Steve Leimberg's Income Tax Planning Email Newsletter - Archive Message #73

Date: 14-Jul-14
From: Steve Leimberg's Income Tax Planning Newsletter
Subject: Austin W. Bramwell, Elisabeth Madden Mullen and Sharon L. Klein on How to Allocate "Bundled" Fees

"Trusts and estates can save tax under three federal tax regimes to the extent that their expenses can be deducted in the computation adjusted gross income or 'AGI.' Recently, the Treasury Department and the Internal Revenue Service published final regulations that define the class of deductions allowed in computing a trust's or estate's AGI, as opposed to being potentially classified as 'miscellaneous itemized deductions' subject to the 2%-of-AGI floor under section 67 (a) of the Internal Revenue Code. Among other rules, the regulations provide that if a 'bundled' fee is attributable both to costs that are subject to the 2%-of-AGI floor and costs that are not, the fee must be allocated between the two.

If, however, the bundled fee is not computed on an hourly basis, only the investment management component of the fee is subject to the 2% floor. To allocate a bundled fee between costs subject to the 2% floor and costs that are not, 'any reasonable method' may be used, including determining the portion of a bundled fee allocable to investment advice. It remains unclear what methods for

making an allocation would be considered reasonable. This commentary suggests several methods that fiduciaries may wish to consider."

On May 9, 2014, the IRS published final regulations regarding which costs incurred by trusts and estates are fully deductible under Internal Revenue Code Section 67(e). Now, **Austin Bramwell**, **Elisabeth Madden Mullen** and **Sharon Klein** provide members with important commentary that contains a number of methods that fiduciaries may wish to consider in allocating non-hourly bundled fees.

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The views expressed herein are the authors' own.

Members should note that a new **60 Second Planner** by **Bob Keebler** was recently posted to the **LISI** homepage. In his commentary, Bob notes that as part of its attempt to implement the Bobrow decision, the IRS has withdrawn a proposed amendment to Regulation Section 1.408-4(b)(4)(ii) that would have allowed multiple IRA 60-day rollovers in one year. You don't need any special equipment - just click on this link.

Now, here is Austin, Elisabeth and Sharon's commentary:

EXECUTIVE SUMMARY:

Trusts and estates can save tax under three federal tax regimes to the extent that their expenses can be deducted in the computation adjusted gross income or "AGI." Recently, the Treasury Department and the Internal Revenue Service ("IRS") published final regulations that define the class of deductions allowed in computing a trust's or estate's AGI, as opposed to being potentially classified as "miscellaneous itemized deductions" subject to the 2%-of-AGI floor under section 67(a) of the Internal Revenue Code of 1986 (the "Code" or "IRC"). Among other rules, the regulations provide that if a "bundled" fee is attributable both to costs that are subject to the 2%-of-AGI floor and costs that are not, the fee must be allocated between the two.

If, however, the bundled fee is not computed on an hourly basis, only the investment management component of the fee is subject to the 2% floor. To allocate a bundled fee between costs subject to the 2% floor and costs that are not, "any reasonable method" may be used, including determining the portion of a bundled fee allocable to investment advice. It remains unclear what methods for making an allocation would be considered reasonable. This commentary suggests several methods that fiduciaries may wish to consider.

FACTS:

Overview

Section 67 of the Code, enacted as part of the Tax Reform Act of 1986, defined a new class of deductions, known as "miscellaneous itemized deductions," that are only allowed to individuals to the extent that those deductions exceed, in the aggregate, 2% of AGI. Miscellaneous itemized deductions of trusts and estates are subject to the same limitation.[i] So that the limitation can be computed for trusts and estates, section 67 also included, for the first time,[ii] a definition of AGI for trusts and estates.

Discussion of section 67 naturally tends to focus on the class of deductions that are "miscellaneous itemized deductions" subject to the 2%-of-AGI floor. For trusts and estates, however, the definition of AGI, found in section 67(e) of the Code, is perhaps more important. In particular, the ability of a trust or estate to claim a deduction in computing AGI has favorable consequences under three different tax regimes:

"Normal" income taxes. First, a reduction of AGI reduces the amount of the 2%-of-AGI floor, which in turn increases the amount of allowable miscellaneous itemized deductions. For example, suppose that a trust's gross income is $100,000 and its deductions for the year are $50,000. If none of the deductions is allowed in computing AGI, [iii] then the 2%-of-AGI floor will be equal to $100,000 times 2%, or $2,000. If the deductions are also classified as "miscellaneous itemized deductions" as defined in section 67(b) of the Code, then allowable deductions will be the amount by which $50,000 exceeds the $2,000 floor, or $48,000. Taxable income will be equal to gross income of $100,000 less $48,000 of allowable deductions, or $52,000.

By contrast, if 80%, or $40,000 of the deductions is allowed in computing AGI, then AGI will be $60,000 (i.e., $100,000 of gross income, less the $40,000 of deductions allowed in computing AGI). The 2%-of-AGI floor will be equal to 2% times $60,000, or $1,200. If the $10,000 of remaining deductions *not* allowed in computing AGI consists of miscellaneous itemized deductions, then the allowable miscellaneous itemized deductions will be $8,800, which is the

amount by which $10,000 exceeds the $1,200 floor. The total allowable deductions will be equal to $48,800, or the $40,000 allowed in computing AGI plus the $8,800 of allowable miscellaneous itemized deductions. The taxable income of the trust will be equal to $100,000 of gross income less $48,800 of allowable deductions, or $51,200.

Alternative minimum tax. Miscellaneous itemized deductions are disallowed entirely for alternative minimum tax ("AMT") purposes under 56(b)(1)(A)(i) of the Code. Under section 63(d) of the Code, however, a deduction allowed in computing AGI automatically escapes classification as a "miscellaneous itemized deduction." Thus, if a deduction would otherwise be classified as "miscellaneous," the AMT disallowance can be avoided to the extent that the deduction can instead be taken into account in computing AGI.

Note that if a trust or estate is subject to AMT, the 2%-of-AGI floor will not affect overall tax liability. Miscellaneous itemized deductions in that case will not merely be limited but fully disallowed. Thus, for many trusts and estates, the AMT impact of taking deductions that would otherwise be classified as "miscellaneous" into account when computing AGI will overwhelm the normal income tax impact.

Net investment income tax. The 3.8% tax under section 1411(a)(2) of the Code applies to the lesser of (i) a trust's or estate's undistributed net investment income or (ii) the difference between AGI and the highest tax bracket threshold. As the tax under the second prong is a function of the amount of AGI, a trust or estate can potentially reduce net investment income tax by reducing AGI.

For the foregoing reasons, it is crucial for fiduciaries and their advisors to understand how AGI is derived in the case of a trust or estate. As noted, the definition of AGI in the case of a trust or estate is set forth in section 67(e) of the Code. Under that section, four categories of deductions are allowed in computing a trust's or estate's AGI:

- Deductions that would be allowed in computing an individual's AGI under section 62(a) of the Code, such as deductions attributable to a trade or business or to property held for the production of rents or royalties;

- Deductions for distributions to beneficiaries under sections 651 or 661 of the Code[iv];

- Personal exemptions under section 642(b) of the Code[v]; and

- Deductions "for costs which are paid or incurred in connection with the administration of an estate or trust and which would not have been incurred if the property were not held in such trust or estate."

If a deduction is not allowed in computing AGI, that does not necessarily mean that it is subject to the 2%-of-AGI floor. On the contrary, a deduction not allowed in computing AGI is only subject to the 2%-of-AGI floor if it also meets the definition of "miscellaneous itemized deduction" under section 67(b) of the Code. Section 67(b) provides a "negative" or "apophatic" definition of miscellaneous itemized deductions: an itemized deduction (i.e., a deduction not allowed in computing AGI, other than a personal exemption) *is* a miscellaneous itemized deduction if it is *not* described in one of twelve categories of deductions listed in subsections 67(b)(1)-(12) of the Code.

For example, deductions for interest expenses under section 163 of the Code, and for certain taxes under 164 of the Code, even if not allowed in computing AGI, *are* included on the section 67(b) list of *non*-miscellaneous deductions, and, therefore, are *not* subject to the 2%-of-AGI floor. By contrast, deductions under section 212 of the Code are *not* included on the section 67(b) list of *non*-miscellaneous deductions and, therefore, are classified as "miscellaneous" deductions to the extent not allowed in computing AGI.

Unfortunately, section 212 of the Code is the section that, under Treas. Reg. § 1.212-1(i), generally permits deductions for expenses, such as fiduciary commissions, incurred in connection with the administration of an estate or trust.[vi] Thus, trust or estate administration expenses, if not allowed in computing AGI under sections 62(a) or 67(e) of the Code, will, by default, be classified as miscellaneous itemized deductions subject to the 2%-of-AGI floor. Knowing how deductions under section 212 of the Code can escape that classification and instead be allowed for purposes of computing AGI is a crucial component of income tax planning for trusts and estates.

The Two Distinct Income Tax Effects of Section 67(e)

Classification of an otherwise "miscellaneous" itemized deduction as a deduction allowed in computing AGI has two effects. The first, more obvious effect, and the one emphasized in the regulations, case law and most commentary, is that the aggregate amount of miscellaneous itemized deductions subject to the 2%-of-AGI floor is reduced. The second, less obvious but perhaps more important effect is that AGI is reduced, and, with it, the 2%-of-AGI floor.

The two effects are illustrated in the following table, which shows the amount of taxable income of an estate or trust if gross income is $100,000, deductions are $50,000, and all deductions would be classified as "miscellaneous" if not allowed in AGI[vii]:

Gross deductions	% deductions allowed in AGI	$ amount deductions allowed in AGI	$ amount deductions subject to 2%-of-AGI floor	AGI	2%-of-AGI threshold	Allowable deductions	Taxable income
$50,000	0%	$0	$50,000	$100,000	$2,000	$48,000	$52,000
$50,000	20%	$10,000	$40,000	$90,000	$1,800	$48,200	$51,800
$50,000	40%	$20,000	$30,000	$80,000	$1,600	$48,400	$51,600
$50,000	60%	$30,000	$20,000	$70,000	$1,400	$48,600	$51,400
$50,000	80%	$40,000	$10,000	$60,000	$1,200	$48,800	$51,200
$50,000	97.959%	$48,980	$1,020	$51,020	$1,020	$48,980	$51,020
$50,000	98%	$49,000	$1,000	$51,000	$1,020	$49,000	$51,000
$50,000	99%	$49,500	$500	$50,500	$1,010	$49,500	$50,500
$50,000	100%	$50,000	$0	$50,000	$1,000	$50,000	$50,000

As shown in the black rows, if aggregate miscellaneous itemized deductions exceed the 2%-of-AGI floor, then, for every dollar of an otherwise "miscellaneous" deduction allowed in computing AGI, allowable deductions increase by $0.02. By contrast, as shown in the green rows, if aggregate miscellaneous itemized deductions are *lower* than the 2%-of-AGI floor, then, for every dollar of an otherwise "miscellaneous" deduction allowed in computing AGI, allowable deductions increase by one dollar.

Note that the dollar-for-dollar reduction is only available if miscellaneous itemized deductions are less than the 2%-of-AGI floor. In the table above, that threshold is not reached until miscellaneous itemized deductions are $1,020 or less and 97.959% of deductions are allowed in computing AGI.

Given the very low threshold, whether a deduction is subject to the 2%-of-AGI floor or not, rarely makes a difference for normal income tax purposes. (It can, on the other hand, make a significant difference for AMT purposes.) What "really" matters, rather, is whether the deduction reduces AGI.

The Final Regulations

Recently, the IRS published final regulations, effective for tax years beginning after May 9, 2014, that define the class of costs which, if paid or incurred in connection with the administration of an estate or trust, "would not have been incurred if the property were not held in such trust or estate" and, therefore, are deductible in computing AGI.[viii] Under these regulations, which adopt the test announced in *Knight v. Comm'r*, 552 U.S. 181 (2008), a cost incurred in connection with the administration of a trust or estate will be allowed in computing AGI if it would not "commonly or customarily . . . be incurred by a hypothetical individual holding the same property."

Examples of costs that are *not* commonly or customarily incurred by a hypothetical individual holding the same property, and, therefore, *are* allowed in computing AGI, include:

- Costs relating to estate and generation-skipping transfer tax returns, and fiduciary income tax returns, and the decedent's final individual income tax return;

- Appraisal fees to determine the fair market value of assets as of a decedent's death, to

determine value for purposes of making distributions, or as required to prepare estate or trust tax returns or generation-skipping transfer tax returns;

• Costs incurred in defense of a claim related to the existence, validity, or administration of an estate or trust; and

• Fiduciary expenses, such as probate court fees, fiduciary bond premiums, legal publication costs, costs of obtaining death certificates, and fiduciary accounting costs.

Examples of costs that *are* commonly or customarily incurred by a hypothetical individual holding the same property, and, therefore, if not described in section 62(a) of the Code, are *not* allowed in computing AGI, and, if not also described in section 67(b) of the Code, are miscellaneous itemized deductions subject to the 2%-of-AGI floor, include:

• Costs of ownership of property, such as condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs[ix]; and

• Virtually all investment advisory fees.[x]

"Bundled" fees, such as fiduciary commissions, legal fees and accounting fees, for costs that are subject to the 2%-of-AGI floor are those that are not so subject must be allocated between the two. If a bundled fee, such as the typical fiduciary commission, is not computed by the hour, then only the portion attributable to investment advice is a miscellaneous itemized deduction. The balance of a non-hourly bundled fee (including, for example, any portion attributable to asset custody fees, despite that those are commonly incurred by individuals) is not subject to the 2%-of-AGI floor and should be allowed in computing AGI.

The regulations provide that "any reasonable method" may be used to allocate a bundled fee. Factors that a fiduciary may consider in making a reasonable allocation include:

• The percentage of the value of the corpus that is subject to investment advice;

• Whether a third party advisor would have charged a comparable fee for similar advisory services; and

• The amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to other matters.

In the preamble to the proposed regulations, the IRS requested examples of how a "reasonable allocation" could be made. The IRS claims to have received no response, other than that different allocation methods may be required for different trusts and in different taxable years.[xi]

COMMENT:

The lack of comments received by the IRS on how a fiduciary might make a "reasonable allocation," and the paucity of secondary literature on the topic, suggests that fiduciaries and their advisors are still pondering how, exactly, they will go about making a reasonable allocation of bundled fees, especially fiduciary commissions. As noted, the *less* that can be reasonably allocated to investment advice, the *more* of the fee that can be taken into account in computing AGI, and the lower the potential income tax liability for "normal" income tax, AMT and net investment income tax purposes. Below, we suggest some methods that fiduciaries could consider in allocating non-hourly bundled fees.

As a note of caution, for an allocation to be respected, it must be "reasonable," not just "creative," "clever," or "just might work." Fiduciaries and advisors should make an independent judgment as to whether the methods suggested below are reasonable. Nevertheless, we believe that they are worth considering, depending on the facts of a particular trust or estate.

General Observations

Selection of most favorable method. The final regulations permit a fiduciary to use "any" reasonable method. Thus, it seems that, if there are two or more possible reasonable allocation methods, the fiduciary could choose the method that results in the smallest portion attributable to investment advice.[xii] Further, it does not appear that there is a requirement of consistency across

multiple trusts and estates. Thus, if a fiduciary serves as trustee of two or more trusts, it seems that the trustee could use one reasonable method for one trust, and a different reasonable method for another trust, depending on the facts in each situation.

To be sure, considerable institutional resources may be absorbed in implementing just one reasonable method. Given the potential costs of allocating fees based on just one method, it may not be feasible for a professional fiduciary to compute and compare allocation results under multiple different methods. As a practical matter, therefore, many fiduciaries may rely for the most part on a single method of allocation.

Use of multiple factors. It seems that the final regulations permit a trust or estate to consider more than one factor in allocating a bundled fee. The more factors that can reasonably support the allocation to services other than investment advice, the smaller the portion that may be allocable to that advice.

Suppose, purely for the sake of illustration, that only one half of a trust's portfolio is subject to investment advice and that only one half of the trustee's attention with respect to that portion is devoted to providing investment advice. In that case, the portion of the trustee's annual commission attributable to investment advice would, it seems, be only one quarter. The one quarter is derived by multiplying the commission by the fraction of the portfolio that is subject to investment advice (i.e., one half), and then multiplying again the fraction of the trustee's attention that is devoted to investment advice (i.e., one half). As one half multiplied by one half is one quarter, a full three quarters of the trustee's commission could, perhaps, be deducted from AGI.

Comparison to Other Fees

Comparison to fees charged by investment managers. One fairly straightforward method for computing the portion of a fiduciary's commission attributable to investment advice is to compare the total amount of the commission to the fees that would be charged by an investment advisor for managing the same portfolio. For example, if the trustee was acting as investment advisor only, assume it would charge 1% a year to manage a trust's portfolio, but its annual commission as fiduciary is 1.25%. In that case, at least 20% of the commission (i.e., (1.25% – 1%) / 1.25%) should be allowed in computing AGI.

A possible downside of this method is that it may, compared to other possible methods, cause a larger portion of a fiduciary's commissions to be allocated to investment advice.

Comparison to costs of fiduciary insurance. Another potential method for allocating a non-hourly commission may be to subtract, as unrelated to investment advice, the portion of the commission that consists of compensation for assuming risk of liability. One of the rationales for allowing commissions is that they compensate fiduciaries for assuming a risk of liability.[xiii] As one court put it, commissions are awarded out of "the body of property which the [fiduciaries] must take under administration and in respect of which they assume a risk of personal liability toward persons interested, for their taking, holding and disposition."[xiv] In other words, a fiduciary is compensated out of trust or estate property not just for his, her or its time, but also for assuming a risk of liability.

To shift the risk, a fiduciary could purchase fiduciary liability insurance out of his, her or its personal funds. The net amount earned by the fiduciary would then be equal to the gross commission, less insurance premiums. That net amount is arguably equal to the portion of the fiduciary's commission that consists of compensation for merely performing the fiduciary's functions, as opposed to assuming a risk of liability. As the balance would consist of compensation for assuming risk and would not be not attributable to the provision of services, it should not be attributed to investment advice and should be deductible in computing AGI.

For example, suppose that the trustee commission is $100,000 but it would cost $75,000 to insure the trustee against liability for breach of duty. In that case, only $25,000 of the commission could, at most, be attributable to performance of the trustee's duties, including providing investment advice. The $75,000 balance would be attributable to compensation for assumption of risk and should be allowed in a full as a deduction in computing AGI.

Anecdotal evidence suggests that the premiums charged for adequate fiduciary liability insurance are quite high. (Indeed, they may be nearly equal in many cases to the fiduciary's annual commission.) If hypothetical fiduciary liability insurance premiums could be used to measure the

portion of commissions that are not attributable to investment advice, then all or nearly of the commissions would end up in many cases being deductible in computing AGI. The rule requiring unbundling of "bundled" fees might then seem to have effectively been thwarted. Many fiduciaries may be uncomfortable with a method that produces such apparently overgenerous results.

Comparison to commissions of fiduciaries possessing no special investment skills. In comments submitted to the IRS in response to the proposed regulations, the New York City Bar Association Committee on Trusts, Estates and Surrogate's Courts suggested a safe harbor allocation based on a comparison between the commissions actually paid to a fiduciary and the commissions that would be paid to a fiduciary possessing no special investment skills. In New York, for example, individual trustees are generally entitled to commissions set by statute.[xv] Corporate trustees, by contrast, are entitled to "reasonable commissions" if the principal value exceeds $400,000.[xvi] The rationale for the higher commissions permitted to corporate trustees is that they are presumed to have special investment skills, and, therefore, may be held to a higher standard of prudence. [xvii] Individual trustees, by contrast, will typically delegate investment responsibility to a professional.

Thus, in a state such as New York, which compensates individual and corporate trustees differently, it may be reasonable to limit the portion of a corporate trustee's commission that is attributable to investment advice to the difference between the corporate trustee's commission and the statutory commission that an individual trustee would receive for administering the same trust. Suppose, for example, that a New York corporate trustee's actual commission is $500,000, but an individual trustee's statutory commission would only be $200,000. In that case, only $300,000 should, at most, be attributable to investment advice.

Unfortunately, it may be difficult in many cases to identify the hypothetical commissions that a nonprofessional fiduciary would charge. Only a minority of states award fiduciary commissions under a statutory schedule. In other states, fiduciaries are entitled to compensation that is "reasonable," without reference to a fixed schedule. Adequate data in those states on the commissions typically awarded to nonprofessional trustees may be difficult to obtain.[xviii] Thus, as a practical matter, the method of comparing a trustee's actual commission to the commission that would be charged by a nonprofessional trustee may not be viable.

Comparison to directed trustee's commissions. Another method for allocating commissions may be to compare a trustee's actual commission to the commissions that would be charged by a "directed" trustee that has no power to make investment decisions absent a direction from another person.

For example, suppose that a trustee has full powers to administer a trust, including to custody assets, file tax returns, prepare accounts, make distributions, consider requests for distributions, etc. In addition, the trustee has powers to buy, sell, retain and otherwise invest the trust's portfolio. The trustee could, in that case, compute the difference between the trustee's actual commissions and the commissions that would be charged by a trustee that has all the same powers other than powers to make investments. The difference is arguably equal to the maximum portion of the trustee's commission that is attributable to investment advice. The balance could then be taken as a deduction in computing AGI.[xix]

This method may have much to recommend it. First, it will often be simple to administer. The commissions that would be charged if the trustee was directed could be determined by reference to a corporate trustee's own published rates for serving as a directed trustee. Thus, to compute the portion of commissions allocable to investment advice, the fiduciary could simply compare the actual commissions charged to the commissions that would have been charged under the fiduciary's schedule of rates for directed trusts.

Second, it seems that a comparison to the commissions that would be charged by a directed trustee would produce balanced results. For example, the fees charged by a professional trustee that does not participate in investment decisions might be approximately 35% of the fees charged by a trustee with investment powers. In that case, if the method of comparing actual commissions to directed trustee commissions is adopted, 65% of the commissions would be attributable to investment advice.

In addition, some portion of the forgone 65% is presumably attributable to the increased liability associated with providing investment advice in a *fiduciary* capacity, particularly since professional trustees are held to a higher standard. [xx] The 65% could potentially be reduced by the

percentage determined to be compensation for heightened fiduciary investment responsibility. It is unclear, however, how the percentage attributable to compensation for heightened responsibility would be computed.

Percentage of Portfolio Subject to Investment Advice

Percentage of portfolio directed to be retained. In some cases, the purpose or even the mandate of a trust may be to retain a particular asset, such as a closely held business interest, life insurance, or a residence. To take an extreme example, suppose that a trust instrument directs the trustee that to retain stock of a closely held business regardless of circumstances, the beneficiaries instruct the trustee to follow that mandate, and the trustee accepts releases and indemnities in exchange for doing so. In that case, the trustee may vote the stock, review reports from management, and take steps to ensure that the corporation is being properly managed. The trustee would not, however, make asset allocation decisions, evaluate particular securities, consider different investment strategies, or perform the other tasks typical for an investment advisor. Given that the work performed by the trustee in that case would be unlike that performed by an investment manager, the trustee could potentially take the position that none of the portfolio is subject to investment advice and, therefore, that all of the trustee's commissions should be deducted in computing AGI.

On the other hand, even where, as in foregoing example, the governing instrument forbids the sale of a particular asset, the trustee could still seek court permission to deviate from the terms of the trust. Perhaps the IRS would argue the mere possibility of a deviation causes even an asset that is directed to be retained to become subject to investment advice. Fiduciaries who determine, based on the terms of the governing instrument, that a portion of a trust's or estate's portfolio is not subject to investment advice should be prepared to defend the view that those terms are so restrictive as to render the fiduciary's services unlike those provided by an investment advisor.

Percentage of portfolio consisting of "special assets." Some trusts' portfolios may include "special assets" whose retention falls outside of normal investment review procedures. For example, suppose that a trustee decides to purchase a residence for use by a beneficiary. The purpose of acquiring the residence is not to earn investment returns but to hold property for the beneficiary in a manner that is in keeping with the meaning of the trust instrument, and can also be tax efficient or offer protection from claims of creditors.

In cases such as the foregoing, the trustee acquires a "special asset" based on factors other than those that pertain to earning investment returns and managing investment risk. A third party investment advisor would not normally consider such extraneous factors in constructing an investment portfolio. Consequently, the portion of the portfolio consisting of such "special assets" should not, it seems, be considered to be subject to investment advice. The fraction of the value of the trust consisting of such assets could then be multiplied by the fiduciary commissions to determine the minimum portion that is not allocable to investment advice

Percentage of portfolio invested in accordance with agreement with beneficiaries. Sometimes the investment philosophy of a trust's beneficiaries conflicts with the professional judgment of the trustee. For example, suppose that the beneficiaries of a trust want the trustee to continue to hold an illiquid asset. The trustee may agree to hold it, subject to releases and indemnifications from the beneficiaries. Once such an agreement is reached, the trustee would presumably exclude the asset from the trustee's normal investment review procedures. Consequently, the portion of the portfolio consisting of the retained asset should, it seems, not be considered subject to investment advice. The fraction of the value of the trust with respect to which the fiduciary does not exercise investment discretion could be multiplied by the fiduciary commissions to determine the minimum portion that is not allocable to investment advice.

Amount of Attention Devoted to Investment Matters

Number of officers who are investment professionals. Another method for allocating bundled fees may be to identify the number of officers involved in administering a trust or estate who are investment professionals. For example, one officer might communicate with the beneficiaries, another perform administrative services, another address legal questions, another compute tax, and another prepare accountings. If, in addition, only one officer makes investment decisions, then, arguably, only one-sixth of the commission should be attributable to investment advice.

Of course, it may not always be possible to define officers' roles so neatly, nor does it take into account the actual time spent by each officer, which likely will be not exactly equal. Officers often collaborate, and each may play some role in the ultimate selection of trust investments.

Furthermore, throughout a given year, different officers may be assigned different sets of responsibilities. Consequently, in many cases, it may not be possible as a practical matter to allocate fees based on the number of officers involved in a trust or estate who have investment management responsibility.

Hours devoted to investments. A fiduciary could also direct officers to keep contemporaneous records in order to determine the amount of time devoted to investment decisions versus other matters. The fiduciary could then multiply the fraction of total hours that involve selection of investments by the amount of commissions in order to determine the portion attributable to investment advice. For example, if officers spend a total of 100 hours per year on matters relating to a trust, and ten of those hours are devoted to reviewing and selecting investments, then only one-tenth of the commission would be attributable to investment advice.

To be sure, it may be impractical – and, perhaps, internally unpopular – for an institution to require officers to keep contemporaneous time logs. Maintaining such logs would itself absorb time and resources. Further, the time devoted by an officer to a trust or estate may have elements of both investment advice and other matters, such as tax planning, legal compliance, or communication with beneficiaries. Additionally, the hours spent on investment advice may be allocable to multiple clients simultaneously, in varying proportions, and very difficult to apportion accurately. For these reasons, having officers keep contemporaneous logs may not be a workable method of allocating bundled fees.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

Elisabeth Madden Mullen

Sharon Klein

CITE AS:

LISI Income Tax Planning Newsletter #73, (July 14, 2014)
at http://www.LeimbergServices.com

CITES:

IRC §§ 56(b)(1)(A)(i), 62(a), 63(d), 67; 163, 164, 212, 642(b), 651, 661, 1411(a)(2); Treas. Reg. §§ 1.67-4, 1.212-1(i); *Knight v. Comm'r*, 552 U.S. 181 (2008).

CITATIONS:

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[i] Technically, the limitation is incorporated into the computation of taxable income of trusts and estates under section 641(b) of the Code.

[ii] Prior to the enactment of section 67 of the Code, the concept of AGI was irrelevant to trusts and estates. The original purpose of AGI was to give individuals a choice, after computing all "above-the-line" deductions (i.e., deductions allowed in computing AGI), between tallying itemized deductions or simply claiming the "standard" deduction. The

standard deduction, however, is not available to trusts and estates. IRC § 63(c)(6)(D). Nor are trusts and estates typically subject to the various AGI-based phase-outs and limitations in the Code. To take two examples, trusts and estates are not subject to the "Pease" limitation on itemized deductions under section 68 of the Code (IRC § 63(e)) or the percentage limitations on the charitable income tax deduction under section 170(b) of the Code.

[iii] In fact, trusts and estates will always be allowed in computing AGI at least a personal exemption under section 642(b) of the Code. IRC § 67(e)(2).

[iv] It is worth noting that, if the distribution deduction is limited to distributable net income or "DNI," then an interrelated or "circular" computation will be required to derive AGI. The "circle" is as follows:

> 1. Under section 67(e) of the Code, a trust's or estate's AGI is computed in the same manner as an individual, except that certain deductions, including distribution deductions under sections 651 or 661 of the Code, are allowed at arriving at AGI;
>
> 2. Distribution deductions under sections 651 or 661 of the Code are limited to DNI;
>
> 3. Section 643(a) of the Code defines DNI as taxable income, computed with certain modifications;
>
> 4. Section 63(a) of the Code defines taxable income as gross income less deductions, including allowable miscellaneous itemized deductions;
>
> 5. To compute the allowable miscellaneous itemized deductions, one must compute the 2%-of-AGI floor;
>
> 6. To compute the 2%-of-AGI floor, one must compute a trust's or estate's AGI;
>
> 7. Under section 67(e) of the Code, a trust's or estate's AGI is computed in the same manner as an individual, except that certain deductions, including distribution deductions under sections 651 or 661 of the Code, are allowed at arriving at AGI . . .

[v] In contrast to trusts and estates, individuals are not allowed a personal exemption in computing AGI.

[vi] Sections 212(1)-(2) grant a deduction for expenses ordinarily and necessarily incurred in connection with the production or collection of income, or the management, conservation or maintenance of property held for the production of income. In fact, many administration expenses of trusts or estates, such as accounting expenses, are not related to either category. Nevertheless, under long-standing regulations, section 212 is the section of the Code under which many typical administration expenses can be deducted.

[vii] In fact, at least the personal exemption under section 642(b) of the Code would be allowed in computing AGI.

[viii] Treas. Reg. § 1.67-4.

[ix] Many ownership costs that would be denied as deductions to individuals as personal, family or living costs under section 262 of the Code are permitted to trusts and estates under section 212 of the Code.

[x] Treas. Reg. § 1.67-4(b)(4), adopting a proviso from the holding of *Knight*, provides that "certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2–percent floor." However, it is unclear what such incremental costs would be.

[xi] In fact, as discussed below, the New York City Bar Association submitted comments suggesting that a reasonable allocation could be made by comparing the commissions of a fiduciary lacking special investment skills to the commissions of a fiduciary possessing special investment skills.

[xii] *Cf. Esmark, Inc. v. Comm'r*, 90 T.C. 171, 196 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989) (approving taxpayer's choice of "the path expected to result in the least tax").

[xiii] See, e.g., *Matter of Estate of Passuello*, 184 A.D.2d 108, 591 N.Y.S.2d 542 (3d Dep't 1992); *Matter of LoBono*, NYLJ, Mar. 21, 1985, at 15, col. 5 (Sur. Ct. Queens County; *Matter of Tucker*, 75 Misc. 2d 318, 347 N.Y.S.2d 845 (Sur. Ct. New York County 1973).[xiv] *Matter of Tucker*, 75 Misc. 2d 318, 347 N.Y.S.2d 845 (Sur. Ct. New York County 1973).

[xv] New York Surrogate's Court Procedure Act 2309.

[xvi] New York Surrogate's Court Procedure Act 2312.

[xvii] *See*, *e.g.*, New York's Estates, Powers and Trusts Law 11-2.3(b)(6).

[xviii] Perhaps fiduciaries in states outside of New York could use New York's statutory commissions for individual fiduciaries to determine what would hypothetically be charged by nonprofessional trustees even outside of New York. That assumes, however, that state differences in the market for fiduciary services, and the standards to which fiduciaries are held, can safely be ignored.

[xix] In some states, it is unclear whether a trustee can be "directed" without risk of liability for investment decisions. *Cf. Matter of Rivas*, 30 Misc. 3d 1207(A) (Surr. Ct. Monroe Co. 2011) *with Estate of Rubin*, 143 Misc. 2d 303 (N.Y. Sur. Ct. Nassau Co. 1989), aff'd, 570 N.Y.S.2d 996 (App. Div. 1991). If a trust is administered in the laws of such a state, a comparison to the fees charged by a hypothetical "directed" trustee should, it seems, assume that the hypothetical trust was governed by the laws of a state that permits directed trustees to be exonerated from liability.

[xx] *See*, *e.g.*, New York's Estates, Powers and Trusts Law 11-2.3(b)(6).