FINAL TREASURY REGULATIONS ON CODE SECTION 67(e)

The Scope of Estates' and Trusts' Miscellaneous Itemized Deductions Not Subject to the 2% Floor

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The Internal Revenue Service has issued long-anticipated final Treasury Regulations delineating which expenses of an estate or a non-grantor trust are not subject to the 2% floor on miscellaneous itemized deductions. The final Regulations contain no surprises and no major victories for taxpayers, as they differ little from the revised Proposed Regulations issued in September of 2011. However, representing a minor win for taxpayers, the final Regulations introduce a modicum of certainty by providing concrete examples of expenses that will either always be or never be subject to the 2% floor. The final Regulations are effective for tax years beginning on or after May 9, 2014.

THE RULE

Internal Revenue Code Section 67(a) provides that a taxpayer's miscellaneous itemized deductions may be deducted only to the extent that such expenses exceed 2% of the taxpayer's adjusted gross income (the "2% floor"). However, Section 67(e) provides that the 2% floor will not apply to such expenses that are paid or incurred in connection with the administration of an estate or trust if those costs would not have been incurred if the property were not held in such estate or trust.

THE ISSUE

Not surprisingly, the Internal Revenue Service and fiduciaries have long been at odds regarding the scope of the Section 67(e) exclusion. The controversy reached a turning point when the United States Supreme Court ruled on the scope of the Section 67(e) exception in *Knight v. Commissioner*, 552 U.S. 181 (2008). In its decision, the Court criticized the Treasury's interpretation of the Section 67(e) exception, which the Treasury had laid out in Proposed Regulations. The Proposed Regulations limited the Section 67(e) exception to costs which were "unique" to a trust or estate, in other words, costs that could not be incurred by an individual. The Court held that the Treasury's interpretation of Section 67(e) was too narrow, and that estate and trust expenses should not be subjected to the 2% floor as long as they were not "customarily or commonly incurred" by an individual.

THE RESOLUTION

The Treasury responded to the *Knight* decision by issuing interim guidance (Notice 2008-32, followed more than 3 years later in new Proposed Regulations in 2011), intended to fall within the Court's holding. The final Regulations incorporate the Court's holding that deductible expenses of an estate or trust are subject to the 2% floor if they are costs commonly or customarily incurred by a hypothetical individual holding the same property. The final Regulations include a non-exhaustive list of four fiduciary expenses that will (with a few exceptions) be subject to the 2% floor: (a) ownership costs, (b) tax preparation fees other than those incurred for the preparation of estate tax returns, generation-skipping transfer tax returns, fiduciary income tax returns, and decedents' final income tax returns; (c) investment advisory fees (subject to a limited exception described below); and (d) appraisal fees other than those incurred for appraisals required in the preparation of the trust's transfer or income tax returns or needed to measure distributions (for example annual valuations for a unitrust). The final Regulations also provide a non-exhaustive list of costs not commonly or customarily incurred by individuals, and thus are not subject to the 2% floor: (a) probate court fees, (b) fiduciary bond premiums, (c) fees for publishing notices legally required in the administration of a decedent's estate, (d) costs of certified copies of a death certificate, and (e) costs of preparing fiduciary accountings.

[1] Many practitioners believed that the Treasury issued the Proposed Regulations in connection with the Supreme Court's grant of certiorari to the *Knight* appellants.

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THE PERSISTENT GRAY AREA

Despite the joint efforts of the Treasury and tax professionals to create clear, easy to administer rules, the final Regulations do not provide a unified, bright line rule for the applicability of the 67(e) exception to the 2% floor.

- *Investment Advisory Fees* –In the *Knight* decision, the Court noted that even investment advisory fees could fall within the category of expenses not commonly or customarily incurred by individuals. Specifically, if investment advisory fees reflect additional charges for the implementation of an unusual investment objective required by the terms of the estate or trust, or resulting from the need to balance the unusual competing interests of the beneficiaries of an estate or trust, the incremental cost of those services should not be subject to the 2% floor. The final Regulations state that this portion of investment advisory fees is limited to the amount of the fees that exceeds the fees normally charged to individual investors.
- *Bundled Fees*–The final Regulations require fiduciaries charging a single fee for mixed services, i.e., various services only some of which are exempt from the 2% floor, to "unbundle" their fee. That is, use a reasonable method to allocate and separately state the portion of the bundled fee which is subject to the 2% floor and the portion which is exempt. Importantly, if the bundled fee is not computed on an hourly basis, then only that portion which is reasonably allocable to investment advice must be separately stated and subjected to the 2% floor. Notably, the final Regulations offer only general guidelines (and no concrete methodology) for devising a reasonable method for allocating a bundled fee among various services.

EFFECTIVE DATE

Existing estates with fiscal years ending in December through April and existing calendar year trusts will have a grace period, so to speak, as their first post-effective date taxable year will begin no earlier than January 1, 2015. However, as drafted, the final Regulations would apply immediately to all estates of decedents dying on or after May 9, 2014, and to all trusts created on or after this date. Likewise, the final Regulations would apply on an accelerated schedule for estates having a fiscal year end during the months of May through November. This may be an unintended consequence, as the Treasury had communicated its intent to give fiduciaries a grace period before having to apply the final Regulations to any of their estates or trusts.

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