

May 23, 2008

The Honorable Douglas H. Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

The Honorable Donald L. Korb  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Mr. William P. O'Shea  
Associate Chief Counsel (Passthroughs  
and Special Industries)  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

HAND DELIVERED: Courier's Desk, CC:PA:LPD:PR

RE: [Notice 2008-32](#) and Proposed Regulations ([REG-128224-06](#)) Regarding Guidance on Which Administrative Costs Incurred by Estates or Non-grantor Trusts Are Allowable in Arriving at Adjusted Gross Income and Which Costs are Subject to the 2-Percent Floor on Miscellaneous Itemized Deductions Under Section 67(a)

Dear Messrs. Shulman, Korb, and O'Shea:

The American Institute of Certified Public Accountants (AICPA) submits these comments in response to Notice 2008-32<sup>1</sup>, REG-128224-06<sup>2</sup>, and the Supreme Court's opinion in *Knight*.<sup>3</sup> We are also providing suggestions for matters to be addressed in future regulations concerning a) which costs incurred by estates and non-grantor trusts are fully deductible in arriving at adjusted gross income under section 67(e) and b) which costs incurred by estates and non-grantor trusts are subject to the 2-percent adjusted gross income floor for miscellaneous itemized deductions under section 67(a).

The AICPA is the national professional organization of Certified Public Accountants comprised of approximately 350,000 members. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

<sup>1</sup> Notice 2008-32, 2008-11 I.R.B. 593.

<sup>2</sup> REG-128224-06, 2007-36 I.R.B. 551 (July 27, 2007).

<sup>3</sup> *Knight v. Commissioner*, 128 S. Ct. 782 (2008).

Our comments generally refer to fiduciaries and trustees throughout. But our analysis applies equally to executors. We respectfully request the following:

1. Proposed regulation section 1.67-4 should be withdrawn in its entirety because it is based on the Second Circuit's interpretation in *Rudkin*,<sup>4</sup> which the Supreme Court rejected in *Knight*.<sup>5</sup>
2. The Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") should issue new proposed regulations, rather than final regulations, to allow public input and comments on the next approach to regulations in this important area.
3. When the final regulations under section 67(e) are issued, they should be effective no sooner than tax years beginning after the date that the final regulations are issued. We believe that an effective date during the middle of a tax year would be burdensome, particularly if the regulations require trustees to unbundle single fees, commissions, or other expenses or conduct surveys on common investor expenses. Trustees need sufficient time to perform the substantial recordkeeping and gather the documentation, if available, needed to meet the high burden of proof required under the *Knight* interpretation. The final regulations should not be effective for the 2008 tax year because the earliest they could be issued would be more than half way through the year. Thus, the provisions in Notice 2008-32 should be extended to cover tax returns for 2008 and for any tax year beginning prior to the issuance of final regulations so that fiduciaries will have time after the final regulations are issued to put processes in place to comply with them.
4. The next set of regulations should provide guidance on the meaning of "commonly incurred" as requested in our earlier comments, which contained 15 examples, submitted to you on February 8, 2008 <http://tax.aicpa.org/Resources/Trust+Estate+and+Gift/Trusts/AICPA+Comments+on+Estate+and+Trust+Administration+Costs+After+Knight.htm>. (See attached). We also ask you to consider our request from prior comments submitted October 8, 2007 before the Supreme Court's decision in *Knight* that if the regulations make a list of which costs are subject to the 2-percent floor and which costs are not, the IRS provide the basis upon which the classifications are made. <http://tax.aicpa.org/Resources/Trust+Estate+and+Gift/Regulation+and+Administration/AICPA+Comments+on+Proposed+Section+67%28e%29+Regs+on+Trust+Advisory+Fees.htm>. (See attached). This will assist us in determining the proper classification for those costs that do not appear on either list. Specifically, we request guidance and examples on the treatment of costs for maintaining real and personal property owned by the trust.
5. The next set of regulations should contain no requirement to unbundle trustees' fees and commissions. We believe that there is no basis for unbundling these fees in the legislative history or in any judicial opinion that has addressed this issue, including the Supreme Court's opinion in *Knight*.

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<sup>4</sup> *Rudkin v. Commissioner*, 467 F3d 149 (2d Cir. 2006).

<sup>5</sup> *Id.* at. p. 5-6.

- a. *Contrary to Congressional Intent.* Congress expressly stated that its goal in enacting the 2-percent floor was to reduce “extensive recordkeeping with regard to what commonly are small and personal expenditures:”

The committee believes that the present-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fosters significant complexity. For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the Internal Revenue Service. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions. [Footnote 8: Common taxpayer errors include disregarding the restrictions on home office deductions, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscriptions to widely read publications outlining business information without a sufficient business or investment purpose.]<sup>6</sup>

To require trustees to unbundle their fees is contrary to Congress' purpose in enacting the 2-percent floor as stated above, which was to reduce complexity and recordkeeping. Moreover, it would make the application of the 2-percent floor more onerous for trustees than for individuals, to whom the statute was originally intended to apply.

- b. *Contrary to the Knight Holding.* The Supreme Court expressly agreed with the holdings of *Mellon* and *Scott*, which allowed a full deduction for trustee fees, tax preparation fees, and judicial accountings because they are costs not “commonly incurred” by individuals.<sup>7</sup> Indeed, every other court that has considered this issue has allowed a full deduction for trustee fees.<sup>8</sup>
- c. *Trustees Are Not Necessarily the Same As Investment Advisers.* The *Knight* opinion narrowly addresses the application of the 2-percent floor to “investment advisory fees” only. It does not address the application of the 2-percent floor to trustee fees. Thus, it does not follow from the *Knight* decision that trustees must unbundle the investment portion of their activities. According to the Investment Advisers Act of 1940 and case law, trustees are not investment advisers. Even though they

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<sup>6</sup> H.R. Rep. No. 426, 99<sup>th</sup> Cong., 1<sup>st</sup> Sess., Dec. 7, 1985.

<sup>7</sup> *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001); *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003);

<sup>8</sup> *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), *Rudkin*, *supra* notes 4 and 5.

necessarily perform investment functions as mandated by law, they are not *advising others* as investment advisers under the Investment Advisers Act of 1940 (Act).<sup>9</sup> Rather, trustees invest and manage their *own corpus* according to specific directions in the trust instrument and fifteen strict investment criteria enumerated in the Prudent Investor Act, none of which apply to an individual.

- d. *Cost Prohibitive and Arbitrary.* Trustees do not currently keep time records. Their fees are based primarily on the liability they assume as trustee, the value of the assets they manage and invest, and an overhead allocation. In addition, their fees are often negotiable and tailored to the needs of each unique trust. This may result in a different fee schedule for every trust relationship.

Thomas Wilkins, Chairman, President, and Chief Executive Officer of Trust Company of Oklahoma succinctly elaborated the problems with unbundling trustee fees in his comment letter to Treasury dated March 19, 2008:

Our fees are determined for our overall fiduciary services for non-grantor trusts. We have one schedule of fees that apply to all non-grantor trusts. We have a common staff that provides these services, which includes fiduciary matters, accounting, safekeeping of assets, trust investment management, tax compliance, etc. While we do have members of our staff that concentrate their activities in specialized areas, our fiduciary staff members are very involved in the investment function, our accounting staff are involved in investment and fiduciary matters and our investment personnel, while they concentrate on fiduciary asset management duties, also spend considerable time dealing with clients on fiduciary and other matters. Additionally, each non-grantor trust is unique in that our staff allocates their time in service areas that are indicated for that relationship. One account may require more of an investment emphasis than another otherwise similar account. Many trusts require more pure fiduciary resources and little trust investment resources. None of our accounts would fit a 'normal' benchmark that would permit the 'unbundling' of our fiduciary fees. It is not feasible to have a separate 'unbundling' of fees for each account since we do not keep time records by account for each member of our staff, nor do we allocate our other non-payroll expenses attributable to our various services at each an [Sic] account nor on a function basis. Additionally, our investment function is wholly integrated with our fiduciary function. Our investment management process and decisions are totally focused on our fiduciary

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<sup>9</sup> Investment Advisers Act of 1940, § 202(a)(11)(A), 15 U.S.C. § 80b-2(a)(20); *Selzer v. Bank of Bermuda Ltd.*, 385 F.Supp 415, 420 (S.D.N.Y. 1974) (finding the Advisers Act inapplicable because "the trustee does not advise the trust corpus, which then takes action pursuant to its advice, rather the trustee acts himself as principal").

duties. We do not see a clearly defined 'fiduciary duties' and 'investment duties' that would permit fee unbundling.<sup>10</sup>

Based on Mr. Wilkins' analysis and our experience as advisors, it would be cost prohibitive, if not impossible, for trustees to unbundle their fees in a way they were not bundled in the first place. In short, we do not believe that trustees can reverse engineer their fees in the manner suggested in the proposed regulation.

Nonetheless, if the regulations require unbundling, trustees will likely do one of two things. They will either make a good faith attempt to unbundle, passing significant additional costs to the trust beneficiaries and lowering tax revenues to the government,<sup>11</sup> or they will apply an arbitrary allocation, which will become standard in the industry to avoid price competition. Neither result is productive or desirable. Such regulations may lead to further administrative disputes and litigation.

6. The next set of regulations should clarify which administrative costs are included in the first clause of section 67(e)(1) as costs "incurred in connection with the administration of the estate or trust." Courts have held that trust "administrative costs" are broad enough to include many other expenses besides miscellaneous itemized deductions. Even though these costs may not be subject to the 2-percent floor themselves, the extent to which they are deductible in arriving at adjusted gross income necessarily affects the determination of the 2-percent floor applicable to miscellaneous itemized deductions.

For example, in *Ungerman v. Commissioner*,<sup>12</sup> the Tax Court held that interest paid on the estate's deferred federal estate tax liability under section 6166 qualified as a "a cost paid or incurred in connection with the administration of an estate or trust" even though it was also allowable as a deduction under section 163. As such, the interest was fully deductible in arriving at the trust's alternative minimum taxable income.

Another type of administration expense involves "affected expenses" of common trust funds, partnerships, and other passthrough entities that are reported to an estate or trust under section 67(c).<sup>13</sup> These are expenses "...that, if paid or incurred by an individual, would be deductible, if at all, as miscellaneous itemized deductions as defined in section 67(b)."<sup>14</sup> Examples of such expenses include the cost of audits by Certified Public Accountants, tax preparation fees, legal fees, and regulatory or compliance costs. Temporary Reg. § 1.67-2T(d)(2) provides an example of a common trust fund, which is treated similar to a partnership, reporting \$600 of such affected expenses to a trust. But it does not answer the question how those affected expenses would be treated under section 67(e). Guidance is

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<sup>10</sup> Thomas Wilkins, Chairman, President, and CEO of The Trust Company of Oklahoma, in comment to Treasury in response to Notice 2008-32 (March 19, 2008), 2008 TNT 40-9.

<sup>11</sup> This presumes that the cost of complying with the 2-percent floor will be fully deductible and therefore reduce tax owed the government.

<sup>12</sup> *Ungerman v. Commissioner*, 89 T.C. 1131 (1987).

<sup>13</sup> Temp. Reg. § 1.67-2T(d).

<sup>14</sup> Temp. Reg. § 1.67-2T(i).

needed to determine whether affected expenses of passthrough entities under section 67(c) are “incurred in connection with the administration of an estate or trust” *and*, if so, whether they are “commonly incurred” by individuals with the same property as the trust.

There are likely numerous other administrative costs included in the first clause of section 67(e)(1) that are deductible under section 212, as well as other sections of the Internal Revenue Code. For example, state income taxes are ordinary and necessary administration costs paid in connection with the management, conservation, and maintenance of property held for the production of income under section 212, even though they are also deductible under section 164. We request that the next set of regulations provide guidance and examples on such administrative costs, including those deductible under sections besides section 212, that are included in the first clause of section 67(e)(1) and that reduce the estate or trust's adjusted gross income for purposes of determining the 2-percent floor on miscellaneous itemized deductions.

7. In response to the request by the IRS and Treasury Department in Notice 2008-32 for safe harbors based on “reasonable estimates of the percentages” and the “value of assets,” and to avoid hair-splitting, complexity, and the onerous recordkeeping burdens mandated by the Supreme Court's interpretation of the statute in *Knight*, we recommend the following safe harbors:

- a. All administration expenses of small estates and trusts, including all investment advisory fees, should be fully deductible under section 67(e) and not subject to the 2-percent floor because these administrative expenses would not be commonly incurred by an individual with the same size portfolio. Small estates and trusts might include, for example, those with assets less than a specified number, such as the greater of: a) \$3,500,000; or b) the current applicable exclusion amount under section 2010(c).

Small estates and trusts could also be based on size of gross income. For example, estates and trusts with gross income less than \$100,000 would be exempt from the 2-percent floor. From a practical standpoint, these small estates and trusts can least afford the cost of complying with the recordkeeping burdens, and they would likely be forced to subject all their administrative costs to the 2-percent floor to avoid a lengthy administrative or judicial battle.

In addition, because these small trusts are more likely to invest in mutual funds,<sup>15</sup> which do not charge a separate fee, the amount of tax revenue to be gained from subjecting small trusts to the 2-percent floor is *de minimis*. And if a small trust does hire an investment adviser rather than investing in mutual funds, the investment

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<sup>15</sup> UNIFORM PRUDENT INVESTOR ACT § 3, cmt. (“It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.”)

advisory expenses should satisfy the test of not being commonly incurred by similarly situated individuals because individuals with such small portfolios do not commonly hire investment advisers.

And finally, it is unlikely that grantors will create multiple small trusts to avoid the 2-percent limitation. IRC section 643(f) already aggregates multiple trusts created with substantially the same grantors, beneficiaries, and purposes. And the added cost of administering multiple small trusts would outweigh any benefit of avoiding the 2-percent floor.

- b. Costs for preparing a fiduciary income return should be fully deductible under section 67(e) and not subject to the 2-percent floor, based on the holdings of every court that has considered this issue and the prior proposed regulations.
  - c. Costs for trust legal and accounting services should be fully deductible under section 67(e) and not subject to the 2-percent floor. The majority of these fees necessarily relate to matters that do not apply to individuals.
  - d. If single fees must be unbundled, then the administrative costs incurred to unbundle them and document which costs are "extra, special, or incremental" should be specifically recognized as fully deductible under section 67(e) and not subject to the 2-percent floor because individuals do not have a similar requirement.
  - e. Appraisal fees should be fully deductible under section 67(e) and not subject to the 2-percent floor because in most cases the trustee is required to incur these costs to prepare fiduciary accountings for the beneficiaries, determine the amount of a unitrust payment, sever or modify a trust, accept substitute assets from the holder of an administrative power under section 675, and in a number of other situations that do not apply to individuals. The rare instances where it might be arguable that an appraisal is subject to the 2-percent limit would not justify the expense of having to analyze the nature and purpose of every appraisal.
  - f. All court imposed costs and fees should be fully deductible under section 67(e) and not subject to the 2-percent floor.
8. We believe that fiduciary fees should be fully deductible and not subject to the 2-percent floor. If, however, the next set of regulations requires trustees to unbundle single fees, we recommend that both of the following safe harbors be adopted.
- a. If the trustee has a fee schedule that the trustee charges if the trustee does not provide investment advisory services, the amount of the trustee fee based on that schedule is fully deductible and not subject to the 2-percent floor. Any excess trustee fee paid or incurred would be subject to the 2-percent floor unless the trustee can show that all or part of this excess amount would not be commonly incurred by individuals.

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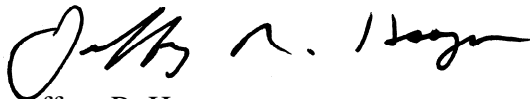
- b. If the trustee does not have a fee schedule as described above, the amount of the trustee fee equal to the greater of: a) 1 ½ percent of fair market value of the assets under management (or some other percentage or amount to be specified in the regulations); or b) the statutory or prevailing rate in the locale, should be fully deductible and not subject to the 2-percent floor. Any excess trustee fee would be subject to the 2-percent floor, unless the trustee can show that all or part of this excess amount would not be commonly incurred by individuals.

We believe that safe harbors such as these will make the Supreme Court's interpretation of a difficult statute somewhat easier for trustees to comply with and for the IRS to administer. It will also help ensure that any extraordinary fees incurred by an estate or trust are fully deductible as long as the trustee can show they would not have been commonly incurred by individuals.

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We thank you for the opportunity to present our comments and welcome the opportunity to discuss them further with you. Please feel free to contact me at (212) 773-2858, or [jeffrey.hoops@ey.com](mailto:jeffrey.hoops@ey.com); Justin P. Ransome, Chair of the AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at (202) 521-1520, or [justin.ransome@gt.com](mailto:justin.ransome@gt.com); or Eileen R. Sherr, AICPA Technical Manager, at (202) 434-9256, or [esherr@aicpa.org](mailto:esherr@aicpa.org), to discuss the above comments or if you require any additional information.

Sincerely,



Jeffrey R. Hoops  
Chair, AICPA Tax Executive Committee

cc: Mr. Eric Solomon, Assistant Secretary for Tax Policy, Treasury Department  
Ms. Catherine Hughes, Attorney Advisor, Treasury Department  
Ms. Jennifer N. Keeney, Attorney, Office of Associate Chief Counsel for Passthroughs and Special Industries, IRS