# SUPREME COURT ADOPTS THE "COMMONLY TEST" IN *KNIGHT* - SWAPPING ONE UNCERTAINTY FOR ANOTHER

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## I. Introduction

On January 16, 2008, nine men in *Knight v. CIR* divined the meaning of IRC § 67(e)(1), which has haunted trustees, lawyers and accountants, academics, journalists, and four U.S. Circuit Courts of Appeals for nearly a generation.[1] The disputed phrase describes which administrative costs of an estate or trust are exempt from the 2-percent floor on miscellaneous itemized deductions under IRC § 67. Congress added this indecipherable phrase in the last two weeks of a heated closed-door session of the Joint Conference Committee in 1986. Since then it has been interpreted three different ways by eight different courts. Although the statute applies to all trust and estate administrative costs, the debate has centered on outside investment advisory fees.

In 1993 the Sixth Circuit held that outside investment advisory fees were deductible if *necessary* to fulfill the trustee's duties.[2] Then in 2001 and 2003 the Federal and Fourth Circuits held that only costs not *commonly* incurred by individuals were fully deductible.[3] And because they believed that individuals commonly incur them, the fees were subject to the 2-percent floor. And most recently in 2006, the Second Circuit held that only costs that individuals are *incapable* of incurring are fully deductible.[4]

When the issue reached the Supreme Court, Chief Justice Roberts in Solomon-like fashion writing for a unanimous Court, adopted the middle-ground approach of the Federal and Fourth Circuits, exempting only costs that an individual would not "customarily" or "commonly" incur outside of a trust. Chief Justice Robert's opinion is practically a mirror image of the Federal Circuit's opinion in *Mellon Bank, N.A v. United States*.[5] Looking back, it is clear that Justice Roberts had that outcome in mind at the oral argument.

Chief Justice Roberts: So how does [the] customary or commonly incurred test work?

[1] Knight v. CIR, 128 S. Ct. 782 (U.S. 2008).
[2] O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993)
[3] 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).
[4] Rudkin v. Comm'r, 467 F.3d 149 (2nd Cir. 2006).
[5] Mellon Bank, N.A. v. United States, 265 F. 3d 1275 (Fed. Cir. 2001).

For good reason, neither party advocated the "commonly test" in briefs or argument before the Supreme Court, both proclaiming it "inadministrable." But because that's the reading the Supreme Court deemed proper, we must now determine on a case by case basis whether costs are "commonly incurred" outside of an estate or trust in order to determine their deductibility.

## II. The Holding

### A. A Unanimous Court

The Court surprised everyone by the lightening speed with which it handed down its decision – just 50 days after the oral argument. In normal circumstances it takes three to five months. Perhaps the Court was worried that the IRS would finalize their regulations applying the "could" test. Perhaps the court wanted to resolve the issue before the start of tax season. Or perhaps the Court simply has a reduced workload these days.

Equally surprising was the Court's unanimity. Judging from the Justices' remarks at the oral argument, it appeared that at least four of the Justices were sympathetic to the trustee – Justices Scalia, Souter, Ginsburg, and Alito. But in the final vote, was this case just too small and unimportant to warrant a full-throated dissent? After all, they have bigger issues to deal with - lethal injection, punitive damages in the Valdez oil spill, and nudity on the beach. The small tax dollars at stake for wealthy taxpayers in *Knight* pales in comparison to these important issues.

Supreme Court veterans like Walter Dellinger, believe that the court was more divided than meets the eye.[6] But adopting the "commonly test" offered many advantages. First of all, it left a handful of deductions on both sides of the table. Second, it punted the problem to Treasury and the IRS to write regulations defining the contours of commonly. After all, they created this problem by failing to do so in the first place. But most importantly, it allowed the Court to achieve its goal of greater consensus.

At his May 21, 2005 commencement speech at Georgetown University Law Center, Justice Roberts spoke of "the clear benefits of a greater degree of consensus on the Court." Unanimity or near unanimity, he said, promotes "clarity and guidance" for the judges and lawyers who must live with the Court's rulings. "The rule of law is strengthened when there is greater consensus and agreement about what the law is."[7] When the court can choose either a narrow but unanimous ruling or a sweeping, landmark decision by a 5-4 vote, he said, "I think it's better to decide on the former ground, and let it go at that."[8]

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[6] Walter Dellinger of O'Melveny & Myers is former Acting Solicitor General, co-counsel in *Knight v. Comm'r*, and lead counsel in *Exxon Shipping Co. v. Baker* (regarding the constitutionality of a $2.5 billion punitive damages awarded against ExxonMobil because its intoxicated ship captain caused 11 million gallons of oil to spill into Prince William Sound in 1989, damaging thousands of commercial fisherman, individuals, and businesses).

[7] Tony Mauro, Is the Honeymoon Over for the Roberts Court?, Legal Times, July 5, 2006, available at http://www.law.com/jsp/article.jsp?id=1151658325717.

[8] "The Roberts Court, Take Two", Time in partnership with CNN, Oct. 6, 2006, available at http://www.time.com/time/magazine/article/0,9171,1541296,00.html

Chief Justice Roberts achieved his goal of consensus by narrowing the scope of his decision to only investment advisory fees, adopting the middle-of-the-road test, and easily finding that the trustee did not meet his burden of proving what people commonly do. Indeed, Justice Roberts has made great strides toward his goal of unanimity. His Court reaches consensus in nearly 50 percent of the cases. Contrast this to an average of about 30 percent of unanimous cases over the preceding 50 years.

**B. Rejecting Both Parties' Arguments**

The Court rejected both parties' explanations of § 67(e)(1). It first criticized the government for substituting "could" for "would," which the Court said "flies in the face of the statutory language." It also dismissed the government's reading of the statute because it would render the first part of § 67(e)(1) entirely superfluous. "…[I]f the only costs that are fully deductible are those that could not be incurred outside the trust context -- that is, that could only be incurred by trusts -- then there would be no reason to place the further condition on full deductibility that the costs be "paid or incurred in connection with the administration of the . . . trust".

Similarly, the Court criticized the trustee's interpretation for superfluity, holding that if § 67(e)(1) allowed all (or nearly all ) costs caused by the fact that the property is held in trust, "the statute's second, limiting condition -- that the cost also be one 'which would not have been incurred if the property were not held in such trust' -- would do no work…" Thus, accepting the Trustee's approach "would render part of the statute entirely superfluous, something we are loath to do."

**C. The Court Adopts the "Commonly" Test**

Having soundly dismissed both parties' arguments, the Court, turned to the test adopted by the Fourth and Federal Circuits, which held that:

> "Costs incurred by trusts that escape the 2% floor are those that would not "commonly" or "customarily" be incurred by individuals. See Scott, 328 F. 3d, at 140 ("Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers"); Mellon Bank, 265 F. 3d, at 1281 (section 67(e) "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts").*** We agree with this approach."

After endorsing the *Mellon/Scott* commonly test, the Court added its own explanation, which it framed as a prediction: "the question of whether a trust-related expense is fully deductible turns on a prediction about what would happen if [] the property were held by an individual rather than by a trust. Justice Roberts found that the direct import of the statutory text is to "…ask whether expenses are 'customarily' incurred outside of trusts…" This, he said, necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. "Thus, in asking whether a particular type of cost "would not have been incurred" if the property were held

by an individual, section 67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."

Terms such as "customarily and "commonly" are poor words for a test because they "have little or no clear and ascertainable meaning."[9] Commonly comes in shades, or else we would not need modifiers such as somewhat common, fairly common, very common, extremely common. But Justice Roberts pointed out that the Code elsewhere poses similar questions – such as whether expenses are "ordinary" as used in the context of deductible trade or business expenses under IRC § 162. "Ordinary," he said, has the connotation of "normal, usual, or customary", which is what § 67(e)(1) requires.[10] With this as a guide, the Treasury Department and the IRS must now craft regulations defining the contours of "commonly."

## D. What Percentage is "Commonly"?

The Court's commonly test is confusing. First the Court says that the direct import of the language is to "ask whether expenses are 'customarily' incurred outside of trusts." If they are, then they are subject to the floor when incurred by a trust. But in the same paragraph, the Court rephrases the statute in a slightly different manner: "… in asking whether a particular type of cost "would not have been incurred" if the property were held by an individual, § 67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." The latter phraseology would exempt only costs that would be unlikely outside of a trust.

Which is the proper inquiry? It is one thing to ask whether something "customarily or commonly occurs" outside of a trust and quite another to ask whether it is uncommon, unusual, or unlikely outside of a trust. The first inquiry tolerates a fairly high rate of occurrence outside of a trust – perhaps 20, 30, or even 40 percent - before a cost is subject to the floor Contrast the second inquiry, which exempts a cost from the floor only if it would be uncommon or unusual outside of a trust. Because commonly and uncommonly are opposites of each other, there is wide chasm of costs in between them. Where do we draw the line? Put simply, what percentage is commonly?

Chief Justice Roberts also struggled to find the proper dividing line during the oral argument:

> **C. J. Roberts:** "Let's say it's $3 million in the trust, and we think maybe 60 percent of people would hire an investment advisor; 40 percent would think they can do just as well on their own. Is that customarily incurred by individuals?
>
> **Mr. Miller (for the government):** "I think it might well be enough…"
>
> **C. J. Roberts:** Your answer …. is "might well be," and that's a fairly vague line when it comes to taxes.

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[9] Charles A. Wright, The Law of Federal Courts 198 (4th ed. 1983) (quoting Benjamin Kaplan, *Continuing Work of the Civil Committee*, 81 Harv. L. Rev. 356, 380 (1967).

[10] Note that "reasonable compensation" under IRC § 162 is one of the most frequently litigated areas in tax law.

Where Treasury draws the line will make a huge difference in how many types of costs are subject to the 2-percent floor.

## E. § 67(e) Requires a Prediction

It appears that the Court found little or no ambiguity in the statute. It began and ended its analysis with conventional statutory construction, finding that the "proper reading" and the "direct import of the language in context" is to "ask whether expenses are 'customarily' incurred outside of trusts." The text, it found, *requires* determining what would happen if the property were held by an individual rather than a trust. "[S]uch an exercise necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. "In the context of making such a prediction ...the word "would" is best read as "express[ing] concepts such as custom, habit, natural disposition, or probability." "Thus, in asking whether a particular type of cost "would not have been incurred" if the property were held by an individual, section 67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."

Finding a plain meaning in the statute allowed the Court to avoid any discussion of legislative history or analysis of the proposed regulations under *Chevron*.

The only good news about the Court's "proper reading" is that it requires us to make a prediction. And because we predict what we believe to be the most likely outcome, our predictions should meet the "more likely than not" standard under the preparer penalty rules.[11] However, substantiating our prediction is quite another matter.

## F. Removing the Modifier "Trust"

The court sent a clear signal that adding the modifier "trust" to distinguish a cost from one commonly incurred by individuals is a circular argument. Addressing the trustee's argument that individuals do not incur trust investment advice fees, the Court replied: "trust investment advice fees are only aptly described as such because the property is held in trust; the statute asks whether such costs would be incurred by an individual if the property were not. Even when there is a clearly analogous category of costs that would be incurred by individuals, the Trustee's reading would exempt most or all trust costs as fully deductible merely because they derive from a trustee's fiduciary duty. Adding the modifier "trust" to costs that otherwise would be incurred by an individual surely cannot be enough to escape the 2% floor."

Following this to its logical extreme of removing the modifier "trust" from every cost subjects nearly everything to the 2-percent floor. Even fees for preparing a Form 1041 might be subject to the floor because individuals commonly incur fees for preparing tax returns. Or do they? In tax year 2005, the IRS Statistics of Income show that 21 out of 134 million, or 16 percent of individual income tax returns reflected fees for tax preparation as an itemized deduction before application of the 2-percent floor.[12] If 16 percent is considered "commonly," then income tax

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[11] IRC § 6694(a)(2).

[12] Table 3--Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2005, available at http://www.irs.gov/taxstats/index.html.

return preparation fees of an estate or trust should be subject to the floor because individuals commonly incur them.

Indeed most of the items that the proposed regulation currently lists as unique to estates and trusts would need to be removed if the trust modifier comes off – fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters.

### G. Who is Our Hypothetical Person?

The Court found that the statute requires us to predict whether a particular type of cost incurred by the trust "would not have been incurred" if the property were held by a hypothetical individual outside of a trust. If it would be uncommon, unusual or unlikely for such a hypothetical individual to incur that cost outside of a trust, it is exempt from the 2-percent floor for the trust. In order to make such a prediction, we must color in the contours of our hypothetical person. We know that he or she has the same property as our trustee. The Court also suggests that our hypothetical person might have "similar objectives" as our trustee. But how similar to they have to be? Similar is another word like commonly – hard to define.

To predict what our hypothetical person would do with the same property we need to know their age, educational background, investment experience, health, family size and circumstances, other available resources, standard of living, risk temperament, and many other characteristics that financial planners are ethically bound to inquire about.[13] Perhaps they are a baby boomer, since this age group constitutes the majority of the investor population today. Based on the Court's "commonly" test, our trustee must show that that the fees he paid or the advice he received are somehow different than what the hypothetical baby boomer would have incurred.

### H. Impact of Prudent Investor Duties

Justice Roberts was unimpressed that the Prudent Investor Act, which requires a trustee to invest and manage trust assets "as a prudent investor would" made a sufficient distinction between the fees paid by a trustee to hire an investment adviser and those that would be paid by an ordinary person. Rather, because the Act requires a trustee to invest in the same manner as a "prudent individual investor,"[14] Roberts believed there must be no distinction between the investment advice sought by a trustee and that sought by a prudent individual investor. I quote:

> "This prudent investor standard plainly does not refer to a prudent trustee, but looks instead to what a prudent investor with the same investment objectives handling his own affairs would do -- i.e., a prudent individual investor. Because a hypothetical prudent investor in petitioner's position would reasonably have solicited investment advice, it is quite difficult to say that the investment advisory fees "would not have been

[13] CFP Board Code of Ethics and Professional Responsibility, Principle 7, Rule 703, Practice Standard 500-2 (The financial planning practitioner shall investigate products or services that reasonably address the client's needs. The products or services selected to implement the recommendation(s) must be suitable to the client's financial situation and consistent with the client's goals, needs and priorities.).

[14] A new term coined by Justice Roberts at Knight v. Comm'r, 128 S. Ct. 782 at

> incurred" -- i.e., that it would be unusual or uncommon for such fees to have been incurred -- if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs."

Either the trustee's counsel failed to communicate that the prudent investor rule is a standard of *fiduciary conduct* that has absolutely no application outside the realm of trusts, or Justice Roberts chose to ignore it as a distinguishing factor. Given that investing under the constraints of the prudent investor rule is not enough to distinguish investment advisor fees paid by a trustee from those paid by an individual, how does the trustee demonstrate that individuals don't commonly incur the same investment advisory fees as the trustee?

## I. Burden of Proof

The Court found that the trustee has the burden to show that it is uncommon or unusual for individuals with the same property to hire an investment adviser and Knight failed to do that. Nor did Knight "assert[] that its investment objective or its requisite balancing of competing interests was distinctive," despite his testimony to that effect in the Tax Court trial as well as his briefing position before the Court explaining that his fiduciary duties extended to 22 beneficiaries of a multi-generational trust and that he did not possess the requisite skills to fulfill those duties without expert advice. Either the Court failed to notice those points or was wholly unimpressed by them, because it found that Michael Knight failed to show that he is in any different position than an individual investor.

The *Mellon* Claims Court also addressed the burden of proof, but in connection with motions for summary judgment filed by both sides. There the government asked the court "to take judicial notice of facts manifested on the financial pages of any newspaper: individuals often pay investment-advisory fees for property not held in trust…" But the court noted that "...the fact that individuals 'often' pay investment advisory fees for property not held in trust suggests that 'on many occasions' they do not." And because the government offered no evidence as to why the court should conclude that the case falls within the first group, it denied the government's motion for summary judgment.

So how does a trustee prove whether it is common or uncommon for individuals with the same property to hire an investment adviser or that his costs are distinctive? Chief Justice Roberts hinted during oral argument that this could be based on common practices and may vary according to the size of the account:

> **C. J. Roberts:** So how does your customarily or commonly incurred test work? Let's say you have two trusts, one $10 million, the other $10,000. I think an individual with $10 million might well seek investment advice, but an individual with only $10,000 might decide it's not worth it. Would you have a different application of the two percent rule for those two trusts?
>
> **Mr. Miller (for the government):** …I think one might well look at that because the comparison would be individuals with similar assets, and as your Honor knows, there might b a difference depending on the size.

Alternatively, the trustee could obtain an affidavit from the investment adviser describing how the services he is providing the trust differ from those he would typically provide to a nontrustee with the same property. After all, the investment adviser is in the best position to know. He certainly has access to data on common investor habits from financial institutions and regulatory agencies he deals with. Such data might show what percent of accounts in each size range are professionally managed and what percent are simply custodial arrangements. An accounting firm might also conduct an in-house survey of individual clients that pay investment advisory fees to see what size individual portfolios are typically under management. Based on the survey, any trust that pays an investment advisor to manage a trust portfolio smaller than that should be entitled to fully deduct the fee.

## III. Practical Applications

### A. Outside Investment Advisory Fees

*Knight* dealt with the application of IRC § 67(e)(1) to *investment advisory fees* only. The Court made it clear that such fees are generally subject to the 2-percent floor. Investment advisory fees are fees (hourly, fixed fee, commission, or combination) charged by investment advisers, who "for compensation, engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[15] Investment advisors must register with the SEC if they manage assets of $25 million or over.[16] Otherwise, they must register only with the states in which they do business.[17]

Specifically excluded from the definition of investment adviser are a) banks, b) lawyers, accountants, engineers or teachers whose performance of such services is solely incidental to the practice of his own profession, c) commission-based brokers or dealers who receive no special compensation for the advice portion, publishers of financial news, d) persons who advise only on obligations of the United States (i.e. treasury bonds, etc.), and e) any other person of class of persons that the SEC exempts under its rulemaking authority. The SEC has exempted trustees from the definition of investment advisers where they are not engaged in the business of advising others.[18]

But the Court left the door open for the trustee to show that he incurred certain extra, special, distinctive, incremental, or additional fees that individuals would not commonly incur.

> As the Solicitor General concedes, some trust-related investment advisory fees may be fully deductible "if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts." [] There is nothing in the record, however, to suggest that Warfield charged the Trustee anything extra, or treated the Trust any differently than it would have treated an individual with similar objectives, because of

[15] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(20).
[16] Investment Advisers Act of 1940 §§ 203(a), 203A(a).
[17] *Id.*
[18] *See* discussion at III.B. this outline.

> the Trustee's fiduciary obligations. [] It is conceivable, moreover, that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor. Here, however, the Trust has not asserted that its investment objective or its requisite balancing of competing interests was distinctive. Accordingly, we conclude that the investment advisory fees incurred by the Trust are subject to the 2% floor.

Thus, to the extent that the trustee can document that all or part of the investment advisory fees he pays are extra, special, distinctive, incremental, or additional, he is allowed a full deduction. The key, therefore, is demonstrating and documenting that either the charges or the services provided by the investment adviser are different. There are as many ways to do this as there are trustees. But the burden of proof is on the trustee.

## B. Trustee Fees

The Supreme Court did not directly address how § 67(e)(1) affects the deduction for trustee fees. But we can reasonably infer from the decision that trustee fees are fully deductible because *Knight* agreed with *Mellon*, which allowed a full deduction for trustee fees on the basis that individuals do not commonly incur them.

In addition, it does not automatically follow that because investment advisory fees are generally subject to the 2-percent floor, that all trustees must now unbundle the "investment portion" of their fees. Nothing in the Court's opinion required or even implied that result. Indeed, trustees are not "investment advisers" if they are not *engaged in the business* of advising *others*.[19] The SEC has issued several orders finding trustees not to be investment advisers because they are managing and investing trust corpus rather than advising others.[20] Nor are banks investment advisers because they are specifically excluded from the definition by statute.[21]

Given that and before final regulations require otherwise, it makes sense to follow the *Mellon* approach, which the Supreme Court endorsed, and deduct trustee fees in full without unbundling. That assumes, of course, that it is possible in the first place. Some might hesitate, however, because the Court warned about adding modifiers such as "trust" in order to gain a full deduction. But removing "trust" from trustee fees reveals nothing more than an assortment of products and services that individuals could commonly incur, such as fees for custody, accounting, asset management, etc. Taken to its extreme, no part of a trustee's fees would be

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[19] *Id.*; see also 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"); Joseph J. Nameth, SEC No Action Letter, 1983 WL 30256 (Jan. 31, 1983) ("We believe that a person who, for compensation, engages in the business of investment management with discretionary power to buy and sell securities is an investment adviser even if such business is operated through the medium of trusts.")

[20] *Id.*

[21] Investment Advisers Act of 1940 § 202(a)(11)(A), 15 U.S.C. § 80b-2(a)(20).

fully deductible. We can only hope that the final regulations will adopt a reasonable approach to trustee fees. Until then, there is no basis to unbundle them.

## C. Delegation Agreements

Whether or not the final regulations allow a full deduction for trustee fees, a trustee who pays an outside investment adviser should consider formalizing the arrangement with a Delegation Agreement.[22] Section 9 of the Uniform Prudent Investor Act encourages trustees to delegate all or part of their fiduciary investment functions if necessary to enable them to comply with the prudent investor standard.[23] Most state versions of the 1994 Prudent Investor Act subject an agent to fiduciary liability when a trustee delegates all or part of his fiduciary investment function to him. A Delegation Agreement simply acknowledges and documents the arrangement that many trustees may be entering into on an informal basis.

Such an agreement acknowledges that the trustee is shifting a trust function to the agent and that the agent becomes liable to the trust for his actions in lieu of the trustee. If the trustee properly delegates, the trustee is no longer liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.[24] To properly delegate, the trustee must a) exercise reasonable care, skill, and caution in selecting the agent, b) establish the scope and terms of the delegation consistent with the terms of the trust; and c) periodically review the agent's actions in order to monitor his performance and compliance with the terms of the delegation.[25] Some states, such as Texas, may have additional requirements in order to shift liability to the agent.[26] But if the trustee properly delegates, the agent is performing a trust function and assumes fiduciary liability for it.[27] The agent essentially steps into the shoes of the trustee. And if trustee fees are fully deductible, so should the agent's fees be fully deductible when provided pursuant to agreement that properly delegates a trust function and the associated liability.

Regardless of whether there is a delegation agreement, investment advisors should provide more detailed descriptions of their services in order to distinguish them from services performed for ordinary individuals. Such descriptions could include, for example, "specialized balancing of the interests of trust beneficiaries" or "compliance with the terms of the Smith Trust Agreement." The Court held that in these cases, the "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor." The cost of routine investment advice, whatever that is, would still be subject to the floor.

Indeed, we may even see a new cottage industry of special trust advisers spring up that provide investment advice only to trustees. If their services are tailored to trustees and unavailable to individuals, they should pass the Court's test of "not commonly incurred outside of a trust."

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[22] *See* EXHIBIT C.
[23] UNIF. PRUDENT INVESTOR ACT § 9.
[24] *Id.* at § 9(c).
[25] *Id.* at § 9(a).
[26] Tex. Prop. Code § 117.011(c).
[27] UNIF. PRUDENT INVESTOR ACT § 9(b), (d).

## D. Legal and Accounting Fees

Lawyers and accountants should provide their trust clients more detailed statements, itemizing which costs are "commonly incurred" by individuals and which are not. Describing their services in more detail is not difficult. Determining whether those services are commonly incurred by individuals may be challenging. Suppose a trust asks for advice on whether or not to engage in a tax-free exchange under IRC § 1031. Such advice may be uncommon for anyone because tax-free exchanges do not occur very often. But they are certainly not unique to a trust. However, if the trustee asks for advice about whether to make a 65-day election under IRC § 643(e), that may be another matter because only a trust can make that election. Should the accountant distinguish on the basis of which code section the advice relates to or how often the accountant provides that type of advice to his other clients? This degree of hair-splitting flies in the face of Congress's intent to simplify recordkeeping when it enacted § 67(a) in 1986. We can only hope that Treasury agrees when they issue final regulations defining the contours of commonly.

## E. Other Costs Potentially Affected

While the Court's decision applied only to the investment advisory fees incurred by the Rudkin Trust, its interpretation of the statute applies broadly to every conceivable type of cost incurred in connection with the administration of an estate or trust, except those specifically exempted under § 67(b) (taxes, interest, casualty losses, charitable, medical, etc.). Although there is not room for a complete laundry list of the possible costs affected here, a few of the costs in question are:

- Trustee fees
- Accounting fees
- Legal fees
- Bank charges
- Safe deposit box
- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)
- Tax advice and preparation
- Property maintenance

Based on the Supreme Court's holding that costs are subject to the 2-percent rule unless the trustee can show that they are not commonly incurred by ordinary individuals with the same property, each category will need to be analyzed and supported separately. It will be interesting to see how the final regulations deal with these other types of costs.

## F. Substantiating Our Predictions

Because the statute requires a prediction and puts the burden of proof squarely on the trustee, how should he support his predictions? There are very few statistics on the relative frequency with which individuals incur many of the costs a trustee incurs. But the trustee must consider

how to gather that information if he hopes to claim the deduction. It isn't enough to provide the details of the trustee's own costs. He must also compare it to what others "commonly" incur.

Surveys. A trustee might consider hiring a professional to conduct a survey for him. But how large a sample will suffice? Should it be local, regional, or national? What constitutes a reliable sample? Will people volunteer to share this confidential information? Presumably, the cost of the survey would also be subjected to the same "commonly" test for deductibility. But that should be easy to show because individuals do not need to take a survey to determine if each cost is deductible. Perhaps more people will offer surveying services after the Knight decision. Or perhaps the large financial institutions will assume the burden for their customers.

Bill Descriptions. All service providers should provide more detailed billing statement to their trust clients describing the unique services they perform for them and indicating whether they commonly provide those same services to other similarly situated individuals.

Affidavits. In addition to providing more detailed bill descriptions, service providers might also consider using affidavits as evidence of what ordinary people commonly incur. It is not enough to document what was done for the trust. There must also be evidence comparing that service to what other people commonly incur. For example, a landlord could testify that it is uncommon to rent space for a family office to an individual with similar property. A roofing contractor could testify that it would be unusual for someone who owned that rent house to replace the roof unless they had an extraordinary trust related reason not common to people outside of a trust. Or an insurance agent could testify about whether most people would typically insure that property without some compelling and distinctive fiduciary obligation.

Such extraordinary efforts to document whether the trustee's costs are commonly incurred by others can be costly and complex. We anxiously await Treasury's response to this challenge.

## III. Treasury Regulations – Coming Soon

No sooner was the ink dry on the Court's opinion when it became clear that proposed regulation § 1.67-4 must be withdrawn or amended because it was based on an interpretation that the Court said "flies in the face of the statutory language." Treasury and the IRS are working to quickly provide preparers with interim guidance on filing fiduciary returns for the 2008 filing season.[28] They are considering what changes will be made to the proposed regulations to comply with the Court's interpretation of § 67(e). The advent of the decision just weeks before the main tax filing season will obviously require some quick government action. Efforts by the AICPA to discuss this guidance with Treasury have been met with resistance.

### A. AICPA Guidance for 2007 Form 1041s

In the meantime the AICPA has issued its own guidance to members who have been calling the AICPA regularly since the *Knight* decision. On February 4, 2008 the AICPA published a Tax Section E-Alert with respect to treatment of fiduciary expenses on returns to be filed during the

[28] 2008 TNT 28-3 TREASURY WORKING ON INTERIM TRUST FEE DEDUCTION GUIDANCE. (Section 67 -- Miscellaneous Deductions) (Release Date: FEBRUARY 07, 2008) (Doc 2008-2696).

2008 filing season.[29] In particular it addresses how to treat outside investment advisory fees, trustee fees, fiduciary income tax preparation fees, and other costs.

Investment Advisory Fees. Based on the Supreme Court's reading of § 67(e)(1), the AICPA concluded that investment advisory fees paid by the trust to an investment advisor are subject to the 2-percent floor unless the trustee can show that there is an "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer" or that the investment advisor "impos[ed] a special, additional charge applicable only to its fiduciary accounts" or that trust has "an unusual investment objective, or require[s] a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2 percent floor."

To satisfy the Supreme Court's test that any part of an investment advisory fee may be deductible without regard to the 2-percent floor under § 67(e), the trustee must substantiate that it would be unusual for an individual who owned the same property to have incurred the same cost**.** Such substantiation could include, for example, the trust agreement investment directives, the special needs of the trust beneficiaries, fee schedules, descriptions of the services provided, or surveys and statistics about common investor traits to the extent they are obtainable.

Trustee Fees and Unbundling. Although the Supreme Court did not specifically address trustee fees, it did agree with the approach of the Federal and Fourth Circuits in *Mellon* and *Scott*, which allowed a full deduction for trustee fees. Therefore, the AICPA Guidance concludes that it would appear that trustee fees are exempt from the 2-percent floor because they "would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur. Further, unbundling is not required until and unless the final regulations require such treatment.

Fiduciary Tax Return Preparation Fees. Based on the Supreme Court's agreement with *Mellon* and *Scott*, and as provided in the proposed regulations, which are not binding until final, tax return preparation fees and judicial accounting fees are exempt from the 2-percent floor because it would be uncommon (or unusual or unlikely) for a hypothetical individual to incur the cost of preparing fiduciary tax returns.

Other Costs. Tax return preparers should inquire about the nature of other costs and determine on a case by case basis whether it would be unusual or uncommon for an individual with the same property to incur the cost. In some cases it will be easy to decide whether a cost is uncommon to individuals, such as disputes over income and principal. However, most types of fees, such as consulting fees, appraisal fees, family office expenses, will require a high level of judgment and adequate substantiation to claim a full deduction.

[29] 2008 TNT 27-39 AICPA OFFERS GUIDANCE TO CPAS ON PREPARING FIDUCIARY RETURNS. (Section 212 -- Expense of Producing Income;) (Release Date: FEBRUARY 07, 2008) (Doc 2008-2661); see EXHIBIT A.

## B. AICPA Comments to Treasury

Four days after issuing guidance to its members, the AICPA also sent comments to Treasury. The AICPA asked Treasury to withdraw the proposed regulations under § 1.67-4 and open a new comment period for the public to explain the complex issues that trustees face when trying to compare their costs to that of an ordinary individual with the same property.[30] They included 15 examples of unique situations that trustees face in managing property under the Prudent Investor Act for the benefit of others. The AICPA also proposed its own solutions to the examples, hoping to learn where the IRS will draw the "commonly" line, whether in terms of percentages, portfolio size, unique circumstances involved, or some combination.

## C. The Fallacy of Safe Harbors

Last October 2007, the American Bar Association also sent comments to Treasury on the proposed regulations suggesting that Treasury adopt some safe harbor percentages for various categories of costs to be fully deductible.[31] A sample of what safe harbors might look like is attached to this outline as **EXHIBIT D**. It contains a listing of every conceivable type of cost that a trust can incur along with suggested percentages that should be subject to the 2-percent floor or not based on whether that portion is commonly incurred by individuals. This is enough to scare anybody away from safe harbors, even Treasury.

Aside from their complexity, safe harbors do little but perhaps save a little AMT tax. Here's why. The floor is a fixed amount based on 2 percent of adjusted gross income (AGI). Everything above that is fully deductible anyway. In order to benefit from an incremental cost, the trustee must show that his non-incremental costs are less than the floor.

EXAMPLE

> Assume we have two trusts, Alpha Trust and Beta Trust. Both have $5 million in assets and pay a 1 percent investment advisory fee, or $50,000. In 2007 they both had AGI consisting of $500,000. Alpha Trust can show that 80 percent of its investment advisory fees are "extra" or "special," leaving only $10,000 subject to the floor. But Beta Trust cannot show that any of its fees are extra or special. Both trusts must reduce their deduction for investment advisory fees by $10,000 (2 percent of AGI), deducting only $40,000. Thus, Alpha Trust is no better off than Beta Trust, despite that it showed that 80 percent of its fees were "extra special."

In sum, a trustee needs to classify nearly all of his costs as uncommon to individuals in order to benefit from a safe harbor. Otherwise, whatever portion is classified as "common to individuals" applies toward the floor just as it would be without the safe harbor, leaving the trustee in no better shape, as the above example shows.

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[30] 2008 TNT 29-17 AICPA ASKS TREASURY TO WITHDRAW PROPOSED 2 PERCENT FLOOR REGS IN LIGHT OF RECENT SUPREME COURT DECISION. (Section 67 -- Miscellaneous Deductions) (Release Date: FEBRUARY 08, 2008) (Doc 2008-2943); see EXHIBIT B.

[31] 2007 TNT 217-19 ABA Members Provide Detailed Comments, Recommendations on Proposed Regs. on Limitations on Estates or Trusts (Section 67 -- Miscellaneous Deductions) (Release Date: OCTOBER 25, 2007) (Doc 2007-24815)

In its defense, to the extent that the safe harbor excludes an amount from the floor, it also excludes it from classification as an AMT adjustment. This will make a difference in a handful of cases where nearly all of the trust's adjusted gross income (AGI) consists of capital gains. In that case, costs protected under the safe harbor are also exempt from being added back to AGI for AMT purposes and the trust avoids a 15 percent AMT on those costs.

## IV. All Signs Point to a Congressional Fix

Did *Knight* really solve anything? Or did we simply swap one uncertainty for another – arguing over the meaning of "commonly" instead of the meaning of the statute?

Nothing in legislative history indicates that Congress intended to eliminate deductions for most of an estate or trust's administrative costs, or to create the type of administrative complexity we now face. Quite the contrary, § 67(e) was enacted to *simplify* recordkeeping. Moreover since § 67(e) was enacted in 1986, forty-four states and the District of Columbia have adopted the heightened investment standard of the Prudent Investor Act.[32] A trustee's duties are much more onerous than ever before and they should be entitled to deduct their administrative costs above the line without limitation just like business expenses.

Worse yet, the final regulations may be so onerous as to discourage a small trustee from even trying to fully deduct his administrative costs, given the small dollars at stake, the substantiation required, and the penalties for failure to do so. In most cases, the potential penalties will exceed the tax savings and the preparer's fees combined. Thus, the IRS will gain an unintended windfall at the expense of the little guy.

The only way to bring administrative relief is a legislative fix. With all of the arguments and research about why change is needed fully developed during the course of the litigation, it should be fairly easy to approach Congress. Furthermore, the change is simple – lop off the offending prong two and build in some anti-abuse language for those who still view trusts as nothing more than a rich man's pocketbook. And the best news of all to any Congressman is that the change would be revenue neutral because most trustees have been claiming administrative deductions above the line all along.

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[32] 7B U. L. A. 1-2 (2006) (listing States that have enacted the Uniform Prudent Investor Act).Five of the remaining six States have adopted their own versions of the prudent investor standard. See Del. Code Ann., Tit. 12, section 3302 (1995 ed. and 2006 Supp.); Ga. Code Ann. Section 53-12-287 (1997); La. Stat. Ann. section 9:2127 (West 2005); Md. Est. & Trusts Code Ann. section 15-114 (Lexis 2001); S. D. Codified Laws section 55-5-6 (2004). Kentucky, the only remaining State, applies the prudent investor standard only in certain circumstances. See Ky. Rev. Stat. Ann. Section 286.3-277 (Lexis 2007 Cum. Supp.); sections 386.454(1), 386.502 (Supp. 2007).

AICPA Tax Section
Service. Ethics. Advocacy.

# TAX SECTION E-ALERT

February 4, 2008

## Important AICPA Guidance for Filing 2007 Form 1041s – Deducting Trust Administrative Costs After *Knight*

In order to assist our AICPA members who prepare fiduciary income tax returns comply with the Supreme Court's decision in *Knight v. CIR, S.Ct. Docket No. 06-1286 (Jan. 16, 2008)*, *aff'ing Rudkin Testamentary Trust v. CIR*, 467 F. 3d 149 (2nd. Cir. Oct. 18, 2006), the AICPA offers this guidance. The AICPA Trust, Estate and Gift Tax TRP's Section 67(e) Task Force developed this guidance specifically for CPAs. But it is useful for anyone who prepares fiduciary income tax returns. It is not meant to replace a member's judgment. Nor does it constitute substantial authority for purposes of the return preparer penalties. Further, each case will differ depending on the unique facts and circumstances and substantiation available. Therefore, members should use this guide only to instruct their own judgment in taking and supporting their return positions.

**Background.** Section 212 allows a deduction for expenses incurred in connection with investments. Section 67(a) limits the deduction of total miscellaneous deductions, including investment expenses, to the excess over 2-percent of adjusted gross income (the 2-percent floor). IRC Section 67(e)(1) exempts certain administrative costs of an estate or trust from the 2-percent floor on miscellaneous itemized deductions. On January 16, 2008, the Supreme Court resolved a 15-year debate that resulted in a circuit split over the proper reading of IRC Section 67(e)(1), which provides that costs are exempt if they were "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." The Rudkin Trust in the *Knight* case, which involved fees paid for investment advisory services, argued that the statute allows a full deduction for all costs caused by the trustee's fiduciary duties. The government argued that a full deduction is allowed only for costs that individuals are incapable of incurring. The government also published prop. reg. section 1.67-4 (REG-128224-06, 72 Fed. Reg. 41243 (July 27, 2007)) taking that position.

**Holding.** The Supreme Court rejected both readings and instead held that the proper reading of IRC Section 67(e)(1) "requires determining what would happen if a fact were changed; such an exercise necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. Thus, in asking whether a particular type of cost "would not have been incurred" if the property were held by an individual, [section] 67(e)(1) excepts from the 2 percent floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." Further, the Supreme Court held that the taxpayer has the burden of proof in establishing its right to the deduction.

Applying that reading to the investment advisory fees paid by the Rudkin Trust, the Supreme Court found that they were subject to the 2-percent floor on miscellaneous itemized deductions because the Rudkin Trust did not show "that its investment objective or its requisite balancing of competing interests was distinctive" from an ordinary individual.

# EXHIBIT A

**Administrative Costs Affected.** Section 67(e)(1) applies to investment advisory fees and all other miscellaneous itemized deductions of an estate or trust, including trustee fees, tax return preparation fees, legal and accounting fees, consulting fees, appraisal fees, property maintenance, insurance, office supplies, travel, telephone, and family office expenses, to name a few. Because the outcome of each case "turns on a prediction" of what would commonly occur if the property were held by an individual, it is not possible to separate costs into categories that are subject to the 2-percent floor and those that are not. However, the Supreme Court's opinion does offer some guidance in the following areas.

Investment Advisory Fees. Based on the Supreme Court's reading of section 67(e)(1), **investment advisory fees paid by the trust to an investment advisor are subject to the 2-percent floor unless the trustee can show** that there is an "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer" or that the investment advisor "impos[ed] a special, additional charge applicable only to its fiduciary accounts" or that trust has "an unusual investment objective, or require[s] a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2 percent floor." Thus, to satisfy the Supreme Court's test that any part of an investment advisory fee may be deductible without regard to the 2-percent floor under section 67(e), **the trustee must substantiate that it would be unusual for an individual who owned the same property to have incurred the same cost**. Such substantiation could include, for example, the trust agreement investment directives, the special needs of the trust beneficiaries, fee schedules, descriptions of the services provided, or surveys and statistics about common investor traits to the extent they are obtainable. Tax practitioners and their clients should be cautioned that the classification of any part of investment advisory fees as unusual or uncommon will be subject to scrutiny by the IRS.

Trustee Fees. The Supreme Court did not require, or even address, whether trustee fees should be unbundled. The Court agreed with the approach of the Federal and Fourth Circuits in *Mellon Bank v. United States*, 265 F.3d 1275 (Fed. Cir. Sept. 7, 2001) and *Scott v. United States*, 328 F.3d 132 (4th Cir. May 1, 2003). And those courts have held that **trustee fees are fully deductible** because they are not commonly incurred by individuals. Moreover, applying the Supreme Court's reading to trustee fees, it would appear that trustee fees are exempt from the 2-percent floor because they "would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."

Unbundling. Practitioners should be aware that the prop . reg. section 1.67-4 requires the unbundling of trustee fees. However, the proposed regulations are effective only for payments made **after the date final regulations** are published in the Federal Register. Therefore, **unbundling is not required until and unless the final regulations require such treatment.** AICPA submitted comments on the proposed regulations, noting among other problems with the proposed regulations, the difficulties involved with the regulations' unbundling approach.

Fiduciary Tax Return Preparation Fees. Based on the Supreme Court's agreement with *Mellon* and *Scott*, and as provided in the proposed regulations, which are not binding until final, **tax return preparation fees and judicial accounting fees are exempt from the 2-percent floor** because it would be uncommon (or unusual or unlikely) for a hypothetical individual to incur the cost of preparing fiduciary tax returns.

Other Costs. Whether other costs, such as legal and accounting fees, are subject to the 2-percent floor also depends on the degree to which it "would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur" such a cost. As the Supreme Court stated, "Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty." Tax return preparers should inquire about the nature of these costs and **determine on a case by case basis** whether it would be unusual or uncommon for an individual with the same property to incur the cost.

In some cases it will be easy to decide whether a cost is uncommon to individuals, such as disputes over income and principal. However, most types of fees, such as consulting fees, appraisal fees, family office expenses, will **require a high level of judgment and adequate substantiation to claim a full deduction**.

**Substantiation.** Although the Supreme Court's reading of the statute is fairly straightforward, substantiating a position based on that reading is very subjective and may be difficult in some cases. **If a preparer makes a good faith effort to apply the Supreme Court's interpretation, the preparer may be able to conclude that his or her position has a more likely than not chance of prevailing on the merits**. In cases where the preparer cannot conclude one way or the other, the preparer should evaluate whether, under IRS Notice 2008-13, 2008-3 I.R.B. 282, the preparer can recommend a tax return position to the taxpayer without being exposed to a possible preparer penalty under section 6694 (*see* Tax E-Alert, January 3, 2008).

**Effective Date.** The Supreme Court's decision is the law of the land until the IRS and Treasury provide further guidance in final regulations. Therefore, tax preparers should read the decision carefully and apply the Supreme Court's reading of the statute to each client situation as best they can. Since the Supreme Court ruled on this issue on January 16, 2008, **preparers filing tax returns on January 16, 2008 or later should be applying the Supreme Court's interpretation to all relevant tax returns**.

The case, relevant documents, and background materials on this issue prepared by the AICPA Tax Division's Trust, Estate, and Gift Tax Technical Resource Panel's Section 67(e) Task Force can be found on the AICPA website. Also, see prior Tax E-Alert, October 18, 2007 and Tax E-Alert September 11, 2007.

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February 8, 2008

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Re: Estate and Trust Administration Costs After *Knight v. CIR*

Dear Ms. Hughes:

In light of the Supreme Court's decision in *Knight v. CIR*, S.Ct. Docket No. 06-1286 (Jan. 16, 2008), the AICPA offers the Department of Treasury and the Internal Revenue Service input on prop. reg. section 1.67-4. The Court agreed with the Fourth and Federal Circuits that "costs incurred by trusts that escape the 2-percent floor are those that would not 'commonly' or 'customarily' be incurred by individuals." However, the number of alternative meanings of "commonly" and "customarily" underscores the need to provide careful and thoughtful guidance on when costs incurred by an estate or trust are "commonly" or "customarily" incurred by individuals. Otherwise, the Supreme Court will not have resolved the issue and the meaning of "commonly" will continue to be litigated. This letter addresses the following matters:

(a) Request for new proposed regulations or additional comment period before final regulations are issued.

(b) Request for interim guidance for 2007 tax return filing season.

(c) Comments related to existing proposed regulations, including examples of common fact patterns that should be addressed in the next version of the regulations.

a. Request for New Proposed Regulations or Additional Comment Period

The AICPA requests that the IRS and Treasury withdraw the current proposed regulations because they are based on the Second Circuit's reading of section 67(e), which the Supreme Court held "flies in the face of the statutory language." The AICPA requests that a new set of proposed regulations be issued. We also suggest that even if it is decided not to issue new proposed regulations, the IRS open a new three-month window for public comments on the meaning of "commonly" and "customarily" for estate and trust administrative expenses. Many of the prior comments on the proposed regulations focused on urging the IRS to delay the regulations until after the Supreme Court decision and may not have addressed the particulars of the proposed regulations to the extent that they otherwise would have. Indeed, many other people may not have commented, hoping that the Supreme Court would clarify everything.

**EXHIBIT B**

b. Interim Guidance for 2007 Filing Season

In the meantime, the AICPA requests that the IRS and Treasury issue interim guidance for trustees and tax preparers this tax season. Such guidance should assure trustees that IRS will continue the position that is presently stated in the proposed regulations that unbundling their trustee fees will not be required until after the proposed regulations are finalized. No court has ever required unbundling, and no pronouncement from the IRS or Treasury has ever mentioned unbundling until the publication of the proposed regulations last summer. Indeed, Form 1041 itself provides that fiduciary fees are to be listed on line 12 and thus are not subject to the 2-percent floor.

c. Comments on Old Proposed Regulations

(1) Treatment of Fiduciary Fees. The AICPA urges the IRS and Treasury to reconsider the proposal to require unbundling of fiduciary fees in the regulations in cases where the fiduciary fees charged are reasonable compared to state law guidelines for trustee's commissions and common practice (e.g., average fees charged by similar institutions in a particular area). Unbundling in those instances is contrary to Congress's intent to simplify recordkeeping and reduce complexity as explained in the House and Senate Committee Reports. In addition, it is questionable whether trustees can unbundle their fees in a way that those fees were not assembled in the first place. Moreover, since unbundling has never been an industry practice, there is valid concern among corporate trustees that being forced to do so will have an adverse business impact because it will open the door to more "a la carte" fee negotiations with beneficiaries or other interested parties. Even if it were administratively feasible, the result would change from year to year as the trustees duties vary. And the extraordinary administrative cost associated with unbundling would fall on the individual beneficiaries who had no input on how or whether the fees were incurred in the first place. Unbundling may be appropriate only in abusive and egregious cases, such as where the total fiduciary fees are substantially larger than (such as twice) that of state guidelines for trustee's commissions.

If the IRS and Treasury decide to require unbundling in the final regulations, the rules should allow a one or two year transition period, as lead time is needed to consider how or whether such fees can be fractured. Moreover, the requirement to unbundle should take effect at the beginning of a tax year rather than midway through the year. We note that trustees have already been charging fees for the 2008 year without unbundling, and such a fundamental change in process takes time to implement.

(2) Treatment of Trustee's Commissions. The IRS should clarify that pure trustee commissions – a stand alone fee – should not be unbundled. For example, many professional trustees charge a single unitary fee whether or not the trust uses an outside investment advisor. Sometime these fees are based on a schedule established by state statute. Unbundling should not be required where the trustee fees are the same regardless of whether or not the trust utilizes an outside investment advisor. Thus, the IRS should clarify that unbundling is not required where the trust will either not use the trustee's investment advice or will use the trustee's advice, but pays the same fee as a trust that uses an outside investment advisor.

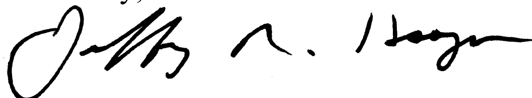
(3) Examples to be Addressed in the Next Version of the Regulations. We include examples illustrating common fact patterns that the regulations should consider in determining the meaning of "commonly" and "customarily" as it relates to:

- Relative size of the portfolio ($2 million versus $10 or $50 million);
- Profile of a "common" or "hypothetical" individual as to age, experience, other resources, etc.;
- Circumstances in which an individual can have the same investment goals as a trustee;
- Individual versus corporate or professional trustee;
- Investment habits of the decedent or grantor before transferring the assets to an estate or trust;
- Whether the trustee has properly delegated an investment function under the Uniform Prudent Investor Act so as to confer fiduciary liability on the agent;
- Trusts with family office expenses (rent, personnel, office supplies, telephone, etc.);
- Legal services;
- Accounting services unrelated to income tax preparation such as trust accounting and tax advice;
- Other consulting services; and
- Trusts with a single beneficiary versus multi-generational trusts.

* * * * * *

We look forward to continuing a dialogue with you and working constructively with Treasury and the IRS to achieve the most certainty and clear and consistent rules in this area. We welcome the opportunity to discuss the current or any new proposed regulations or to answer any questions you may have. I can be reached at 212-773-2858, or Jeffrey.Hoops@ey.com; or you may contact Justin Ransome, Chair, AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at 202-521-1520, or Justin.Ransome@gt.com; or Eileen Sherr, AICPA Technical Manager, at 202-434-9256, or esherr@aicpa.org.

Sincerely,



Jeffrey R. Hoops
Chair, Tax Executive Committee

Enclosure

cc: Mr. Eric Solomon, Assistant Secretary for Tax Policy, Treasury Department
Ms. Linda Stiff, Acting Commissioner, Internal Revenue
Mr. Donald Korb, Chief Counsel, Internal Revenue Service

Mr. William P. O’Shea, Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service

Ms. Jennifer N. Keeney, Attorney, Office of Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service

## American Institute of Certified Public Accountants

## Estate and Trust Administration Costs After *Knight v. CIR*
## Examples

We include the examples below, illustrating common fact patterns that prop. reg. section 1.67-4 should consider in determining the meaning of "commonly" and "customarily" as it relates to:

- Relative size of the portfolio ($2 million versus $10 or $50 million);
- Profile of a "common" or "hypothetical" individual as to age, experience, other resources, etc.;
- Circumstances in which an individual can have the same investment goals as a trustee;
- Individual versus corporate or professional trustee;
- Investment habits of the decedent or grantor before transferring the assets to an estate or trust;
- Whether the trustee has properly delegated an investment function under the Uniform Prudent Investor Act so as to confer fiduciary liability on the agent;
- Trusts with family office expenses (rent, personnel, office supplies, telephone, etc.);
- Legal services;
- Accounting services unrelated to income tax preparation such as bookkeeping and tax advice;
- Other consulting services; and
- Trusts with a single beneficiary versus multi-generational trusts.

***Example (1).*** Trust owns $2 million of U.S Treasury bonds, which the Decedent owned and managed during his lifetime. The Decedent's Spouse is Trustee and current income beneficiary of the Trust. The trust pays her no fee for serving as trustee. Upon her death, the trust divides into a separate trust for each of the couple's five children and grandchildren and terminates at the death of the youngest beneficiary living at the time of the Decedent's death. The Decedent's will that created the Trust requires the Trustee to provide adequate income for the current beneficiaries based on their accustomed standard of living and to preserve and protect the principal against inflation. The trust should last approximately 100 years based on normal life expectancies of the beneficiaries. Spouse/Trustee has no experience in managing money. A financial advisor recommends that she sell the bonds and invest in mutual funds because it is safer and more economical based on her portfolio size. Instead, Spouse/Trustee hires ABC Advisors to design and manage a portfolio of individual stocks and bonds that will satisfy the

**EXHIBIT B**

specific purposes of the Trust. ABC charges the Trust one percent of the portfolio value for its services every year.

*Recommended Solution*: The fees are not subject to the 2-percent floor because the investment advice is unique to the purposes of the trust. The investment advisor is required to balance the needs of the income beneficiary versus the needs of the remainder beneficiaries as opposed to the investment advice for an ordinary person with $2 million of securities who would benefit from the income and any growth in the underlying assets.

***Example (2).*** Same facts as Example 1, except that the U.S. Treasury bonds were worth $5 million. Recent reliable surveys and statistics show that 25 percent of people in the area with a $5 million portfolio utilize the services of an investment advisor.

*Recommended Solution*: The fees are not subject to the 2-percent floor because it would not be commonly incurred since only 25 percent of individuals in a similar situation would have incurred such fees.

***Example (3).*** Same facts as Example 1, except that the U.S. Treasury bonds were worth $10 million. Recent reliable surveys and statistics show that 55 percent of people in the area with a $10 million portfolio utilize the services of an investment advisor.

*Recommended Solution*: The fees are subject to the 2-percent floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, and other circumstances of the trust, or that they are incremental to or different than what an ordinary person with $10 million of securities would commonly incur.

***Example (4).*** Same facts as Example 1, except that the Trust is not multi-generational. It terminates on the Spouse's death and divides equally among the five children. The Spouse is 80 years old and does not need the trust money to live comfortably. Thus, her main motive in hiring the advisor is to grow the trust assets for her children.

*Recommended Solution*: The fees are subject to the 2-percent floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, and other circumstances of the trust, or that they are incremental to or different than what an ordinary person with $2 million of securities would commonly incur.

***Example (5).*** Same facts as Example 3, except that Spouse/Trustee properly delegates her investment function to ABC Advisors under the Prudent Investor Act, which confers fiduciary liability upon ABC for its investment advisory services.

*Recommended Solution*: The fees are not subject to the 2-percent floor because the investment advisor is a trustee under the state's Prudent Investor Act and it is unusual for an individual to incur trustee fees.

***Example (6)***. The Decedent creates a separate trust during his lifetime for each of his five children, placing $2 million in each Trust. Each child is the Trustee of his own Trust, which

pays them a trustee fee of 1 percent of the corpus value each year and terminates when the child reaches age 50. Child number one hires an investment advisor to design a portfolio so that he can retire at age 50 when the Trust terminates. Child number two invests in blue chip stocks that he picks himself. Child number three invests in oil and gas wells. Child number four invests in hedge funds and limited partnerships. And Child number five invests in indexed mutual funds. *Recommended Solution*: The fees incurred by the Trust of Child number one are not subject to the 2-percent floor as long as the trustee can meet his burden to show that people with his portfolio (such as his siblings) would not normally hire a professional advisor.

***Example (7).*** A non-grantor Trust incurs $50,000 of legal fees during the year. A fourth of the fees relate to a lawsuit by one of the beneficiaries against the Trustee for imprudently investing in tobacco stocks. Another fourth relates to a lawsuit against the Trustee for withdrawing capital gains as part of income. Another fourth relates to whether the Trust should change its situs to a state that allows the Trust to convert to a unitrust. The last fourth relates to a shareholder derivative action involving one of the securities.

*Recommended Solution*: The legal fees related to the derivative lawsuit are subject to the 2-percent floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, and other circumstances of the trust or that it would be uncommon for an ordinary person to hire counsel for this purpose. The rest of the legal fees are not subject to the 2-percent floor because they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust.

***Example (8).*** A non-grantor Trust incurs significant legal fees during the year to defend a lawsuit against the trustee for breach of fiduciary duty for improper investing under the state's Prudent Investor Act. As part of the settlement agreement, the Trustee agrees to hire a professional investment advisor who will invest strictly according to the purposes, terms, distribution requirements, and other circumstances of the trust.

*Recommended Solution*: The investment advisor's fees are not subject to the 2-percent floor because they are uniquely tailored to the litigation settlement terms and the Trust agreement.

***Example (9).*** A non-grantor Trust incurs $10,000 of accounting fees during the year in addition to the normal fees for tax return preparation. The $10,000 of fees are to prepare an accounting of the trust's activities for the beneficiaries.

*Recommended Solution*: These accounting fees are not subject to the 2-percent floor since producing such an accounting is unique to a trust and would not be common for an individual to incur.

***Example (10).*** A non-grantor Trust incurs $30,000 of accounting fees during the year in addition to the normal fees for tax return preparation. A third of the fees is for special tax advice on whether the Trust should make a section 643(e)(3) election to recognize the gain upon distribution of property. In addition, one third relates to special tax advice on whether the Trust could achieve a higher after-tax rate of return by investing in rental real estate. The last third

relates to advice on whether the trust should transfer its assets to an LLC to reduce state income taxes.

*Recommended Solution*: One third of the accounting fees related to the special trust tax election is not subject to the 2-percent floor because the election can only be made by a trust or estate and not by an individual. The remaining 2/3 of the accounting fees are subject to the 2-percent floor unless the trustee can show that they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust or that it would be uncommon for an individual to incur these services.

***Example (11).*** Trust is a multi-generational Trust similar to the one in Example 1, except that its assets consist of $50 million of securities and income producing real estate. The Trustee is an unrelated individual who is paid a fee of one-percent of the portfolio value. The Trustee determines that the most economical means of managing the Trust assets is to open a family office and staff it with a full time clerk, office manager, and money manager. In doing so, the Trust incurs rent of $30,000, salaries and payroll taxes of $250,000, employee benefits of $30,000, office supplies of $15,000, telephone expenses of $5,000, legal and accounting fees of $30,000, and other miscellaneous administrative costs of $10,000 in addition to the Trustee's fee.

*Recommended Solution*: The family office expenses are not subject to the 2-percent floor as long as the Trustee can show that they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust and it would be uncommon for an individual to incur these services.

***Example (12).*** Decedent worked for More Oil Company throughout his career. When he died, his estate consisted entirely of More Oil Company stock. His will created a Bypass Trust, naming A+ Trust Co. as trustee. His will directed the trustee to retain the More Oil Company stock, overriding the duty to diversify under the Uniform Prudent Investor Act. A+ Trust Co. charges a fee of 1 percent of the trust portfolio regardless of whether it actively manages a diversified portfolio or retains the More Oil Company stock.

*Recommended Solution*: No part of the trustee fees are subject to the 2-percent floor because trustee fees are unique to a trust and the trustee is providing little or no investment advisory services.

***Example (13).*** Same facts as Example 12, except that in addition to the 1 percent fee charged, A+ Trust Co. charges an additional fee of 0.75 percent of the trust portfolio specifically related to managing a portfolio when their duty to diversify a portfolio under the Uniform Prudent Investor Act is being overridden.

*Recommended Solution*: No part of the trustee fees are subject to the 2-percent floor because trustee fees are unique to a trust and the trustee is providing little or no investment advisory services.

***Example (14).*** Decedent owned an art collection during his lifetime. His will directs that the collection, along with other assets, be transferred to a Trust for his children. The Trustee pays an

appraiser $15,000 to value the collection so that he can determine the suitability of the investment (in light of the terms and purpose of the Trust) and in order to reflect the proper fair market value of assets on the Trust records for trust accounting purposes.

*Recommended Solution*: The appraisal fees are not subject to the 2-percent floor because an individual would not have a trust accounting and would not commonly face the same needs that caused the trustee to obtain the appraisal.

***Example (15).*** ABC Trust Company offers its services to be the trustee of trusts. The annual fee for these services is a percentage of the value of the assets held in the trust, so the fee varies only based on the size of the assets. ABC Trust Company does not charge separate investment advisory fees for internal investment advice. If a particular trust wants to seek investment advice from outside persons or organizations, the trust will be required to pay for those services, but the fee to the corporate trustee will not be reduced.

*Recommended Solution*: No part of the trustee fees are subject to the 2-percent floor because trustee fees are unique to a trust and they are incurred regardless of any investment advisory services performed by the trustee.

**SMITH TRUST**
**INVESTMENT DELEGATION AGREEMENT**

This Investment Delegation Agreement is made and entered into this _______ day of _________________, 2008, by and between **JOE SMITH**, Trustee (the "Trustee") of the **SMITH TRUST** created under that certain Trust Agreement dated October 27, 2007 (the "Trust"), and **ABC ADVISERS, INC**., a Texas limited partnership (the "Agent") for the purposes and upon the terms hereinafter set forth.

WHEREAS, the Trust is an irrevocable trust created under the laws of the State of Texas by and between **MARY SMITH** as Grantor, and the Trustee; and

WHEREAS, the underlying Trust Agreement provides: [HOPEFULLY THE TERMS OF THE TRUST DO NOT PROHIBIT THE TRUSTEE FROM SELECTING AND EMPLOYING INVESTMENT ADVISORY SERVICES AND INVESTMENT MANAGEMENT SERVICES]; and

WHEREAS, Section 117.011 of the Texas Trust Code [Uniform Prudent Investor Act § 9] authorizes a trustee to employ and delegate investment and management functions to an investment agent and provides that a trustee shall not be responsible for investment decisions made by such agent under certain circumstances; and

WHEREAS, the Trustee desires to employ the Agent and to delegate the investment management responsibilities to the Agent with respect to certain Trust assets as permitted by the terms of the Trust Agreement and Section 117.011 of the Texas Trust Code; and

WHEREAS, the Agent, in consideration of the receipt of a reasonable fee for providing such investment management services, is willing to accept investment management responsibilities with respect to the Trust assets transferred to its control.

NOW, THEREFORE, it is agreed as follows:

1. Retention of Agent: The Trustee hereby retains the Agent to provide investment management services with respect to the Trust assets described in Schedule A attached hereto and those assets which may from time to time be transferred to the Agent's control upon the terms and conditions of that certain Investment Management Agreement, attached hereto as Schedule B and made a part hereof for all purposes (the "Account"), and the Agent hereby accepts the retention and agrees to provide such investment management services.

2. Acknowledgement of Duty: The Agent acknowledges that, with respect to the investment management of the Account, it owes a duty to the Trust to exercise reasonable care to comply with the terms of the delegation. Agent agrees to submit periodic investment performance reports to the Trustee and consult with the Trustee from time to time as needed to carry out its delegated duties.

# EXHIBIT C

3. Scope of the Delegation: The Agent shall carry out its investment management responsibilities in accordance with the purposes and terms of the Trust Agreement and in accordance with such written guidelines and policy directives as shall be furnished to it, in writing, by the Trustee. Agent agrees to evaluate investment and management decisions respecting individual assets not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the Trust. Agent further agrees to make a reasonable effort to verify facts relevant to the investment and management of trust assets and may invest in any kind of property or type of investment consistent with the standards of the Uniform Prudent Investor Act.

The Agent agrees to invest and manage Trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the Trust. In satisfying this standard, Agent agrees to exercise reasonable care, skill, and caution. The Agent agrees to consider such of the following as are relevant to the Trust in investing its assets:

(a) general economic conditions;

(b) the possible effect of inflation or deflation;

(c) the expected tax consequences of investment decisions or strategies;

(d) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(e) the expected total return from income and the appreciation of capital;

(f) other resources of the beneficiaries;

(g) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(h) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(i) [OTHER TO BE INSERTED DEPENDING ON THE CIRCUMSTANCES]

4. Assets Transferred to the Account: The Trustee will determine what portion of the Trust assets will be transferred to or from the Account from time to time. The Trustee shall notify the Agent, in writing, of any proposed transfers to or from the Account.

5. Governing Law: The provisions and terms of this Agreement shall be governed and construed in accordance with the laws of the State of Texas. The parties agree to be subject

to the jurisdiction of the courts of the State of Texas solely with respect to the determination of any issues relating to the interpretation or enforcement of the terms of this Agreement.

6. No Arbitration or Limitation: Nothing in this Agreement shall require the Trustee or any beneficiary of this Trust to arbitrate disputes with Agent or shorten the time period in which claims may be brought against the Agent by the Trustee or any beneficiary.

EXECUTED and AGREED TO this _______ day of _________________, 2008.

_____________________________________________
JOE SMITH-Trustee of the Smith Trust
"Trustee"

ABC Advisers, Inc.

_____________________________________________

By: ____________________
Title: ____________________
"Agent"

The author gratefully acknowledges the contributions of Kent H. McMahan, Partner, Fulbright & Jaworski, L.L.P., 1301 McKinney, Suite 5100, Houston, TX 77010-3095 to this Delegation Agreement.

# FIDUCIARY ADMINISTRATION EXPENSES

## TWO PERCENT FLOOR SAFE HARBORS

| 1 | LEGAL FEES | % EXEMPT FROM 2% | % SUBJECT TO 2% |
|---|---|---|---|
| 0.01 | Interpreting the Trust Instrument | 100% | 0% |
| 0.02 | Legal Research re Interpreting Trust | 100% | 0% |
| 0.03 | Advising Trust Beneficiaries | 90% | 10% |
| 0.04 | Amending Trust Instrument | 100% | 0% |
| 0.05 | Advising Fiduciaries | 90% | 10% |
| 0.06 | Advising Trust Accountants | 85% | 15% |
| 0.07 | Correspondence to Beneficiaries | 90% | 10% |
| 0.08 | Correspondence to Trustees | 95% | 5% |
| 0.09 | Advising Return Preparers | 95% | 5% |
| 0.10 | Other Legal Research | 75% | 25% |
| 0.11 | Drafting Trustee Minutes | 100% | 0% |
| 0.12 | Executing Trustee Minutes | 100% | 0% |

| 2 | ACCOUNTING FEES | % EXEMPT FROM 2% | % SUBJECT TO 2% |
|---|---|---|---|
| 0.01 | Collecting Accounting Data | 100% | 0% |
| 0.02 | Preparing Trust Books and Records | 100% | 0% |
| 0.03 | Reviewing Trust Books and Records | 100% | 0% |
| 0.04 | Interpreting Trust Provisions | 100% | 0% |
| 0.05 | Advising Fiduciaries | 100% | 0% |
| 0.06 | Advising Beneficiaries | 100% | 0% |
| 0.07 | Advising Return Preparers | 95% | 5% |

| 3 | FIDUCIARY TAX PREPARATION FEES | % EXEMPT FROM 2% | % SUBJECT TO 2% |
|---|---|---|---|
| 0.01 | Collecting Tax Data | 100% | 0% |
| 0.02 | Preparing Tax Work Papers | 100% | 0% |
| 0.03 | Inputting To Tax Prep Software | 100% | 0% |
| 0.04 | Cross Referencing Work Papers | 100% | 0% |
| 0.05 | Tax Return Processing | 100% | 0% |
| 0.06 | Reviewing Tax Returns | 100% | 0% |
| 0.07 | Advising Beneficiaries on Flow Throughs | 100% | 0% |
| 0.08 | State Income Tax Returns | 100% | 0% |
| 0.09 | Supporting Spreadsheets | 100% | 0% |

# EXHIBIT D

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| 4 | **FIDUCIARY FEES-NO INVESTING** | **% EXEMPT FROM 2%** | **% SUBJECT TO 2%** |
|---|---|---|---|
| 0.01 | Trustees | 100% | 0% |
| 0.02 | Executors - Personal Representatives | 100% | 0% |

| 5 | **INVESTMENT MANAGEMENT FEES** | **% EXEMPT FROM 2%** | **% SUBJECT TO 2%** |
|---|---|---|---|
| 0.01 | Management Directed To Satisfying Trust Income Requirement | 25% | 75% |
| 0.02 | Management Directed To General Appreciation | 0% | 100% |
| 0.03 | Management Directed To Income – No Trust Requirement | 0% | 100% |
| 0.04 | Management Satisfying Mandatory State Law | 0% | 100% |
| 0.05 | Management Satisfying Discretionary State Law | 0% | 100% |
| 0.06 | Management For Wholly Charitable Trusts | 0% | 100% |
| 0.07 | Management For Charitable Split Interest Trusts | 10% | 90% |
| 0.08 | Management - Prudent Investor Rule States | 0% | 100% |
| 0.09 | Other Investment Management | 0% | 100% |
| 0.10 | Security Custody Fees | 0% | 100% |

| 6 | **OTHER TRUST ADMINISTRATION** | **% EXEMPT FROM 2%** | **% SUBJECT TO 2%** |
|---|---|---|---|

**CATEGORIES STILL NEEDED HERE**

| 7 | **OTHER ESTATE ADMINISTRATION** | **% EXEMPT FROM 2%** | **% SUBJECT TO 2%** |
|---|---|---|---|