December 7, 2011

Via electronic submission:
Notice.Comments@IRSCounsel.Treas.gov

The Honorable Douglas H. Shulman Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Jeffrey Van Hove Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Curtis G. Wilson Associate Chief Counsel for
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on IRS REG-128224-06 regarding IRC § 67(e), Exception to the 2-Percent Floor for Estates and Trusts, Prop. Reg. § 1.67-4.

Dear Messrs. Shulman, Wilkins, Van Hove, and Wilson:

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (“RPTE Section”) in response to the matter referenced above. These comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by the RPTE Section’s Individual and Fiduciary Income Tax Committee, and the Estate and Gift Tax Committee. Carol A. Cantrell, Chair of the Individual and Fiduciary Income Tax Committee, supervised the preparation of these comments and participated in their preparation. In addition, substantial contributions were made by Robert E. Barnhill III, Samuel A. Hercules, Sasha A. Klein, Lindsay Roshkind, Thomas M. Sheehan and Timothy M. White. These comments were reviewed by Jonathan Blattmachr on behalf of the RPTE Section’s Committee on Governmental Submissions.
Although the attorneys who prepared these comments represent clients who might be affected by the legal issues addressed herein, no such member (or firm or organization to which any such member belongs) was engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

Once again, we appreciate the opportunity to submit these comments and we respectfully request that the Internal Revenue Service (the “Service”) consider our recommendations. Members responsible for preparing these comments on behalf of the RPTE Section are available to meet and discuss the issues raised herein with the Service and its staff, and to respond to any questions.

**Purpose of the Regulations**

IRC § 67(a) permits individuals and fiduciaries to deduct miscellaneous itemized deductions only to the extent they exceed 2 percent of the individual’s or entity’s adjusted gross income. There is, however, an exception to the 2-percent limitation for certain expenses incurred by estates and trusts in IRC § 67(e). While it is well-settled which expenses are subject to the 2-percent floor for individuals, it is not clear which expenses of estates and trusts are exempt from the floor. In order to promote administrative efficiency, the regulations under § 67(e) should clearly define which expenses of estates and trusts are exempt from the floor, thereby allowing fiduciaries to take full advantage of the statutory exception.

In July 2007, the Service issued a proposed regulation that exempted costs from the floor only if an individual “could not (emphasis added) have incurred” the cost. However, the Supreme Court rejected this interpretation of § 67(e) in *Knight v. Commissioner* in favor of exempting costs “that would not (emphasis added) commonly or customarily be incurred by individuals.” [Knight v. Comm’r, 552 U.S. 181 (2008)]. The Court held that in making this determination, the statute requires the trustee to predict whether such costs “would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur.” Accordingly, the Service withdrew and replaced the 2007 proposed regulation with a new regulation that was intended “to reflect the reasoning and holding in *Knight.*”

**General Rules**

The 2011 proposed regulation provides two general rules for determining whether a cost is “commonly or customarily incurred” by an individual and therefore subject to the floor. First, it provides that costs not dependent on the identity of the owner are “commonly or customarily incurred” by individuals. Second, it provides that costs incurred by an owner of property simply by reason of being the owner of the property are “commonly or customarily incurred” by individuals, and are, therefore, subject to the floor.
A Hubert Approach

We believe that the general rules in the proposed regulation are sound, but require more structure, clarity, and examples. To that end, we recommend the final regulations adopt an approach similar to the Hubert regulations under Treasury regulation § 20.2056(b)-4. By that we mean that the final regulations could adopt two separate classes of deductions, with examples. One class would be subject to the floor and the other not. In Hubert v. Commissioner, a dispute arose over whether expenses paid from a residuary marital share of an estate reduced the marital deduction. [Comm’r v. Hubert, 520 US 93 (1997)] The Supreme Court held for the taxpayer, but invited the Service to write regulations more clearly defining which costs reduce the marital deduction. Accepting the Court’s invitation, the Hubert regulations created two distinct classes of expenses - transmission expenses, which reduce the marital deduction and management expenses, which do not.

In Hubert, transmission expenses are defined as costs that would not have been incurred but for the decedent’s death and the consequent necessity of collecting the decedent’s assets, paying the decedent’s debts and taxes, and distributing the decedent’s assets. Examples include executor fees, attorney fees (except to the extent specifically related to investment, preservation or maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees. Management expenses are those expenses incurred in connection with the investment, preservation, or maintenance of the decedent’s property. Examples of management fees provided include investment advisory fees, stock brokerage commissions, custodial fees, and interest. There have been no recorded judicial disputes over the Hubert regulations.

Like Hubert, we believe that the § 67(e) regulations could adopt a framework that defines two separate classes of costs. Entity-related costs would be exempt from the floor and include costs that depend on the identity of the payor, as described in the proposed regulation. Asset-related costs would be subject to the floor and include ownership costs, as described in the proposed regulation.

Costs That Depend on the Identity of the Payor (“Entity-Related Costs”) The proposed regulation provides that costs not dependent on the identity of the payor are “commonly incurred by individuals.” That is, costs that depend on the identity of the payor are fully deductible. Such costs would not have been incurred absent an entity. They relate to the existence and the management of the entity itself rather than any specific asset. The proposed regulation provides an example of an entity-related cost as defending a claim related to the existence, validity or administration of the estate or trust.
Other examples of entity-related costs would include executor fees, rent, salaries, office supplies, dues and subscriptions, common trust fund fees, fiduciary accounting fees, fiduciary liability insurance, probate fees, court costs, and legal, accounting, and appraisal costs related to the existence of the entity rather than a specific asset. Such costs are incurred by reason of the entity’s existence rather than by reason of a specific asset. They would not have been incurred in the absence of the fiduciary entity.

In that regard, tax preparation costs properly incurred by the fiduciaries and deductible under § 212 should be fully deductible as entity-related costs. This approach would eliminate the confusion caused by the examples in the proposed regulation of different types of tax returns. The proposed regulation provides that the cost of preparing individual tax returns other than the decedent’s return, gift tax returns, and tax returns for a sole proprietorship or a retirement plan are commonly incurred and therefore subject to the floor. There are several problems with these examples. First, it would be very rare for a trust to pay for preparing the tax return of an individual other than the decedent. In the unlikely event that it did, such a cost would either be a beneficiary distribution or a breach of fiduciary duty. Second, tax preparation fees for sole proprietorships and retirement plans would be fully deductible as business expenses under § 162. Accordingly, we recommend that these examples be omitted from the final regulation and that all tax preparation fees be fully deductible as entity-related costs.

Ownership Costs (or “Asset-Related Costs”)
The proposed regulation provides that ownership costs are commonly incurred by individuals, and are, therefore, subject to the floor. Ownership costs are defined as costs incurred by an owner of property simply by reason of being the owner of the property. Such costs relate directly to the ownership of a particular asset. We agree that such costs would generally be subject to the floor. As such, we recommend that the regulations provide a rebuttable presumption that asset-related costs are subject to the floor unless the trustee demonstrates that a hypothetical individual would not commonly or customarily incur the cost, consistent with Knight v. Commissioner. The taxpayer may use any reasonable method to predict whether a hypothetical individual would not commonly or customarily incur the cost.

Examples of asset-related costs would be investment advisory fees, insurance and maintenance of property not related to business or the production of rents and royalties, and consulting fees related to a specific asset, such as ad valorem tax consulting fees.

The proposed regulation illustrates ownership costs with condominium fees, real estate taxes, insurance premiums, maintenance and lawn service, automobile
registration and insurance costs, and partnership costs. We believe these examples are problematic. First, real estate taxes are statutorily excluded from miscellaneous itemized deductions under § 67(b)(2) and should be removed from the list. Second, we suggest that the regulation clarify that costs incurred in connection with a trade or business or for the production of rents or royalties are fully deductible under § 162 or § 62(a)(4).

For the same reason, we recommend that the regulation omit the example of a corporate trustee charging a separate fee for leasing and managing the trust’s rental real estate. The example concludes that the separate real estate management fee is subject to the 2-percent floor because it is a fee commonly or customarily incurred by an individual owner of rental real estate. However, the example is contrary to § 62(a)(4), which allows a full deduction for expenses attributable to the production of rents and royalties, and should be removed from the regulation.

Bundled or Mixed Fees
If an estate or trust pays a single fee or commission that covers both costs subject to the floor and costs exempt from the floor, the single fee must be allocated between the two categories. The proposed regulation provides that fiduciary fees, legal and accounting fees, and investment advisory fees are bundled fees. It further provides that if the bundled fee is computed hourly, it must be allocated between costs that are subject to the floor and those that are not. There is no exception for de minimus costs within a bundled fee that are subject to the floor. Nor does the regulation specify who has the burden to provide sufficient detail to determine which costs are subject to the floor. If these rules become final, we suggest that the Service specify who has the burden to provide sufficient detail about the costs. We also believe it would be reasonable to treat individual costs that do not exceed the greater of $2,500 or one-tenth of the fair market value of the trust corpus as di minimus.

The proposed regulation further provides that with respect to single fees or commissions (i.e. non-hourly fees), the trustee need only determine what portion of the fee is for investment advice and the rest is fully deductible. Trustees may use any reasonable method to make this determination. If the final regulations include this approach, we request guidance on whether it would be reasonable to assign a value to the non-investment services performed by the trustee and allocate the remainder to investment management. Such non-investment services would include reviewing the trust instrument, assuming fiduciary liability, considering the impact of situs on actual or proposed trust transactions (i.e. decanting, rule against perpetuities, real estate transactions, etc.), preparing fiduciary accountings, valuing unitrust assets, deliberating over distributions, planning for tax issues that are unique to a trust, calculating income and principal, reviewing estate and GST consequences, considering fiduciary tax elections, evaluating cash v. in-kind distributions, and the
like. The balance of the fee not allocated to such non-investment services would be assigned to investment services.

However, we strongly believe that the final regulations should omit any requirement to unbundle a single trustee fee. Not only is the task nearly impossible to do with any degree of accuracy, but any attempt to do so would be arbitrary and may encourage trustees to compete based on allocation methods. Such arbitrary allocations such as by head count in the trust department or by hourly time entries will only raise very contentious issues, waste valuable resources, and expose the trustee to additional legal liability from beneficiaries and regulatory authorities. To eliminate these concerns, we recommend that a single trustee fee that is not computed on an hourly basis, or otherwise separately stated, be entirely exempt from the floor. To prevent potential abuses by trustees who charge a single fee, but pay separate fees outside the trust, the final regulations could look through the single fee and apply the entity and asset test to each such separate fee.

More importantly, there is nothing in the Supreme Court’s decision that supports the conclusion that unbundling of investment advisor fees justifies unbundling trustee fees. Indeed, unbundling trustee fees is contrary to Knight, which adopted the Fourth and Federal Circuit holdings that “It is undisputed that trustee fees are fully deductible.” [Mellon, 265 F.3d at 1279] and that “… fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e).” [Scott, 328 F.3d at 140] In addition, every court that has considered the deductibility of fiduciary administrative costs under § 67(e) has consistently held that trustee fees are fully deductible. Therefore, we strongly recommend that the final regulations omit the requirement for trustees to unbundle a single trustee fee.

**Conclusion**

In sum, we urge the Service to consider our recommendation to adopt a Hubert approach by separating costs between entity-related and asset-related costs and to abandon the unbundling requirement for single trustee fees. Entity-related costs would be exempt from the floor while asset-related costs would be presumed to be subject to the floor, absent proof to the contrary. Both entity-related and asset-related costs would satisfy both prongs of § 67(e), while being consistent with the holding in Knight. This approach would add clarity, structure and definition to the regulations, build on concepts already included in the proposed regulation, and provide an easily
December 7, 2011
Comments by ABA RPTE Section
IRS REG-128224-06 regarding IRC § 67(e)
Page 7

administrable and flexible framework for the government and the taxpayer to work within.

Very truly yours,

Andrew F. Palmieri  
Section Chair

cc: Tina Portuondo, RPTE Section Chair-Elect  
Gideon Rothschild, RPTE Section Vice Chair, Trust & Estate Division  
Cara Lee T. Neville, Secretary, American Bar Association  
Thomas M. Susman, Governmental Affairs, American Bar Association