WRMarketplace
An AALU Washington Report

Thursday, August 21 2014 **WRM# 14-33**

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Topic: What Accountants, Investment Advisors and Trustees Should Know - Final Treasury Regulations Provide Guidance on Deductibility of Trust and Estate Expenses

MARKET TREND: Higher income tax brackets and the imposition of new taxes make the deductibility of administrative expenses key considerations for estates and non-grantor trusts.

SYNOPSIS: Miscellaneous itemized deductions are allowed only to the extent the total exceeds 2% of adjusted gross income ("2% floor"). Expenses incurred in connection with the administration of an estate or non-grantor trust, however, are deductible without regard to the 2% floor if the expense would not have been incurred if the property were not held in such trust or estate. Trustee's fees, for example, are expenses that would not be incurred if the property were not held in a trust. Long-awaited final Treasury Regulations have been issued which provide guidance on administrative expenses that qualify for exclusion from the 2% floor. The regulations provide, in general, that if an administrative expense would not be incurred by an individual owner of the same property, then the expense is deductible without regard to the 2% floor. The final regulations also require the unbundling of "bundled" fees or commissions (i.e., fees that include costs subject to, and costs excluded from, the 2% floor), such as those charged by fiduciaries, attorneys and accountants.

TAKE AWAYS: Fiduciaries and other service providers (including attorneys and accountants) for estates and non-grantor trusts will need to review their billing practices and, if appropriate, implement procedures to unbundle certain fees to comply with the new rules and maximize allowable deductions. Investment advisory fees are subject to the 2% floor (as costs of property ownership commonly incurred by individuals) and generally will need to be unbundled. The cost of certain property appraisals and fees for the preparation of estate and generation-skipping transfer tax returns, fiduciary income tax returns and a decedent's final individual income tax returns, however, should remain fully deductible by estate and non-grantor trusts without regard to the 2% floor.

MAJOR REFERENCES: *Internal Revenue Code ("Code") § 67; Treas. Regs. § 1.67-4 (T.D. 9664); Amendment to T.D. 9664.*

Deductions play an important role in determining (and possibly reducing) individual and fiduciary income tax obligations. With the imposition of the new net investment income tax and higher capital gains and income tax rates, the maximization of available deductions has become

even more significant, particularly for estates and non-grantor trusts ("**NG trusts**") that are subject to highly compressed income tax brackets (highest income tax bracket reached at $12,150 of income in 2014). Effective for taxable years beginning after December 31, 2014, the IRS has issued long-awaited final Treasury Regulations[1] providing guidance on the types of costs and expenses incurred by estates and NG trusts ("**T&Es**") that are excluded from the 2% floor on miscellaneous itemized deductions.

2% FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS

Taxpayers are allowed to take certain itemized deductions in calculating their income tax obligations. However, the 2% floor imposed under Code § 67(a) provides that miscellaneous itemized deductions[2] claimed by an individual are allowed only to the extent the total exceeds 2% of the individual's adjusted gross income.

> *Example:* T, an individual, has adjusted gross income of $150,000. For T to take miscellaneous itemized deductions, the total of those deductions must exceed $3,000 (2% of $150,000), and only the amount that exceeds the 2% floor will be allowed.

T&Es are also subject to the 2% floor on miscellaneous itemized deductions, except for costs incurred in connection with the administration of a T&E if the cost "would not have been incurred if the property were not held in such trust or estate."[3]

Conflicting court rulings, particularly with respect to the deductibility of investment advisory fees, however, provided little clarity as to which T&E administration expenses were excluded from the 2% floor. Although the IRS issued proposed regulations in 2007 to address the issue, the subsequent U.S. Supreme Court ruling in *Knight v. Commissioner*[4] caused the IRS to withdraw and issue new proposed regulations reflecting the *Knight* decision in 2011. The 2011 proposed regulations now have been adopted as final, with minor changes ("**final regulations**").

THE FINAL REGULATIONS

Following a "hypothetical individual" analysis used in the *Knight* decision, the final regulations provide that an administrative cost incurred by a T&E with respect to a piece of property that is ***"commonly or customarily" incurred by an individual holding the same property is an expense subject to the 2% floor***. If the cost would not be incurred if the property were held by an individual, then the expense qualifies for the exception and may be deducted in full by the T&E.[5] The type of product or service rendered to the T&E in exchange for the cost, rather than its description, is determinative when evaluating whether the exception to the 2% floor applies.[6]

In addition to the general rule, the final regulations provide guidance on the deductibility of specific administrative expenses that may be incurred by a T&E.

Investment Advisory Fees

Generally. Fees for investment advice (including related services provided to an investor as part of an investment advisory fee) are commonly incurred by individual investors and therefore are ***subject to the 2% floor when incurred by T&Es***.

Special Charges. The final regulations concede, however, that a T&E may require specialized investment advice not relevant to an individual. In such instances, certain

"incremental costs" may be excluded from the 2% floor, but only to extent they exceed the investment advice fees normally charged to an individual investor. These "incremental costs" are ***special, additional charges*** incurred solely because the investment advice is (i) rendered to a T&E rather than to an individual, (ii) attributable to an unusual investment objective, or (iii) attributable to the need for a specialized balancing of the interests of various parties (beyond the usual balancing required by the varying interests of current and remainder beneficiaries) such that a reasonable comparison with individual investors would be improper.[7]

Ownership Costs. "Ownership costs" are expenses that are incurred merely by owning a piece of property (*e.g.*, insurance premiums, maintenance expenses, homeowner/condo association fees, automobile registration, etc.).[8] As these costs are commonly or customarily incurred by individual owners of such property, they generally ***are subject to the 2% floor when incurred by T&Es***.[9]

Tax Return Preparation Fees. The excludability of a T&E's tax preparation fees from the 2% floor depends upon the type of return being prepared. The final regulations identify an ***exclusive list of returns for which T&Es can deduct preparation costs without regard to the 2% floor***:

- Estate and generation-skipping transfer tax returns;
- Fiduciary income tax returns; and
- A decedent's final individual income tax returns.

The preparation costs of any other tax returns filed by a T&E (***including gift tax returns***) are costs commonly and customarily incurred by individuals and are thus miscellaneous itemized deductions subject to the 2% floor.[10]

Appraisal Fees. Although individuals frequently value assets for insurance and other purposes, T&Es are required to obtain valuations for tax and administration purposes that an individual would not undertake. The final regulations acknowledge that ***T&Es may deduct fees for the following appraisals without regard to the 2% floor***:

- Appraisals to determine the fair market value of assets as of the decedent's date of death (or the alternate valuation date);
- Appraisals to determine value for purposes of making distributions to beneficiaries; and
- Appraisals otherwise required to properly prepare the T&E's tax returns, or a generation-skipping transfer tax return.

Although not specifically identified in the final regulations, appraisals required for the preparation of fiduciary accounts should also be excluded from the 2% floor as such appraisals would not be needed by an individual. The costs of appraisals secured for other purposes (such as to insure artwork or jewelry) are costs commonly or customarily incurred by individuals and accordingly are subject to the 2% floor.[11]

Litigation Expenses. T&E litigation costs that are subject to the 2% floor include costs incurred in defense of a claim against the estate, the decedent, or the NG trust that are unrelated to the existence, validity, or administration of the T&E. By implication, litigation costs incurred in defending the existence, validity or administration of a T&E are administration expenses that may be deducted without regard to the 2% floor.[12]

Other Fiduciary Expenses. Certain other fiduciary expenses that ***are not subject to the 2% floor*** include:

- Probate court fees and costs;
- Fiduciary bond premiums;
- Legal publication costs for notices to creditors or heirs;
- The cost of certified copies of the decedent's death certificate; and
- Costs related to fiduciary accounts.[13]

TREATMENT OF BUNDLED FEES

A "bundled fee" is a single fee, commission or other expense that is charged for a combination of services. Fiduciary fees, for example, may include fees for trust administration, investment services, real estate management, tax preparation and other services. The final regulations ***require the unbundling and allocation of such fees between costs that are and are not subject to the 2% floor***. The requirement is not limited to fiduciary fees – attorneys' fees and accountants' fees also may need to be unbundled.[14]

> *Example*: The executor of an estate retains an accountant to prepare the decedent's final income tax returns, estate tax returns, and gift tax returns to report taxable gifts made prior to the decedent's death. The accountant has agreed to a single fee for his services, computed on an hourly basis. For purposes of preparing the estate's fiduciary income tax returns, the cost of preparing the decedent's gift tax return is a miscellaneous itemized deduction subject to the 2% floor and must be unbundled from the charges for preparation of the other returns (which, as discussed above, are specifically excluded from the 2% floor).

Exception for Fees Not Computed Hourly. The final regulations also provide a key exception to the unbundling requirement: If a bundled fee is not computed on an hourly basis, then ***only the portion of the fee that is attributable to investment advice is subject to the 2% floor*** – the remaining portion of the bundled fee is excluded from the 2% floor.[15]

> *Example*: C, a corporate trustee, assesses a flat annual fee for serving as the trustee of NG trust. The fee is based on the value of the NG trust's assets and is not calculated on an hourly basis. The services provided by C include general trust administration functions, tax preparation and investment advisory services. Because C's fee is not calculated on an hourly basis, only the portion of the fee attributed to C's investment advisory services must be unbundled and reported as a miscellaneous itemized deduction subject to the 2% floor.

Out-of-Pocket Expenses and Payments to Third Parties. Out-of-pocket expenses billed by a fiduciary or other service provider to the T&E are treated as separate from the bundled fee for purposes of the 2% floor. For example, if a corporate trustee obtains an appraisal of NG trust property and bills the expense to the NG trust as an out-of-pocket expense, the appraisal fee is treated separately from the trustee's fee and its exclusion from the 2% floor will be determined under the rules regarding appraisal fees (discussed above).

Payments made out of a bundled fee to a third party that would have been subject to the 2% floor if paid directly by the T&E are subject to the 2% floor. For example, if a corporate trustee uses an outside investment firm to provide investment advice and the fee for the advice is paid out of the bundled fee, then for purposes of the 2% floor, the investment advisory fee is treated as if the

T&E had paid the fee directly. Fees or expenses separately assessed by the fiduciary or other provider for services rendered to the T&E that are commonly or customarily incurred by an individual also will be subject to the 2% floor.[16]

Reasonable Allocation Method. The T&E may use any reasonable method to allocate a bundled fee between costs that are excludable and non-excludable from the 2% floor, including allocating a portion of a bundled fiduciary commission to investment advice. Facts that may be considered in determining whether an allocation is reasonable include:

- The percentage of the value of the corpus subject to investment advice;
- Whether a third party advisor would have charged a comparable fee for similar advisory services; and
- The percentage of time the fiduciary's attention is devoted to investment advice for the T&E, as compared to dealing with beneficiaries, making distribution decisions, and carrying out other fiduciary functions.

The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2% floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable.[17]

TAKE AWAYS

- Fiduciaries and other service providers (including attorneys and accountants) for T&Es will need to review their billing practices and, if appropriate, implement procedures to unbundle certain fees to comply with the new regulations and maximize deductions allowable to T&Es.

- Investment advisory fees are subject to the 2% floor (as costs of property ownership commonly incurred by individuals) and generally will need to be unbundled.

- The cost of certain property appraisals and fees for the preparation of estate and generation-skipping transfer tax returns, fiduciary income tax returns and a decedent's final individual income tax returns, however, should remain fully deductible by T&Es without regard to the 2% floor.

NOTES

[1] Treas. Regs. § 1.67-4. *See also*, T.D. 9664, IRB 2014-22 (May 27, 2014).
[2] Code § 67(b) excludes certain deductions from the definition of "miscellaneous itemized deductions", such as (1) above-the-line deductions taken into account in computing adjusted gross income, (2) interest deductions under Code § 163 (3) deductions for certain taxes paid (such as state and local taxes and property taxes) under Code § 164; and, (4) estate taxes paid on income in respect of the decedent under Code § 691(c).
[3] Code § 67(e).
[4] 552 U.S. 181 (U.S. 2008).
[5] Treas. Regs. § 1.67-4(a).
[6] Treas. Regs. § 1.67-4(b)(1).
[7] Treas. Regs. § 1.67-4(b)(4).
[8] Treas. Regs. § 1.67-4(b)(2).
[9] Unless excluded from the definition of miscellaneous itemized deductions under Code § 67(b) (see footnote 2).
[10] Treas. Regs. § 1.67-4(b)(3).
[11] Treas. Regs. § 1.67-4(b)(5).
[12] Treas. Regs. § 1.67-4(b)(1).
[13] Treas. Regs. § 1.67-4(b)(6).
[14] Treas. Regs. § 1.67-4(c)(1).

[15] Treas. Regs. § 1.67-4(c)(2).
[16] Treas. Regs. § 1.67-4(c)(3).
[17] Treas. Regs. § 1.67-4(c)(4).

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