Income tax planning: The impact of new IRS regulations on trusts and estates

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It's the final countdown for corporate trustees who are burdened with the decision of how to implement the final regulations under section 67 issued by the IRS in May 2014. These regulations, which were essentially unchanged from the much-maligned proposed regulations, govern the costs incurred by trusts and estates that are subject to the 2 percent floor on miscellaneous itemized deductions under section 67. The regulations apply to tax years beginning on or after May 9, 2014. Thus, for existing trusts using a calendar year, 2015 will be the first tax year governed by the new regulations. However, the final regulations apply for the 2014 tax year to the estates of individuals dying on or after May 9, 2014, as well as new trusts created after that date. The proposed regulations were very controversial, with many commentators contending that the regulations misinterpreted the U.S. Supreme Court decision in Knight v. CIR, 552 US 181, 128 S. Ct. 782 (2008). It is likely that the lack of substantive changes to the proposed regulations coupled with the years of IRS inertia since issuing the proposed regulations will further exacerbate fiduciary and preparer frustration with respect to the implementation of the final regulations under section 67.

For high-net-worth individuals, estates and trusts, the final regulations also impact the calculation of net investment income subject to the 3.8 percent Medicare surtax. The surtax is assessed on the lesser of the trust or estate's undistributed net investment income and the trust or estate's adjusted gross income (AGI) in excess of $12,150 (for 2014). Costs subject to the 2 percent floor will probably not reduce the amount of AGI. Moreover, allocation of expenses affects the calculation of distributable net income, which in turn affects the determination of undistributed net investment income.

The most contentious aspect of the final regulations requires investment advisory fees to be unbundled so as to segregate costs that are "commonly" or "customarily" incurred by an individual from the incremental cost attributable to advice that is uniquely provided to the trust or estate. Reg. section 1.67-4(b)(4) states that additional fees attributable to "an unusual investment objective or the need for a specialized balancing of the interests of the various parties (beyond the usual balancing of the varying interests of the current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper" are not subject to the 2 percent floor. Applying this vague standard will be difficult for fiduciaries, investment advisors and preparers. Preliminary interpretive guidelines are set forth below.

Background

Under section 67(a), miscellaneous itemized deductions may be deducted by an individual taxpayer only to the extent that the deductions exceed 2 percent of the taxpayer's AGI. Section 67(e) applies the same rule to estates and trusts except that "the deductions 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" are allowed in full. A two-part test evolved from Congress' statutory language. Part one asks whether the expenses were incurred during the administration of a trust or estate, and part two asks whether the expense would have been incurred if the property rights involved were not held in such trust or estate. The second prong triggered substantial litigation. Ultimately, the U.S. Supreme Court weighed in and ruled in Knight v. CIR, 552 US 181, 128 S. Ct. 782 (2008), that section 67(e)(1) "excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." Since the Court's analysis employed vague terms like "uncommon," the debate over the proper interpretation of the second prong has raged on. In 2011, the Treasury issued proposed regulations. Despite receiving caustic and detailed criticism from commentators, including the American College of Trust and Estate Counsel and the American Institute of Certified Public Accountants, these regulations were adopted largely intact.

General Rule

The final regulations provide that a cost is subject to the 2 percent floor to the extent that it is a cost "commonly or customarily" incurred by a hypothetical individual. The regulations specifically address ownership costs, tax preparation fees, investment advisory fees, appraisal fees, fiduciary expenses and bundled fees.

The regulations require companies that provide investment advisory fees to divide–or unbundle– their fees into an amount that an individual hiring an investment advisor would incur and the amount unique to an estate or trust. Presumably, fees incurred as a result of probate proceedings, meetings with the executor and family members, dealing with beneficiaries in creating separate trusts or trust shares, and similar administrative expenses would be incurred as a direct result of a client's death and therefore would be fully deductible.

The U.S. Supreme Court acknowledged the difficulty inherent in unbundling fees in the Knight opinion, stating that "a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison to individual investors would be improper." While this quote was incorporated into the final regulations, it is unclear at this point whether the IRS is prepared to embrace fully the sentiment behind the Court's analysis.

The regulations go on to provide that "any reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not." The reasonable method can account for "the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions." This misses the U.S. Supreme Court's point that trusts quite often have beneficiaries in different generations and circumstances or complex family business assets that require an investment policy geared toward balancing the interests and tax attributes. It is incumbent on trustees under the duties of loyalty and impartiality to account for all of the moving parts. By definition, this requires investment advice that is different than what an individual "commonly" needs. The bottom line of these regulations is that all time spent on trust and beneficiary matters will have to be accounted for–and justified—as distinctive from time spent on non-trust and estate clients.

For estates and larger trusts or trusts with significant investment and trustee fees, it will be important to the trust beneficiaries and, therefore, the fiduciary to unbundle the fees. Beginning with the fiduciary or investment advisor, tax advisors will need to request documentation from the fiduciary of the time spent– or portion of a wrap fee–that is attributable to the circumstances unique to the trust. By reviewing the Knight case as well as the criticisms of the proposed regulations, fiduciaries can find many examples and hypotheticals that can provide guidance for fiduciaries in establishing internal policy. For example, if a beneficiary was grumbling about income not being properly pushed out to tier two beneficiaries, and the fiduciary undertook a review of its investment and distribution policy and made some changes, it seems clear under Knight that the cost of that review and new policy implementation would be fully deductible by the trust. Most tax advisors of high-net-worth individuals expect that the larger fiduciaries and investment advisors will develop procedures for unbundling their fees so that their clients are able to fully deduct the portion of the fees attributable to "dealings with beneficiaries and distribution decisions and other fiduciary functions." This could take some time to implement, however.

Litigation expenses

Under Reg. section 1.67-4(b)(1), costs incurred in defending a claim against the trust or estate would be fully deductible as long as the lawsuit involved the existence, validity or administration of the estate or trust. This presumably would include all lawsuits against all estates and trusts–whether in domestic relations, probate or chancery courts. It is hard to see what line the IRS is attempting to draw since administration is a very expansive term.

Ownership costs

Ownership costs–such as insurance premiums, maintenance fees and property fees are the costs incurred by an owner of property. Since these costs are customarily incurred by individuals, they are subject to the 2 percent limitation. However, these costs may be deductible under other federal tax provisions. For example, real estate taxes are generally deductible by a trust or estate under section 164.

Tax preparation fees

The final regulations provide that the costs associated with preparing all estate tax returns, fiduciary income tax returns, and a decedent's final income tax return are not subject to the 2 percent limitation, but the expense of preparing gift tax returns, which are commonly prepared for individuals, would be subject to the 2 percent floor.

Appraisal fees

Appraisal fees incurred to prepare the Form 706 or for any estate settlement reason or trust distribution are fully deductible under the final regulations.

Effective date and section 645 election

Under Reg. section 1.67-4(d), the regulations are effective for tax years beginning on or after May 9, 2014. Thus, for calendar-year taxpayers, the regulations are effective for 2015. An election under section 645 should be advantageous for estates of decedents who died after the effective date. The regulations–and exceptions from the 2 percent floor–are more easily applied to estates. Estates generally have unique expenses due to the dictates of probate law that require various administrative actions and create concrete duties and requirements for fiduciaries.

Conclusion

The final regulations incorporate the U.S. Supreme Court's holding in Knight that deductible expenses of an estate or trust are subject to the 2 percent threshold if such expenses are "commonly" or "customarily" incurred by an individual taxpayer. While the final regulations include a list of expenses that fall on either side of the 2 percent rule, there remains a lot of room for interpretation. In many situations, these rules do not provide for straightforward administration. Corporate fiduciaries must grapple with this uncertainty and develop internal policies on how to apply the final regulations until further guidance is provided

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