

FINAL REGULATIONS FOR COSTS PAID OR INCURRED BY ESTATES OR NON-GRANTOR TRUSTS

On May 9, 2014, the Internal Revenue Service (“IRS”) issued final regulations (1.67-4) regarding which costs paid or incurred by estates or non-grantor trusts are subject to the 2% floor for miscellaneous itemized deductions. The final regulations only made a few modest changes to the proposed regulations issued in 2007.

In General.

Under Section 67(e) of the Internal Revenue Code of 1986, as amended (“Code”), an exception is provided to the 2% floor on miscellaneous itemized deductions that are paid or incurred regarding the administration of an estate or a non-grantor trust and that would not have been incurred if the property were not held in such estate or trust. *A cost is subject to the 2% floor to the extent that it is included in the definition of miscellaneous itemized deductions under Code Section 67(b), is incurred by the estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property.*

Commonly or Customarily Incurred.

In analyzing a cost to determine whether it is commonly or customarily would be incurred by a hypothetical individual owning the same property, *it is the type of the product or service rendered to the estate or non-grantor trust in exchange for the cost that is determinative.*

For example, costs that are incurred commonly or customarily by individuals include costs incurred in 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.

Ownership Costs.

Ownership costs are costs that are chargeable to or incurred by the owner or property simply by reason of being the property's owner. Accordingly, *ownership costs are commonly or customarily incurred by a hypothetical individual owner of such property.* Such ownership costs include, but are not limited to, partnership costs deemed to be passed through to and reportable by a partner if these costs are defined as miscellaneous itemized deductions pursuant to Code Section 67(b), condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs. However, the final regulations state that such ownership costs may be fully deductible under other Code sections.

Tax Preparation Fees.

Costs relating to all estate and generation-skipping transfer ("GST") tax returns, fiduciary income tax returns and the decedent's final individual income tax returns are *not subject to the 2% floor.*

However, the costs of preparing all other tax returns (e.g., *gift tax returns*) are costs commonly and customarily incurred by individuals and *are subject to the 2% floor.*

Investment Advisory Fees.

Fees for investment advice (including any related services that would be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and therefore ***are subject to the 2% floor.***

Nevertheless, ***certain incremental costs of investment advice beyond that amount that would normally be charged to an individual investor are not subject to the 2% floor.*** Such an incremental cost is a special, additional charge that is added solely because the investment advice is rendered to an estate or trust rather than to an individual or attributable to an unusual investment objective or the need for specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen). ***The portion of the investment advisory fees not subject to the 2% floor*** per the prior sentence ***is limited to the amount of those fees, if any, that exceeds the fees normally charged to an individual investor.***

Appraisal Fees.

Appraisal fees incurred by an estate or a non-grantor trust to determine the fair market value of assets as of the decedent's date of death (or the alternate valuation date), to determine value for purposes of making distributions, or as otherwise required to properly prepare the estate's or trust's tax returns, or a GST tax return, are not incurred commonly or customarily and thus ***are not subject to the 2% floor.***

However, ***the cost of appraisals for other purposes (e.g., insurance)*** is commonly or customarily incurred by individuals and ***is subject to the 2% floor.***

Certain Fiduciary Expenses.

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 *are not subject to the 2% floor.*

Bundled Fees.

If an estate or non-grantor trust pays a single fee, commission or other expense (e.g., fiduciary's commission), attorney's fee or accountant's fee) for both costs that are subject to the 2% floor and costs (more than a de minimis amount) that are not subject to the 2% floor, then, except to the extent provided by future IRS published guidance, the single fee, commission or other expenses (*"bundled fee"*) *must be allocated between the costs that are subject to the 2% floor and those that are not.*

If a bundled fee is not computed on an hourly basis, only the portion of that fee is attributable to investment advice is subject to the 2% floor, while the remaining portion is not subject to that floor.

Out-of-pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee. In addition, payments made from the bundled fee to third parties that would have been subject to the 2% floor if they had been paid directly by the estate or non-grantor trust are subject to the 2% floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee for services rendered to the estate or non-grantor trust that are commonly or customarily incurred by an individual.

Any reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2% floor and those costs that are not subject to that floor, including the allocation of a fiduciary commission that is a bundled fee to investment advice. Factors that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus 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 dealings with beneficiaries and distribution decisions and other fiduciary functions. The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2% floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.

Effective Date.

The final regulations apply to taxable years beginning on or after May 9, 2014.