Fiduciary Trust Expenses:
Section 67 Regulations, Expense Deductibility & Bundled Fiduciary Fees

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2:00 – 3:15 pm Eastern
Panelists

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BACKGROUND – SECTION 67(E)
Section 67(a) provides that for an individual, the miscellaneous itemized deductions are allowed to the extent that aggregate exceeds 2% of the adjusted gross income ("2% floor").

Section 67(e) establishes that the adjusted gross income (AGI) of an estate or a nongrantor trust must be computed in the same manner as is the AGI of an individual.

Under this general rule, absent an express exception, all administrative deductions claimed by a fiduciary would be subject to the 2% floor.
The express exception is found in section 67(e)(1), which allows certain fiduciary administrative costs to be deducted above the line in computing AGI (without being subject to the 2% limitation).

For the exception to apply, two requirements must be met –

- The costs must have been paid or incurred in connection with the administration of the estate or nongrantor trust; and
- The costs must have been expenses that would not have been incurred if the property were not held in such trust.

Deductions under section 67(e)(1) are not subject to the 2% limitation.
O’Neill v. Commissioner, 994 F2d 302 (6th Cir. 1993) -
  - Held that section 67(e) exempts all costs incurred because property was held in nongrantor trust.

Mellon Bank, NA v. United States, 265 F3d 1275 (Fed. Cir. 2001) and Scott v. United States, 328 F.3d 132 (4th Cir. 2003) -
  - Held that section 67(e) exempts only costs that are customarily incurred outside of nongrantor trusts.

Rudkin Testamentary Trust v. Commissioner, 467 F3d 149 (2nd Cir. 2006) –
  - Held that costs are exempt from the 2% floor only if they could not have been incurred by an individual.
On January 2008, in a unanimous decision, the Supreme Court issued a

The Court affirmed, in result only, the Second Circuit's ruling in favor of the
government that investment advisory fees paid to third-party providers were
subject to the 2% floor.

The Supreme Court decision adopted the approach which reasons that fully
deductible expenses are those that would not “commonly” or “customarily” be
incurred by individuals.

In making the decision the Supreme Court cited:
- *Scott v. United States*, 328 F.3d 132 (4th Cir. Va. 2003) and
INCOME TAX TREATMENT
Section 67 defines miscellaneous itemized deductions as all itemized deductions (those eligible to reduce taxes) other than a specific list of deductions. The most common itemized deductions that are not MID are interest, taxes, charitable gifts and medical expenses; MIDs are deductible only to the extent in excess of 2% of adjusted gross income.

MIDs are generally: a) unreimbursed employee expenses (not applicable in this context), b) tax preparation costs, and c) other expenses. Other expenses includes several items but specifically includes expenses to produce or collect income or to manage or maintain property for production of income.

Similar MID definitions apply for individuals and trusts and estates.
• Trust and estate tax rates are high
  – Incremental ordinary federal tax rate – 39.6%
  – State and other taxes add to tax burden
  – Trusts reach highest federal rate with income of $12,300

• Deductions “above the line” are more powerful
  – Obviously … the deductions are not subject to 2% floor
  – The deductions reduce AGI thereby reducing the 2% floor
  – Certain unbundled expenses may be investment expenses that can reduce otherwise valid interest expense deductions under Section 164(d)(4)(C)
• Deductions in excess of 2% AGI floor are also alternative minimum income tax preference items
  – Increases in AMT could be significant
  – AMT is imposed, in part, based on amount of AGI (so categorization of deductions may be very important)
  – Increases to AMT income could exceed add-back of preference items in situations where AMT exemption phases out (2015 exemption is $23,800 and phase out from AGI $79,450 to $174,650).
  – Generally, AMT tax rate is 26% to 28%
Assume a typical trust with a $5M portfolio that generates $10K of interest income, $80K of dividends and $200K of capital gains with a 1.5% trustee fee of $75K.

<table>
<thead>
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<th>Items</th>
<th>Tax</th>
<th>AMT</th>
<th>Total</th>
<th>Increase</th>
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<tr>
<td>Old Rules</td>
<td>$41.9K</td>
<td>-</td>
<td>$41.9K</td>
<td>-</td>
</tr>
<tr>
<td>50/50 Trustee Fee</td>
<td>$43.1K</td>
<td>$6.4K</td>
<td>$49.5K</td>
<td>18%</td>
</tr>
<tr>
<td>20/80 Trustee Fee</td>
<td>$43.1K</td>
<td>$10K</td>
<td>$54.0K</td>
<td>29%</td>
</tr>
</tbody>
</table>

In the example above the addition of a state tax burden would not change the structure because the trustee fees exceed the 2% floor.
The Section 1411 Net Investment Income Tax applies at a rate of 3.8% to certain net investment income above statutory threshold amounts.

An estate or trust is subject to NII if it has undistributed NII and AGI above the highest tax bracket ($12,300).

NII could increase if the portion of the fee attributable to investment advice becomes subject to the 2% AGI floor, resulting in a partial denial of the deduction. Only the portion of the fee that is deductible for income taxes qualifies for a deduction from NII. NII could also increase because of an increase in AGI.

Fiduciary fees are allocated between NII and non-NII using a reasonable method. The balance of the fiduciary fee is 100% deductible for both regular and NII tax purposes.

NII increases are likely to be relatively modest.
The reporting change could result in added tax costs of 28% to more than 39.6% of the amount that is classified as an investment advisory expense.

Reporting change could implicate the AMT tax.

For high income trusts the reporting change could result in a significant tax increase (although a relatively modest increase compared to trust resources).
FINAL REGULATIONS UNDER 67(E)
Final Regulations – Deductions Subject to the 2% Floor

- Under the Final Regulations, which are intended to conform to the Supreme Court’s opinion in Knight, a cost incurred by a fiduciary taxpayer is subject to the 2% floor if:
  - (i) it is considered a miscellaneous itemized deduction under section 67(b) and
  - (ii) it “commonly or customarily would be incurred by a hypothetical individual holding the same property.”

- The Final Regulations apply to all estates and non-grantor trusts with tax years beginning on or after January 1, 2015.

- The Final Regulations do not define the term “commonly or customarily,” but provide instances of fees that are not commonly or customarily incurred by individuals.

- The Final Regulations also provide a non-exhaustive list of certain expenses commonly or customarily incurred by individuals.
Ownership costs are those “costs that are chargeable or incurred by an owner of property simply by reason of being the owner of the property.”

These are considered subject to the 2% floor unless they are not classified as a miscellaneous itemized deduction under section 67(b) – discussed on the next slide.

Examples of ownership costs subject to the 2% floor include:

- Condominium fees
- Insurance premiums
- Maintenance and lawn services, and
- Automobile registration
- If expenses are incurred in a trade or business activity, they are not classified as miscellaneous itemized deductions under section 67(b) and they are not subject to the 2% floor.

- Similarly, expenses incurred with respect to activities appropriately reported on Schedule E, Page 1 (e.g., rent and royalty activities) are also not miscellaneous itemized deductions under section 67(b) and are not subject to the 2% floor.

- Deductions passed through on a schedule K-1 from an investment in a passthrough entity are properly characterized by the pass through entity that incurred them.

- Similarly, expenses that are deductible under their own provisions, such as deductible interest expense, property taxes and the 691(c) deduction, are not categorized as miscellaneous itemized deductions under section 67(b) are not subject to the 2% floor.
Costs related to estate and generation-skipping transfer (GST) tax returns, fiduciary income tax returns and a decedent’s final individual income tax return are not subject to the 2% floor.

Costs related to any other tax returns, including a decedent’s gift tax returns, are subject to the 2% floor.
Fees related to investment advice and associated services are subject to the 2% floor, except to the extent:

- They exceed the fees charged to an individual investor; and
- The incremental costs are charged solely because the investment advice is given to a trust or estate or is attributable to an unusual investment objective or the need for a specialized balancing of various parties (beyond balancing the interests of current and remainder beneficiaries).
The Final Regulations include a list of appraisal costs not subject to the 2% floor, including:

- those in connection with determining fair market value of assets for an estate tax return,
- for purposes of making distributions; or
- for purposes of preparing fiduciary or GST tax returns.

Appraisal costs other than those specified as non-2% appraisal costs in Treas. Reg. § 1.67-4(b)(5) are subject to the 2% floor.
Certain expenses incurred by a fiduciary taxpayer not commonly or customarily incurred by individuals are not subject to the 2% floor.

Such expenses include probate costs and legal publication costs of notices to creditors or heirs.

For those acquainted with Form 706, a similar determination is made for purposes of applying the Hubert regulations.

- Specifically, if an expense is characterizable as a “transmission expense,” then it should escape characterization as being subject to the 2% floor.
- So-called “management expenses” would generally be subject to the 2% floor.
A “bundled fee” is “a single fee, commission, or other expense for both costs that are subject to the 2% floor and costs (in more than a de minimis amount) that are not.”

Bundled fees are frequently encountered with respect to fiduciary fees or attorney and accountant fees. Generally, bundled fees must be allocated between costs subject to the 2% floor and those not subject to the floor, except:

– For bundled fees not computed on an hourly basis, only the portion related to investment advice is subject to the 2% floor and any remaining portion is not subject to the 2% floor,

– Any out-of-pocket expenses billed to the estate or trust are treated separately from the bundled fee and are subject to their own separate analysis, and

– Any payments made from a bundled fee to a third party that would have been subject to the 2% floor if paid directly by the estate or trust are treated separately from the bundled fee.
A taxpayer may employ any “reasonable method” in allocating bundled fees between costs subject to and not subject to the 2% floor.

The Final Regulations include a non-inclusive list of examples of factors that may be used in allocating such expenses. Such examples include:

- The percentage of fair market value of corpus subject to investment advice,
- Whether a third party would have charged a comparable fee for similar services and
- The relative proportion of the fiduciary’s attention to investment advice with respect to the trust or estate compared to other fiduciary functions.

What is reasonable?

Editorial note – this determination is analogous to that required in allocating indirect expenses to tax-exempt income of a trust. Stated differently, the situations where there is no allocation of expenses subject to the 2% floor are few.
TAX RETURN PREPARER ISSUES
• The fiduciary bears the responsibility for categorizing expenses as subject to or not subject to the 2% floor

• Likewise, the fiduciary is responsible for providing instruction to the tax return preparer on the reasonable method to be used for allocation of bundled fees between costs subject to and not subject to the 2% floor
  – When a tax preparer is advising a fiduciary client, who makes the ultimate determination of method?
  – In situations where the fiduciary provides the amount or percentage of bundled fees that are subject to the 2% floor and not subject to the 2% floor, what is the taxpayer’s responsibility to investigate whether the fiduciary’s method is reasonable?
PRACTICAL CONSIDERATIONS
Any Reasonable Method: The final regulations allow a fiduciary to unbundle fees on any reasonable method
- Trustee may select from any one or more reasonable methods
- Trustee may specifically select the method that provides best tax result (may have a fiduciary obligation to do so)
- Trustee has no obligation to select a consistent method if acting with respect to several trusts

Factors: The final regulations suggest multiple unbundling factors. It is unclear how the factors apply. Presumably, the more factors that support an allocation to fiduciary functions the higher the allocation of items to fiduciary functions and vice versa. The listed factors include, but are not limited to, the following:
- The percentage of value subject to investment advice
- Whether a 3rd party would have charged a similar fee for similar advisory services
- The amount of attention devoted to fiduciary functions

Remember the Exception: If a bundled fee is not computed on an hourly basis, only the portion of that fee that is attributable to investment advice is subject to the 2% floor
The final regulations provide that the portion of assets subject to investment advice may be a factor in unbundling. What does this mean? Are not all assets subject to investment advice when held by a fiduciary?

Direction to retain investments

- A trust instrument may direct or permit the trustee to retain certain assets
- This is often the case with closely held stock, concentrated stock positions and real estate
- While the fiduciary may spend time properly maintaining the investments – the fiduciary may not be treated as performing the traditional services of an investment advisor and the fee may be properly characterized as fiduciary in nature because a “reasonable comparison with individual investors would be improper”
Special assets
- Some trustees may acquire real estate or other assets that are held primarily for trust purposes and not for investment
- A third party investment advisor would not consider trust factors in constructing a portfolio
- That fraction of the unbundled fee attributable to special assets may be properly characterized as fiduciary in nature

Mandate to hold assets
- Some trusts may require the trustee to hold an investment or the trustee may have obtained beneficiary releases to hold a specific investment
- The trustee may arguably treat such investments as not subject to investment advice
Comparison to Other Fees

- Comparison to other fees
  - Fairly straight forward method for capturing portion of fee treated as investment advice
  - May overstate investment portion when compared to other reasonable allocation methods
  - Example: If fiduciary charges 1% to act as investment adviser and 1.5% to act as trustee, the fiduciary fee is 33%. Note however, that the investment adviser costs of 1% may understate the obligation because the investment adviser is not subject to the same fiduciary standards as the trustee

- Comparison to directed trust
  - Fairly straight forward method for capturing portion of fee treated as investment advice
  - Example: If fiduciary charges 1.5% to act as trustee and .50% to act as a directed trustee, the fiduciary fee is 33%
Insurance Approach and Hourly Structure

- Fiduciary insurance approach
  - Consider subtracting from the unbundled fee an amount equal to fiduciary insurance as such payment merely compensates the trustee for risk and is not provided for investment services
  - Allocation method may be best suited to individuals acting as trustee, particularly when they are not professionals
  - Fiduciary insurance is expensive and may result in a very small allocation to investment services

- Hourly or other allocation
A Few Thoughts

- Trustee of insurance trust
- Individual trustee serving with a reduced or modest trustee fee
- Private trust company serving with reduced or modest trustee fee
- Trustees generally do not favor a suggestion to categorize time spent. An allocation based on time could also produce large variations in fees from year to year
- Should the trustee be concerned if the tax return reflects a modest allocation of expense to investment management? Could the tax return reflect poorly on a trustee that is subject to an inquiry regarding investment management or performance?
- Individual trustee serving with a corporate co-trustee
- Individual trustee that retains investment house for management
- Private trust company with investment committee and distribution committee
- Family office expenses charged to a trust
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