



Final Regulations Issued For Investment Advisory Fees and Other Costs Incurred By Trusts and Estates Subject to the 2-Percent Floor

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On May 8, 2014, the Internal Revenue Service published final Treasury Regulations, §1.67-4, prescribing when costs incurred by estates or nongrantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a) of the Internal Revenue Code. The final regulations are effective on May 9, 2014.

Background. Above the line deductions reduce gross income to determine adjusted gross income. Below the line deductions reduce gross income to determine taxable income. Section 67(a) limits certain below the line deductions, called miscellaneous itemized deductions, to amounts that exceed 2-percent of adjusted gross income. This limitation applies to trusts and estates, but section 67(e) provides that an estate or nongrantor trust is allowed a deduction in determining adjusted gross income for costs “which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” Therefore, the costs described in section 67(e) that are incurred by an estate or trust are not subject to the 2-percent floor.

Historically, it was unclear whether certain costs paid by trusts and estates, including investment advisory fees, were allowed in full under section 67(e) or were subject to the 2-percent floor. There was a split among the federal Circuit Courts of Appeal. The Sixth Circuit held that investment advisory fees were fully deductible, while the Fourth and Federal Circuits held that these fees were subject to the 2-percent floor, because they are “commonly” or “customarily” incurred outside of trusts. The Second Circuit held that that a trust could fully deduct these fees because they are costs that could have been incurred by an individual property owner. In January 2008, the United States Supreme Court in *Knight v. Comm’r*, 467 F.2d 149 (2008), held that investment advisory fees incurred by a trust were subject to the 2-percent floor because they are a cost that “would be incurred by an individual if the property were not [held in trust].” The standard adopted by the Supreme Court was whether a particular cost would be uncommon, unusual or unlikely for an individual to incur.

After *Knight*, through a series of notices and proposed regulations, the IRS and the Treasury Department issued temporary guidance to fiduciaries while they considered how and whether to implement the Supreme Court's decision in final regulations. Under that temporary guidance, fiduciaries who did not separately charge for investment advisory fees were not required to unbundle their fiduciary fees and could continue to deduct their fiduciary fee without subjecting the portion allocable to investment advice to the two-percent floor. On May 8, 2014, final Treasury Regulations were published and made effective for taxable years beginning on or after May 9, 2014.

Final Regulations. The final regulations provide that a cost is subject to the 2-percent floor if (i) it is included in the definition of miscellaneous itemized deductions, (ii) it is incurred by an estate or a non-grantor trust, and (iii) it would commonly or customarily be incurred by a hypothetical individual holding the same property.

Commonly or Customarily Incurred. To determine if a cost is commonly or customarily incurred by an individual owning the same property, the final regulations require that one look at the product or service rendered rather than the description of the product or service. The final regulations specify that costs incurred in the 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 are subject to the 2-percent floor. The final regulations did not adopt the provision in the proposed regulations that had provided that costs, without regard to the identity of the payor, would be commonly or customarily incurred in all cases. This provision was removed from the final regulations because it effectively represented a disguised reassertion of the standard rejected in *Knight* by making the 2-percent floor applicable to any expense that *could* be incurred by an individual.

Ownership Costs. Ownership costs are subject to the 2-percent floor. Ownership costs are costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property. They include condominium fees, insurance premiums, maintenance and lawn services, automobile registration and insurance costs. They also include partnership costs passed through to a partner, but only if defined as miscellaneous itemized deductions under section 67(b). Some costs may be fully deductible under other provisions of the Internal Revenue Code. For example, real estate taxes are fully deductible under section 62(a)(4) or section 164(a), and costs incurred in connection with a trade or business or for the production of rents or royalties are fully deductible under section 162 or section 62(a)(4). A separate fee for managing rental real estate owned by the estate or nongrantor trust is fully deductible under sections 62(a)(4), 212 and 611.

Tax Preparation Fees. Not subject to the 2-percent floor are costs related to all estate and generation-skipping transfer tax returns, fiduciary income tax returns and the decedent's final individual income tax returns. The costs of preparing all other tax returns, including gift tax returns, are subject to the 2-percent floor.

Investment Advisory Fees. Fees for investment advice and related services are subject to the 2-percent floor. It is possible that a trust or estate may incur incremental costs of investment advice above the amount normally charged an individual. These incremental costs are not subject to the

2-percent floor. They may include special or additional charges that are added solely because the investment advice is rendered to a trust or estate or that is 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).

Appraisal Fees. Appraisal fees to determine the fair market value of assets as of the decedent's date of death (or alternate valuation date), to determine the value of assets to make distributions, or to prepare the estate's or trust's tax returns or a generation-skipping transfer tax return are not subject to the 2-percent floor. The cost of an appraisal for other purposes (such as to determine the proper amount of insurance needed on certain property) is subject to the 2-percent floor.

Certain Fiduciary Expenses. The following expenses are not subject to the 2-percent floor: 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.

Bundled Fees. Notwithstanding that most commentators objected to the requirement in the proposed regulations that a fiduciary commission be unbundled, the final regulations require unbundling. A single fee, commission or other expense that includes costs subject to the 2-percent floor and those that are not must allocate between the costs subject to the 2-percent floor and those that are not. It appears, however, that fiduciary fees, accountant fees and attorney fees, which are not computed on an hourly basis, only must be unbundled for amounts allocable to investment advice.

If services, expenses or payments are traceable or are separately assessed, they are examined separately and may be subject to the 2-percent floor. If payments are made to a third party out of the bundled fee, they are subject to the 2-percent floor if they would have been subject to the 2-percent floor if the trust or estate had made the payment directly.

Conclusion. A chart summarizing the final regulation follows:

Expenses Subject to 2-percent Floor	Fully Deductible Expenses
Costs incurred in the 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.	Costs incurred in the defense of a claim against the decedent, or the non-grantor trust that are related to the existence, validity or administration of the estate or trust.
Ownership costs: condominium fees, insurance premiums, maintenance and lawn services, automobile registration and insurance costs.	Real estate taxes deductible under section 62(b)(7) and 164(a). Costs incurred in connection with a trade or business, including the production of rents or royalties under section 162(a)(4).
Partnership costs passed through to a partner only if defined as miscellaneous itemized deductions under section 67(b).	A separate fee for managing rental real estate or nongrantor trust under sections 62(b)(7) and 611.

Costs of preparing all returns, except those specifically mentioned in column 2.	Costs related to all estate and generation-skipping returns, fiduciary income tax returns and the decedent's individual income tax return.
Investment advice and related services.	Incremental costs over and above investment advice to a trust or estate, such as for 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).
The cost of an appraisal for purposes not described in column 2 (such as to determine the proper amount of insurance needed on certain property).	Appraisal fees to determine the fair market value of the decedent's date of death (or alternate valuation date) of assets to determine the value of assets to make distributions, to prepare the estate's or trust's tax returns or a generation-skipping transfer tax return.
	Probate court fees and costs, fiduciary bond premiums, publication costs of notices to creditors or heirs, and certified copies of the decedent's death certificate related to fiduciary accounts.
Portion of bundled fiduciary fee attributable to investment advisory fees. Payments made from a bundled fee that would have been subject to the 2-percent floor if paid directly by the nongrantor trust or estate.	Portion of bundled fiduciary fee not attributable to investment advisory fee.
Separately assessed or paid expenses commonly or customarily incurred by an individual.	

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