association Section of Real Property, Trust and Estate Law; Comments of the American Institute of Certified Public Accountants.

12 In addition, Ronald D. Aucutt of McGuire Woods LLP urged the IRS to exclude from the 2 percent floor the administration expenses of multi-beneficiary trusts. Also, Heidi Strassburger of Kaspick & Co. LLC suggested that the IRS exclude investment advisory fees for pooled income funds from the 2 percent floor.

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13 *See Knight v. Comm'r,* 552 U.S. ___ (No. 06-1286), 128 S.Ct. at p. 790 (Jan. 16, 2008).
14 *Ibid.,* 128 S. Ct. at pp. 789-90.
15 *Ibid.,* 128 S. Ct. at p. 791.
16 *Ibid.*
17 Proposed Treas. Regs. Section 1.67-4(d).
18 *See* Comments of the New York City Bar Ass'n. The American Bankers Association, in turn, took the position that given the difficulty in implementing the information systems needed to generate the data required by the proposed regulations, the final regulations should not become effective in all events until, at the earliest, taxable years beginning on or after Jan. 1, 2010.

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