Tax Alert

Internal Revenue Service Delays Effective Date of Regulations Regarding Estates and Non Grantor Trusts Costs Subject to the 2% Floor Limitation

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The Internal Revenue Service (IRS) recently issued final regulations, effective for taxable years beginning on or after May 9, 2014, identifying which expenses incurred by an estate or non-grantor trust are subject to the 2% floor for miscellaneous itemized deductions for income tax purposes.

In response, the American Bankers Association (ABA) submitted a letter expressing concern that fiduciaries would need more time to determine how the "unbundling" of fiduciary fees (discussed below) can be done fairly, consistently, accurately and in keeping with the fiduciary duties owed as a trustee or executor. As a result of this letter, the regulations were amended to delay their effective date to tax years beginning on or after January 1, 2015.

Background

Under Internal Revenue Code (IRC) Section 67(a), miscellaneous itemized deductions are allowed to the extent that the total miscellaneous deductions exceed 2% (the "2% floor") of adjusted gross income (AGI). IRC Section 67(e) requires that the adjusted gross income of an estate or trust be computed in the same manner as an individual's AGI. However, IRC Section 67(e)(1) also provides that trust and estate expenses incurred in connection with their administration are fully deductible if they would not have been incurred if the property were not held by the estate or trust. This has been the cause of much confusion and litigation.

A specific issue which became a source of litigation was whether investment advisory fees incurred by a trust or estate and paid to an outside investment advisor may be deducted fully or are instead subject to the 2% floor. In 2007, the IRS issued proposed regulations which provided that a cost is fully deductible to the extent that the cost is unique to an estate or trust. If a cost is not unique to an estate or trust, then that cost was subject to the 2% floor. The proposed regulations also required trustees who charged a combined single fee for a bundle of trust services to unbundle such fees.

In 2008, the Supreme Court *in Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. 181, 128 S. Ct. 782 (2008)*, held that fees paid to an investment advisor by an estate or non-grantor trust generally are subject to the 2% floor for miscellaneous itemized deductions under section 67(a). The Supreme Court's reasoning indicated that the proper inquiry was whether a hypothetical individual would commonly or customarily incur the same expenses. This approach differed from the 2007 proposed regulations which focused on whether or not the service provided was unique to an estate or trust.

In 2011, the IRS withdrew the 2007 regulations and replaced them with new proposed regulations. The 2011 proposed regulations reflect the Supreme Court's reasoning in Knight.

Final Regulations

The final regulations provide that an administration expense of an estate or non-grantor trust is subject to the 2% floor if the expense would be commonly or customarily incurred by a hypothetical individual owning the same property as the estate or non-grantor trust. They also provide guidance regarding bundled fees, allowing any reasonable method to allocate the portion of the bundled fee that is subject to the 2% floor and clarify the following common types of expenses:

Subject to the 2% Floor

- Real estate taxes and trade or business expenses are fully deductible and are not considered itemized deductions subject to the 2% floor.
- The costs of preparing tax returns aside from those listed below(for example, gift tax returns) are subject to the 2% floor.

Investment advisory fees are generally subject to the 2% floor. However, an investment advisory fee is fully deductible to the extent it exceeds the fee generally charged to an individual and is being charged solely because the investment advice is rendered to a trust or estate rather that to an individual, or the excess stems from an unusual investment objective of the trust or estate, or the excess stems from a need for a specialized balancing of interests.

Not Subject to the 2% Floor

- Appraisals needed to determine the fair market value of assets as of the decedent's date of death, for the purpose of making distributions or required to properly prepare the estate or trust's tax returns are not subject to the 2% floor.
- The cost of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the 2% floor.
- Fiduciary expenses such as probate court fees and costs are not subject to the 2% floor.

The final regulations require that a bundled fee which consists of both costs that are fully deductible and costs that are subject to the 2% floor must be unbundled. Specific payments out of a bundled fee to a third party, and expenses separately assessed that are common or customary to an individual, will be subject to the 2% floor. Where amounts are allocable to investment advice, but are not traceable to separate payments, the final regulations continue to allow the use of any reasonable method to make the allocation to investment advice. The final regulations also provide non-exclusive factors to determine whether an allocation is reasonable.

The change in the effective date of the final regulations gives fiduciaries additional time to determine a reasonable method to "unbundle" these fees, especially for fiscal year estates and non grantor trusts.

Please contact your WeiserMazars tax professional for more information.

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