IRS Guidance on the 2-Percent of AGI Floor for Trusts and Estates

The Final Regulations under IRC § 67(e)


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On May 9, 2014, the IRS issued final regulations under § 1.67-4 that provide guidance on which costs incurred by estates or trusts other than grantor trusts (non-grantor trusts) are subject to the 2-percent of adjusted gross income floor for miscellaneous itemized deductions under Section 67(e) of the Internal Revenue Code (the "2-percent floor"). Although the IRS has deferred the effective date of these final regulations so that they now apply to taxable years beginning on or after January 1, 2015, it has nevertheless created enormous concern among corporate fiduciaries in particular. Chief among these concerns is how a fiduciary should go about subdividing (or "unbundling") a single fiduciary fee that represents a composite of various functions that the fiduciary has performed, including the providing of investment advice (which is generally subject to the 2-percent floor) and managing other aspects of its relationship with beneficiaries including distribution decisions (which is not subject to the 2-percent floor).

The stakes involved here are much higher than one might otherwise expect. Miscellaneous itemized deductions that are subject to the 2-percent floor are disallowed entirely for purposes of the alternative minimum tax ("AMT").[1] So for those trusts and estates in an AMT posture, this is not simply a matter involving a small potential reduction in the after-tax cost of particular expenses. Rather, it may well be an "all or nothing" proposition as to whether significant expenses are effectively deductible at all.

The Basic Rules

IRC Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a non-grantor trust "that would *not* have been incurred if the property were *not* held in such estate or trust."[2] A cost is subject to the 2-percent floor to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust, and "commonly or

customarily would be incurred" [3] by a hypothetical individual holding the same property.

This standard raises the question of what it means for a cost to be "commonly or customarily incurred" by a hypothetical individual holding the same property. The Regulations instruct that "[i]n analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative." [4] Such costs that are incurred commonly or customarily by individuals (which would be subject to the 2-percent floor) include, for example, costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust, [5] and ownership costs (including those that pass through to the trust or estate from a partnership). [6]

In addition, the Final Regulations provide guidance concerning the following specific categories of costs:

- Tax preparation fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2-percent floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor. [7]

- Appraisal fees. Appraisal fees incurred by an estate or a non-grantor trust to determine the fair market value of assets as of the decedent's date of death (or the alternate valuation date), 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, are not incurred commonly or customarily by an individual and thus are not subject to the 2-percent floor. The cost of appraisals for other purposes (for example, insurance) is commonly or customarily incurred by individuals and is subject to the 2-percent floor. [8]

- Certain Fiduciary Expenses. Certain other fiduciary expenses are not commonly or customarily incurred by individuals, and thus are not subject to the 2-percent floor. Such expenses include without limitation the following: probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts. [9]

The Special Case of Investment Advisory Fees

The Final Regulations provide that fees for investment advice (including any related services that would be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and therefore are subject to the 2-percent floor. This basic rule gets complicated, however, as a result of the Final Regulations' attempt to follow the imprimatur of the United States Supreme Court's 2008 decision in *Knight v. Commissioner*, 552 U.S. 181, 128 S. Ct. 782 (2008). The Supreme Court, in *Knight*, held that fees paid to an investment advisor by an estate or non-grantor trust generally are subject to the 2-percent floor, subject to certain potential exceptions. These potential

exceptions are where "the rubber hits the road," so to speak. Following the Supreme Court's instructions in *Knight*, the Final Regulations provide that certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2-percent floor. For this purpose, such an incremental cost is a special, additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual or attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper. The portion of the investment advisory fees not subject to the 2-percent floor by reason of the preceding sentence is limited to the amount of those fees, if any, that exceeds the fees normally charged to an individual investor. [10]

How this all plays out as a practical matter will likely be the subject of continued uncertainty and litigation in the years to come.

Bundled Fees

Another area of considerable uncertainty under the Final Regulations results from its requirement that "bundled fees" be unbundled into a portion that is subject to the 2-percent floor and a portion that is not subject to the 2-percent floor. The Final Regulations provide that "[i]f an estate or a non-grantor trust pays a single fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's fee) for both costs that are subject to the 2-percent floor and costs (in more than a de minimis amount) that are not, then, except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin, the single fee, commission, or other expense (bundled fee) must be allocated, for purposes of computing the adjusted gross income of the estate or non-grantor trust in compliance with section 67(e), between the costs that are subject to the 2-percent floor and those that are not." [11]

The Final Regulations provide an important exception to having to unbundle fees where a bundled fee is not computed on an hourly basis. In that case, only the portion of that fee that is attributable to investment advice is subject to the 2-percent floor; the remaining portion is not subject to the 2-percent floor. [12] Although the Final Regulations are unclear on this point, presumably the Final Regulations' guidance (in accordance with the Supreme Court's instructions in *Knight*) that certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2-percent floor would also apply here.

In addition, out-of-pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee. In a similar vein, payments made from the bundled fee to third parties that would have been subject to the 2-percent floor if they had been paid directly by the estate or non-grantor trust are subject to the 2-percent floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the estate or non-grantor trust that are commonly or customarily incurred by an individual. [13]

According to the Final Regulations, any reasonable method may be used to

allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not (such as for investment advice). Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, 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 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. 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-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.[14]

The quandary posed by unbundling raises the following question – what methods will the IRS consider "reasonable" in allocating a bundled fee between those costs that are subject to the 2-percent floor (such as for "basic" investment advice) and those costs that are not (potentially everything else)? The author offers the following suggestions:

- One method may be to compare the amount of the corporate fiduciary's commissions against the amount of commissions that an individual fiduciary would be entitled to receive under the applicable state fiduciary commissions statute. Where the applicable state fiduciary commissions statute (such as section 2309 of the New York Surrogate's Court Procedure Act in the case of New York) specifies the amount of commissions that an individual fiduciary would be entitled to receive and the corporate fiduciary does not outsource its investment advisory function, the amount of the "spread" in the fiduciary commissions amounts could potentially be attributed to the corporate fiduciary's investment advisory function (and therefore potentially subject to the 2-percent floor), with the remaining portion not subject to the 2-percent floor.
- Another approach could involve comparing the amount that a trustee (including its corporate affiliate) would charge for a "directed trust" (*i.e.*, a trust in which the trustee is not responsible for the investment advisory function) to a trust in which the trustee is responsible for the investment advisory function. In such event, a strong case can be made that the "spread" in trustee commissions amounts reflects the value of the investment advisory function (which would be potentially subject to the 2-percent floor), with the remaining portion not subject to the 2-percent floor.

Significantly, the Final Regulations only require that the method of allocating a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not be ***"reasonable."*** The approaches suggested above would appear to lend

themselves to such a determination. Presumably, other principled methods of allocation will satisfy the reasonableness requirement as well.

[1] IRC § 56(b)(1)(A)(i).

[2] Treas. Reg. § 1.67-4(a) (emphasis added).

[3] Treas. Reg. § 1.67-4(a).

[4] Treas. Reg. § 1.67-4(b)(1).

[5] Treas. Reg. § 1.67-4(b)(1).

[6] Treas. Reg. § 1.67-4(b)(2).

[7] Treas. Reg. § 1.67-4(b)(3).

[8] Treas. Reg. 1.67-4(b)(5).

[9] Treas. Reg. 1.67-4(b)(6).

[10] Treas. Reg. § 1.67-4(b)(4).

[11] Treas. Reg. § 1.67-4(c)(1).

[12] Treas. Reg. § 1.67-4(c)(2).

[13] Treas. Reg. § 1.67-4(c)(3).

[14] Treas. Reg. § 1.67-4(c)(3).

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