Deductibility of Fiduciary Expenses

IRS Publishes Final Regulations on Deductibility of Fiduciary Expenses Incurred by Estates and Trusts

SUMMARY

On May 8, 2014, the Treasury Department and the Internal Revenue Service (“IRS”) adopted final regulations (the “Final Regulations”) governing the treatment of expenses incurred by estates and non-grantor trusts, including ownership costs, tax preparation fees, investment advisory fees, appraisal fees and others (collectively, “fiduciary expenses”), for purposes of the limitations on the deduction of miscellaneous itemized deductions. Consistent with the Supreme Court’s reasoning and holding in Knight v. Commissioner of Internal Revenue, the Final Regulations provide that fiduciary expenses that “commonly or customarily” would be incurred by a hypothetical individual holding the same property are deductible only to the extent the fiduciary expenses (together with other miscellaneous itemized deductions) exceed two percent of the relevant taxpayer’s adjusted gross income (“AGI”). The Final Regulations further require that an estate or non-grantor trust that pays a single “bundled” fee covering both costs that are fully deductible and costs that are not must allocate the fee between the two types of costs in a reasonable manner.

BACKGROUND

A taxpayer’s “miscellaneous itemized deductions”\(^1\) are deductible only to the extent the miscellaneous itemized deductions exceed two percent of the taxpayer’s AGI, and such amounts are not deductible for the purpose of computing the Alternative Minimum Tax. This limitation often is referred to as the “two percent floor.” Generally, miscellaneous itemized deductions of estates and trusts are subject to the two percent floor. Costs which are paid or incurred in connection with the administration of an estate or trust and which would not have been incurred if the property were not held in an estate or trust are not subject...
to the two percent floor,\(^2\) and are therefore fully deductible for regular and Alternative Minimum Tax purposes.

On July 26, 2007, the Internal Revenue Service (the “IRS”) issued proposed regulations governing the income tax deductibility of fiduciary expenses, including fees incurred by a trust for outside investment advice (the “2007 Proposed Regulations”). The 2007 Proposed Regulations provided that expenses incurred by estates or trusts, other than expenses that are “unique” to an estate or trust, are deductible only to the extent such expenses (together with other miscellaneous itemized deductions) exceed two percent of the estate’s or trust’s AGI. Expenses that are unique to an estate or trust would be deductible without regard to the two percent floor. Under the 2007 Proposed Regulations, an expense would be considered unique if “an individual could not have incurred that cost in connection with property not held in an estate or trust.”\(^3\)

If an estate or trust pays a single “bundled” fee for services (i.e., for a trustee’s fees and the custody and investment of trust assets), the 2007 Proposed Regulations required that the taxpayer use a reasonable method to allocate the total fee between the portion that is unique to an estate or trust and, thus, fully deductible, and the portion that is not unique to an estate or trust and is subject to the two percent floor.

On January 16, 2008, in a unanimous opinion in *Knight v. Commissioner of Internal Revenue*, the Supreme Court held that investment advisory fees paid by an estate or a non-grantor trust are generally subject to the two percent floor.\(^4\) Adopting an interpretation of the relevant Internal Revenue Code provision that differed from the 2007 Proposed Regulations, the Court resolved a split among the Circuit Courts on this issue and held that whether a trust-related expense is exempt from the two percent floor and thus fully deductible depends on the question of whether an individual would have incurred such costs in the absence of a trust. Applying this test to the facts in *Knight*, the Court found that a hypothetical, individual investor would have solicited investment advice, just as the Trustee did; therefore, the investment advisory fees were subject to the two percent floor.\(^5\)

On September 7, 2011, the Treasury Department and IRS withdrew the 2007 Proposed Regulations, replacing them with proposed regulations that reflected the Supreme Court’s reasoning and holding in *Knight* (the “2011 Proposed Regulations”). On May 8, 2014, the Treasury Department and the IRS adopted as final the 2011 Proposed Regulations, with minor modifications.

### FINAL REGULATIONS

Consistent with the Supreme Court’s reasoning and holding in *Knight*, the Final Regulations provide generally that a cost paid or incurred by an estate or non-grantor trust is subject to the two percent floor to the extent that such cost is included in the definition of miscellaneous itemized deductions\(^6\) and “commonly or customarily” would be incurred by a hypothetical individual holding the same property.\(^7\) In the analysis of whether a cost commonly or customarily would be incurred by such an individual, it is the
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type of service rendered to the estate or non-grantor trust that is determinative, rather than the description of the product or service. Costs that are commonly or customarily incurred by individuals include certain types of ownership costs, certain tax preparation fees, investment advisory fees, certain appraisal fees, and others.

Pursuant to the Final Regulations, ownership costs, meaning costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property, are subject to the two percent floor. Examples of ownership costs include condominium fees, insurance premiums, maintenance and law services, and automobile registration and insurance costs.

Tax preparation fees and appraisal fees are each subject to the two percent floor in certain situations. In general, costs relating to preparation of estate and generation-skipping tax returns, fiduciary income tax returns, and the decedent’s final individual income tax returns, are not subject to the two percent floor; by contrast, costs associated with preparing other tax returns, such as gift tax returns, are costs that are commonly and customarily incurred by individuals and are subject to the two percent floor. Similarly, although appraisal fees are not subject to the two percent floor if the appraisal fees are incurred by the estate or non-grantor trust to determine the fair market value of assets as of a decedent’s date of death, determine value for purposes of making distributions, or as otherwise required to properly prepare tax returns, appraisal fees are subject to the two percent floor when the appraisal is used for other purposes, such as insurance.

Investment advisory fees, including fees for related services that would be provided to an individual investor as part of an investment advisory fee, in general are commonly or customarily incurred by a hypothetical individual investor. Accordingly, such costs are subject to the two percent floor. However, if the investment advisory fee includes “incremental costs” imposed solely because the investment advice is provided to an estate or trust or are attributable to an unusual investment objective or specialized need, the excess of the fee over amounts that normally would be charged to an individual investor is not subject to the two percent floor.

Certain other fiduciary expenses are not commonly or customarily incurred by individuals, and as a result are not subject to the two percent floor. These expenses include, without limitation, 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 birth certificate and costs related to fiduciary accounts.

Under the Final Regulations, if an estate or non-grantor trust pays a single “bundled” fee for services, the taxpayer generally must allocate the total fee between costs that are subject to the two percent floor and costs that are not, based on a reasonable method. The Final Regulations provide for exceptions, however, pursuant to which certain fees and expenses are not subject to allocation, including (1) bundled fees not computed on an hourly basis (only the portion attributable to investment advice is subject to the two percent floor), (2) payments made from the bundled fee to third parties that would have been subject
to the two percent floor had they been paid directly by the estate or non-grantor trust, and (3) any amounts separately assessed (in addition to the usual or basic fiduciary fee or commission) by the fiduciary or other service provider that are commonly or customarily incurred by an individual.\textsuperscript{19} Fees described in both (2) and (3) remain subject to the two percent floor.\textsuperscript{20} Out-of-pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee and would need to be evaluated in accordance with the general rules.

Prior to the publication of the Final Regulations, the Treasury Department and IRS had issued interim guidance governing the treatment of bundled fees. The interim guidance generally allowed taxpayers to deduct the full amount of bundled fees, without regard to the two percent floor, for any taxable year beginning before the date that final regulations are published in the Federal Register.\textsuperscript{21}

The Final Regulations were published in the Federal Register on May 9, 2014, and are effective for tax years beginning on or after that date.\textsuperscript{22}

\textsuperscript{19} \textsuperscript{20} \textsuperscript{21} \textsuperscript{22} 

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Defined by exclusion as all expenses not listed in Section 67(b) of the Internal Revenue Code.

I.R.C. § 67(e)(1).

Prop. Reg. § 1.67-4(b) (repealed).


552 U.S. at 193–94.

Defined by exclusion as all expenses not listed in Section 67(b) of the Internal Revenue Code.


Id.


Id.


Prop. Reg. § 1.67-4(b)(5).


Id.

Id.


Prop. Reg. § 1.67-4(c)(1), (4).

Prop. Reg. § 1.67-4(c)(2), (3).

Prop. Reg. § 1.67-4(c)(3).


Prop. Reg. § 1.67-4(d).