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May 27, 2008

(via U.S. Mail and [notice.comments@irs.counsel.treas.gov](mailto:notice.comments@irs.counsel.treas.gov))

Internal Revenue Service  
 CC:PA:LPD:PR (Notice 2008-32)  
 Room 5203  
 P.O. Box 7604  
 Ben Franklin Station  
 Washington, DC 20224

Re: Comments of the American College of Trust and Estate Counsel--  
 Proposed Regulations under Section 67(e) of the Internal Revenue Code

Dear Sir or Madam:

I am the President of The American College of Trust and Estate Counsel (the "College"), a professional association of over 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities.

This submission constitutes the response of the College to your request for public comment concerning proposed regulations under Section 67(e) of the Internal Revenue Code ("Code"), which includes in particular Proposed Treasury Regulations Section 1.67-4. The College understands that before the proposed regulations are issued in final form, they will be modified to conform to the United States Supreme Court decision in *Knight v. Commissioner*.<sup>1</sup> The College views the proposed regulations as a serious and studied attempt to provide guidance to this area. We have identified, however, some significant aspects to the proposed regulations, as we believe they should be modified taking the *Knight* case into account, which we believe are problematic, along with suggestions for their resolution.

<sup>1</sup> 552 U.S. \_\_\_\_\_ (2008), 128 S. Ct. 782 (2008)(United States Supreme Court Docket No. 06-1286).

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## Background

On July 27, 2007, the Treasury issued Proposed Treasury Regulation §1.67-4 (the “Proposed Regulations”) interpreting Section 67(e) of the Code concerning limitations on deductibility of miscellaneous itemized expenses for income tax purposes by non-grantor trusts<sup>2</sup> and decedents’ estates.<sup>3</sup> The Proposed Regulations were issued prior to the U.S. Supreme Court decision in *Knight v. Commissioner*.<sup>4</sup> The Proposed Regulations adopted in large measure the test articulated by the Second Circuit in *Rudkin v. Commissioner*<sup>5</sup> which construed Section 67(e) as excepting from the application of the two percent floor on miscellaneous itemized deductions set forth in Section 67(a) (the “Two Percent Floor”) only those costs incurred by an estate or non-grantor trust that “could not have been incurred if the property were held by an individual.” The U.S. Supreme Court in *Knight* expressly rejected the *Rudkin* interpretation of Section 67(e), and instead adopted the interpretation of the Fourth and Federal Circuits in *Scott v. U.S.*<sup>6</sup> and *Mellon Bank, N.A. v. U.S.*,<sup>7</sup> respectively, that costs incurred by non-grantor trusts and estates escape application of the Two Percent Floor if those costs are ones that would not “commonly” or “customarily” be incurred by individuals.

In Notice 2008-32,<sup>8</sup> the Internal Revenue Service (“IRS” or “Service”), announced that the IRS and Treasury expect to issue final regulations consistent with the U.S. Supreme Court’s holding in *Knight*. Notice 2008-32 also announced that the final regulations would address the issue raised when a non-grantor trust or estate pays a single fee, referred to as a “Bundled Fiduciary Fee,” for costs incurred by a fiduciary, some of which under the Proposed Regulations would be subject to the Two Percent Floor and some of which would be fully deductible without regard to the Two Percent Floor. Notice 2008-32 also announced that the final regulations may include safe harbors for determining the allocation of a Bundled Fiduciary Fee between costs subject to the Two Percent Floor and those that are not. Finally, the Notice requested comments, to be submitted by May 27, 2008, regarding:

- a. Whether safe harbors would be helpful.
- b. How such safe harbors should be formulated.

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<sup>2</sup> A grantor trust is one the income, deductions and credits against tax of which are attributed under section 671 of the Code to the trust’s grantor (or in some cases to the trust’s beneficiary who was not the trust’s grantor). A non-grantor trust is one of which none of the income, deductions or credits against tax is attributed under that section to the grantor (or a trust beneficiary).

<sup>3</sup> Section 67 Limitations on Estates and Trusts, REG-128224-06, 72 Fed. Reg. 41243 (July 27,2007).

<sup>4</sup> 552 U.S. \_\_\_\_\_ (2008), 128 S. Ct. 782 (2008)(United States Supreme Court Docket No. 06-1286).

<sup>5</sup> 467 F.3d 149 (2<sup>nd</sup> Cir. 2006).

<sup>6</sup> 328 F.3d 132 (4<sup>th</sup> Cir. 2003).

<sup>7</sup> 265 F.3d 1275 (Fed. Cir. 2001).

<sup>8</sup> 2008-11 I.R.B. 1 (Feb. 27, 2008).

- c. Reasonable estimates of the percentage(s) of the total costs of administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor contained in Code Sec. 67(a) including, but not limited to, costs for investment management and advice.
- d. Whether the safe harbors should reflect the nature or value of the assets in the nongrantor trust or estate, and/or the number of beneficiaries of the nongrantor trust or estate.

The comments below are submitted in response to those requests.

### Overview

As reflected by the several decisions construing Section 67(e), including the recent decision by the Supreme Court of the United States in *Knight*, application of the exception contained in Section 67(e) to the Two Percent Floor could require a case by case determination dependent upon the specific facts involved with respect to the administration expenses incurred by the particular estate or trust. The greater the specificity of the facts that would be taken into consideration, the more demanding the proof will be to establish whether or not an individual would customarily or commonly incur the costs at issue, and the less likely it will be that relevant empirical data would be available to establish the conduct of individuals. We think that such an interpretation of Section 67(e) would require extensive and burdensome record-keeping by fiduciaries and fact specific proof by either or both of the IRS and the fiduciary and likely would result in significant audits by the IRS of fiduciary income tax returns. Examinations requiring such fact specific detail would be time intensive and cause disputes between the IRS and taxpayers that do not currently exist. We believe that one of the key purposes of enacting Section 67 was to alleviate extensive record-keeping with regard to what commonly are small expenditures. The expenditures at issue in the case of a non-grantor trust or an estate that would be covered under Section 67(e) are typically those described in Section 212 consisting of expenses incurred for the production of income. Moreover, the fact that small amounts typically are involved with most estates and trusts presents significant administrative and enforcement problems for the Internal Revenue Service.<sup>9</sup> This background causes us to recommend that the final Treasury Regulations adopt rules that will make the administration of Section 67(e) simpler and reasonable for both the Service and fiduciaries. Although we believe that in certain areas safe harbors may be helpful, these comments focus on suggesting presumptions that may be used to assist in categorizing expenses that are or are not subject to the application of the Two Percent Floor.

### Categorizing Expenses

We begin by categorizing what in our experience are the typical expenses that fiduciaries incur. Although a breakdown of categories could be set forth in several ways,

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<sup>9</sup> H. R. Rep. No. 99-426, p. 109 (1985), as quoted by the Court in *Knight, supra*, note 2, slip opinion at page 2.

we think that the following list of broad categories is reasonably accurate: fiduciary fees; investment advisory fees; custodial fees; legal fees; fiduciary accounting (including record-keeping) fees; court costs; guardian ad litem fees; costs of collecting (or marshalling) property belonging to a decedent or grantor whose assets are held in trust, and the costs of distributing such assets to beneficiaries. Several of the listed fees involve many components of their own. For example, accounting fees (or fees paid to accountants) may include services for preparation of a decedent's pre-death income tax returns, preparation of a decedent's pre-death gift tax returns, preparation of an estate tax return, preparation of fiduciary income tax returns, record-keeping, audits and accountings (often unique to fiduciaries under the laws of some states<sup>10</sup>). Litigation expenses commonly incurred by fiduciaries include matters involving will contests, will and trust construction proceedings, contested accountings, claims against the fiduciary and or advisors to the fiduciary, claims against a decedent, grantor or fiduciary and those held by the fiduciary or by a decedent or grantor against others, and disputes with respect to the tax liability of the estate, trust, decedent or grantor. Certainly, these categories could be broken into even further more discrete components. However, to avoid disputes between the IRS and taxpayers generated by overlapping categories and gaps between categories, we think that any attempt to break down categories of expenses into what might be viewed as their smallest component is not worthwhile. Hence, we conclude that broad categories for allocations of expenses create a preferable manner of proceeding to come up with a more administrable system.

Having identified broad categories of expenses incurred by estates and trusts, one approach that we think ought to be considered in determining those that are subject to application of the Two Percent Floor and those that are not is reflected in the so-called "Hubert" regulations set forth in Treas. Reg. § 20.2056(b)-4. These regulations divide expenses for estate tax purposes into categories of transmission expenses and management expenses. We are unaware that significant disputes have arisen between the IRS and taxpayers under these regulations as to the estate tax treatment of expenses, which may affect the valuation of the estate tax marital deduction. We think using such similar categories for purposes of Section 67(e) not only helps to harmonize the tax treatment of these expenses for estate and income tax purposes but is a rational way to apply the section: if the expense is of a type that would be incurred in connection with the transmission of wealth, it would be deductible without regard to the Two Percent Floor, but if it is a type that would be incurred in connection with the management of wealth, it is subject to the Two Percent Floor. We also think the approach in these regulations is consistent with the rule apparently adopted by the Supreme Court in *Knight* that administration expenses of an estate or trust are subject to the Two Percent Floor if they are of the type commonly or customarily incurred by individuals. In particular, Treas. Reg. § 20.2056(b)-4(d)(1)(ii) provides:

"Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of

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<sup>10</sup> See, e.g., New York Surrogate's Court Procedure Act section 106, prescribing "official" forms for a fiduciary to use in preparing an account. In our experience, this form of accounting is truly sui generis .

collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense. Examples of these expenses could include executor commissions and attorney fees (*except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the assets*), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.” (Emphasis added.)

Under the proposed rule, the type of expenses that are not commonly or customarily incurred by individuals but are by executors of an estate include those for “collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property.” Hence, investment advisory fees, custody fees, brokerage and similar expenses would be subject to the Two Percent Floor because they relate to the management of the property held by the executor unless the executor establishes that some unique factor shows that the expense would not customarily or commonly be incurred by an individual. On the other hand, expenses to marshal or collect a decedent’s assets, costs relating to accounting to beneficiaries or to a court, expenses to prepare trust and estate tax returns, litigation expenses in a will or similar contest would not be subject to the Two Percent Floor unless the IRS establishes some unique factor showing that the expense would customarily or commonly be incurred by an individual. We think it is appropriate to mention specifically that under the Hubert regulations approach suggested above the costs of preparing a decedent’s unfiled income and gift tax returns would be in the nature of transmission expenses and would be deducted without regard to the Two Percent Floor because they relate to actions necessary to collect and transmit property belonging to the decedent.

We think that the approach in the Hubert regulations could also be adapted to the administration of a non-grantor trust. A trustee of a non-grantor trust is holding property that the grantor chose to transmit to beneficiaries over time and thus can be viewed as participating in the transmission of property. This approach draws a distinction between expenses incurred primarily as a result of the trustee holding property to be transmitted to beneficiaries, and expenses incurred to manage the property subject to the fiduciary relationship. Thus, trustees’ compensation (except in the case of a Bundled Fiduciary Fee discussed below), attorneys fees to represent the fiduciary with respect to fulfilling the fiduciary’s obligations as a fiduciary, expenses incurred to distribute property to the beneficiaries, expenses related to fiduciary accountings, court costs and other litigation expenses, expenses incurred in construction proceedings and defending against trust contests, fees related to trust tax returns, and appraisal fees should be deductible without regard to the Two Percent Floor unless the IRS can establish some unique factor showing that the expense would customarily or commonly be incurred by an individual. On the other hand, expenses incurred to manage the assets held in trust, including investment advisory fees, custodial fees, stock brokerage commissions, and maintenance fees, would be subject to the Two Percent Floor unless the taxpayer can establish some unique factor

showing that the expense would not customarily or commonly be incurred by an individual.

### Unbundling of Expenses

As is reflected in Treas. Reg. § 20.2056(b)-4(d)(1)(ii), quoted above, specifically the italicized language, a cost may involve expenses some of which are subject to the Two Percent Floor and some that are not. We anticipate that the most typical case where that would arise are fees paid to a corporate or professional fiduciary, which often involve asset management expenses. Other areas of expense that might also involve expenses both subject to the Two Percent Floor and not subject to the Two Percent Floor may be attorneys' fees, investment advisory fees and accounting costs, although we think that these cases will arise less frequently than with professional fiduciary commissions or fees. Application of the Hubert regulations in this context suggests that such expenses should be unbundled. To avoid undue administrative complexity and burden to the IRS and the taxpayer, we suggest that such unbundling of a fee composed of expenses subject to the Two Percent Floor and expenses not subject to the Two Percent Floor is appropriate only where both components of the fee are not insignificant. To illustrate, even if a portion of an investment advisory fee is attributable to some unique investment goal or special balancing of interests, if such portion is not significant, the entire fee would be subject to the Two Percent Floor. In such case, unbundling would be permitted only if the fiduciary establishes that there was a significant incremental charge for the fee relating to a unique investment goal or balancing. For example, a trustee of a trust required to pay its fiduciary accounting income to a beneficiary may request the investment manager to ensure that the trust produces a reasonable amount of such income. Although the advisor may consider that goal in choosing investments, if the incremental cost of doing that is not more than an insignificant amount of the advisor's compensation, the entire fee would be subject to the Two Percent Floor. A component part of a fee is determined to be insignificant based on its relative value to the fee as a whole.

We think that the following rule with respect to fiduciary fees is appropriate to consider:

A "Bundled Fiduciary Fee" is any fee, commission or other compensation paid to a fiduciary not only for the responsibilities of acting as fiduciary but also for additional services that an individual fiduciary with no special skills would ordinarily hire a professional to provide. Examples of such additional services include investment advisory fees, accounting fees, tax return preparation fees, appraisal fees, brokerage commissions for the sale or purchase of property, and management fees for the professional management of property. If the fiduciary charges a Bundled Fiduciary Fee, the fiduciary must unbundle the fee by making a reasonable allocation of the fee among the significant components of the fee, including each of the services provided in addition to that charged for the responsibilities of acting as a fiduciary. An allocation is presumptively reasonable if it uses as a benchmark the fees charged by the fiduciary to

non-fiduciary accounts for providing the additional services separately, or alternatively uses as a benchmark the fees customarily charged by the fiduciary with respect to its fiduciary accounts solely for acting as fiduciary without providing any additional services. The fiduciary, in either case, must reasonably establish what the fees customarily charged by the fiduciary solely for providing the additional services or solely for acting as a fiduciary without such additional services would be. The portion of a Bundled Fiduciary Fee allocated to the responsibilities of acting as fiduciary shall be deductible without regard to the Two Percent Floor. The portion of the Bundled Fiduciary Fee allocated to each additional service shall be independently analyzed to determine whether it would customarily or commonly be incurred by an individual.

We acknowledge that the determination of the portion of a Bundled Fiduciary Fee that should be allocated to the responsibilities of acting as a fiduciary may not be simple, given the many considerations that can be factored into negotiating a corporate fiduciary's fee, and suggest that this is an area in which a "safe harbor" could be useful. In New York, for example, individual trustees receive certain "statutory" commissions (set forth in section 2309 of the Surrogate's Court Procedure Act ("SCPA")). However, corporate fiduciaries in New York charge "reasonable compensation" for their services as a trustee. Corporate fiduciaries approximately 25 years ago lobbied for this different (reasonable compensation) fees treatment for themselves on the ground that they provide "special skills" in investment, etc. In all cases of which we are aware, corporate fiduciaries in New York on average charge significantly more for their services as trustee than the statutory rates individual trustees receive. We think that one safe harbor that might be used would be to provide that a trustee's commission or fee not in excess of the New York statutory rates under SCPA 2309 for individuals is deductible without regard to the Two Percent Floor but any fee or commission in excess of those rates is presumed subject to the Two Percent Floor except to the extent the fiduciary establishes that the excess is attributable to an expense that is of a type not commonly or customarily incurred by individuals.

We suggest that the standard provided above for defining a Bundled Fiduciary Fee could also be applied to other categories of fees. For example, in the case of attorneys fees, the following rule could apply:

A "Bundled Attorney Fee" is any fee or other compensation paid to an attorney in providing services to the fiduciary related not only to representing the fiduciary in connection with the fiduciary's responsibilities of transmitting wealth to the beneficiaries of an estate or trust, but also for additional services related to representing the fiduciary in connection with the management of the assets held by the fiduciary. An example of attorney fees that relate to the transmission of assets to beneficiaries would include fees paid to an attorney relating to the sale or other disposition of assets if such sale or other disposition is necessary to the administration of the estate or trust, for example, in

order to raise funds to pay estate taxes or to make distributions to beneficiaries. Examples of additional services relating to asset management include addressing landlord-tenant issues, providing advice relating to the investment, preservation or maintenance of assets during the period of estate or trust administration, and providing advice with respect to controlled entities involving the on-going operations and management of those entities. If the attorney charges a single fee for services provided to the fiduciary, the attorney must unbundle the fee by making a reasonable allocation of the fee among the significant components of the fee. If the attorney generates his or her fee by charging for billable time, then the attorney can categorize the time charges based on whether they relate to transmission-type activities or management-type activities to provide the fiduciary with an unbundled fee divided between charges that are not subject to the Two Percent Floor and charges that are subject to the Two Percent Floor. Regardless of how the attorney generates the fee charged to the fiduciary, amounts allocated to activities which are not significant in relation to the total value of the fee would not be required to be unbundled.

#### Suggestion for De Minimis Amounts and Small Estates and Trusts

In addition to the foregoing presumptions and safe harbor suggestions based on categories of expenses, we think it appropriate to adopt a rule that if the expenses for the year of an estate or trust fall under a certain threshold those expenses should be deductible without regard to the Two Percent Floor. We also think it is appropriate to consider exempting certain “small” estates and trusts from the Two Percent Floor rule. We think these rules are appropriate because, unlike individuals, estates and trusts may not choose to have a standard deduction but must “itemize” in order to obtain income tax deductions for expenses.

#### Suggestion for Issuance of Regulations

We appreciate this opportunity to comment on the Proposed Regulations. We also understand the need to provide guidance prior to the end of 2008 on which taxpayers can rely in filing their tax returns for the current tax year. However, we are concerned that the standard articulated in *Knight* is sufficiently distinct from the standard included in the Proposed Regulations that we are not able to formulate a clear picture of the manner in which the IRS or Treasury intend to modify the Proposed Regulations, and cannot effectively respond to this invitation to comment on the Proposed Regulations. For this reason, we suggest that the regulations when issued be issued as Temporary and Proposed Regulations. This not uncommon practice will permit standards for the application of the Two Percent Floor to be in place prior to the end of the year and at the same time permit practitioners the opportunity to provide comments on the administrability of the revised regulations based on their experience.

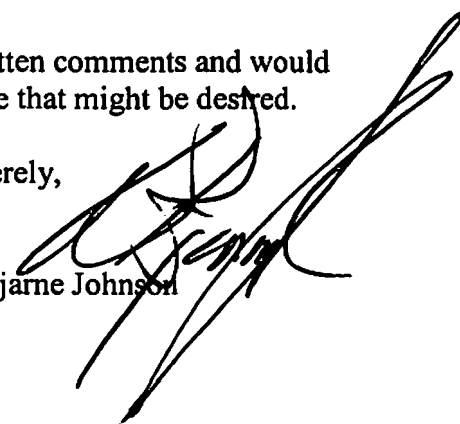


These comments were prepared by members of the College's Fiduciary Income Tax Committee. Principal responsibility for their preparation was exercised by Barbara A. Sloan of McLaughlin & Stern, LLP . The principal authors of the comments were Jonathan G. Blattmachr of Millbank, Tweed, Hadley & McCloy and Diana S.C. Zeydel of Greenberg Traurig, P.A . Also participating in the preparation of these comments were Barbara A. Sloan of McLaughlin & Stern, LLP, T. Randolph Harris of McLaughlin & Stern, LLP, and Dana L. Mark of Kaye Scholer LLP.

We appreciate the opportunity to submit these written comments and would welcome the opportunity to offer any additional assistance that might be desired.

Sincerely,

W. Bjarne Johnson

A handwritten signature in black ink, appearing to read 'W. Bjarne Johnson', is written over the typed name. The signature is fluid and cursive, with a large initial 'W' and 'J'.