American Bankers Association
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December 6, 2011

VIA ELECTRONIC MAIL

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
U.S. Department of the Treasury
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Section 67 Limitations on Estates or Trusts; 76 Federal Register 55322 (September 7, 2011).

Dear Mr. Shulman:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Internal Revenue Service's (Service) new proposal under Section 67(e) of the Internal Revenue Code (Code). Many ABA members provide fiduciary and related services to individual and institutional clients; as of the end of 2010, approximately 1600 banks and thrifts held more than $19 trillion in fiduciary assets for both retail and institutional customers in 14.5 million accounts.[2]

In their fiduciary capacity, our member banks[3] provide a number of services to their fiduciary customers, including trust administration, investment management, custody of assets, tax preparation and accounting. While acting as a fiduciary or trustee, banks must follow strict duties of loyalty, prudence, and care to the trust and its beneficiaries and are subject to liability for failure to comply with their fiduciary responsibilities. In exchange for providing these services, banks charge trustee and executor fees that would be subject to the proposed amendments.

ABA and our members have closely followed the Service's efforts to regulate trust and executor fees, and are just as concerned about the new proposal as we were with the initial proposal issued in 2007 and withdrawn in September 2011. As noted in our previous letters,[4] we believe that trustees and executors charge their fees in exchange for fulfilling the singular and unique duties that the fiduciary relationship requires and that these fees are not the sum of separately imposed fees for distinct services. We therefore still maintain that trustee and executor fees are fully deductible and that Section 67(e) does not require their allocation.

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[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Learn more at www.aba.com.

[2] FDIC Quarterly Banking Profile, Table VIII-A (Fourth Quarter 2010).

[3] As used in this letter, the term "banks" includes banks, savings associations, and trust companies that act in fiduciary and related capacities.

[4] ABA Letter to IRS (October 24, 2007); ABA Letter to IRS (May 9, 2008). Letters attached.

Background

Generally when computing a taxpayer's taxable income, miscellaneous itemized deductions are allowed only to the extent they exceed two percent of the taxpayer's adjusted gross income (AGI). However, Section 67(e) of the Code makes an exception for costs that are incurred in connection with the administration of an estate or trust, which would not have been incurred if the property were not held in such estate or trust. Under this exception, these deductible costs are not subject to the two percent limitation for miscellaneous itemized deductions.

"Unbundling" of Fiduciary Fees

Both the current and prior version of the proposed regulations include a provision that requires fiduciaries to "unbundle" their fees into those costs subject to the two percent limitation and those costs that are not. If a "bundled" fiduciary fee is not computed on an hourly basis, the current proposal requires that the portion of that fee that is attributable to investment advice is subject to the two percent limitation, while the remaining portion of that fiduciary fee is fully deductible. Therefore, this would require the trustee or executor to "unbundle" its fee in order to determine the portion that is attributed to investment advice and thus subject to the two percent limitation.

The Plain Meaning of Section 67(e) and All Related Court Decisions Are Clear and Unambiguous With Regard to Fiduciary Fees

As mentioned above, Section 67 of the Code provides an exception to the general rule that miscellaneous itemized deductions are subject to the two percent floor. In particular, Section 67(e) allows a full deduction for costs incurred in connection with administering the trust or estate that "would not have been incurred if the property were not held in such trust or estate." By the plain meaning of this phrase, those costs, such as trustee and executor fees, that were incurred because the assets were in a trust or estate and subject to fiduciary constraints, would be fully deductible.

The Supreme Court decision in *Knight v. Commissioner of Internal Revenue*, 552 U.S. 181 (2008), following the reasoning in several appellate court decisions, stated that generally investment advisory fees charged by a third-party to a trust or estate are subject to the "two percent floor." However, the *Knight* decision did not address the treatment of fiduciary fees nor did it suggest that these fees must be "unbundled."

Indeed, the opinions of the Federal Circuit in *Mellon Bank, NA v. U.S.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001) and the Fourth Circuit in *Scott v. U.S.*, 328 F.3d 132, 140 (4th Circuit 2003), both of which the Supreme Court cited with approval in *Knight*, implicitly rejected the idea of unbundling by explicitly acknowledging the full deduction of trustee fees as opposed to other fees paid by the trust. In *Mellon Bank, N.A.*, the court straightforwardly held: "It is undisputed that trustee fees are fully deductible." Similarly, in *Scott*, the court stated: "Other costs ordinarily incurred by trusts, such as fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e)."

In addition to these pronouncements by the several Courts of Appeal which the Supreme Court favorably cited, nothing in the statute itself requires the burdensome task of "unbundling" a so-called "Bundled Fiduciary Fee." The statute simply poses the question of whether a particular expense would have been incurred if not held in a trust or estate. Fiduciary fees by their nature are not imposed on individuals but rather only on trusts and estates in accordance with applicable state law. Applicable state law allows and prescribes the amount of trustee and executor fees either by statute or in connection with

the approval of a court having jurisdiction over the trust or estate. Under a reasonable reading of the statute, fiduciary fees are not "commonly" or "customarily" incurred by individuals, and, therefore, are fully deductible and need not be unbundled to determine their components.

Proposal Departs From Statutory Meaning

We further question the validity of the unbundling provision of the proposal on the basis of a *Chevron* analysis. The first prong in any *Chevron* analysis asks "whether Congress has directly spoken to the precise question at issue". *See, Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.,* 467 U.S. 837, 842 (1984). In the absence of an explicit grant of rulemaking, as is the case with Section 67(e), *Chevron* directs that any ambiguity in statutory language be treated as an implicit delegation of rulemaking authority to the Service.

In other words, it is only when the statute is ambiguous that a rulemaking is implicitly delegated. There is no mention in any of the case law (*Mellon*, *Scott*, or *Knight*) of any ambiguity with regard to fiduciary fees. In fact, as noted above, in each of these cases, the various courts all agreed that fiduciary fees are fully deductible, which implicitly rejects existence of any statutory ambiguity. Therefore, the unbundling proposal attempts to fill a gap regarding an ambiguity that, in fact, does not exist.

Reasonable Method of Allocation Is a Fiction

The proposal states that "[a]ny reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not."[5] The Service also asks for comments on "the types of methods for making a reasonable allocation, including possible factors on which a reasonable allocation is most likely to be based, and on the related substantiation that will be needed to satisfy the reasonable method standard proposed in these regulations."

As we have stated in previous letters, the trustee and executor's role comprises specific and often interrelated responsibilities and liabilities that when taken together may be greater than the sum of its parts. Furthermore, a standard method of allocation, reasonable or not, may not always relieve the fiduciary from liability under state law. Leaving the determination of a reasonable method up to the individual fiduciary could leave the fiduciary open to challenge by trust or estate beneficiaries, as well as by the Service. Therefore, it is not possible to suggest a "reasonable method" of extracting a portion of a bundled fee as representing investment advice that could apply across the board to any and all trusts. And, if one were to determine a "reasonable method" on a trust by trust basis, then these proposed regulations are, in all practicality, really no less burdensome than the prior proposed regulations on this point.

Specific Costs Cited in the Proposal

In the subsection defining costs "commonly" or "customarily" incurred by a hypothetical individual, the proposal makes a number of confusing and potentially incorrect assertions about the tax treatment of particular costs. First, the proposal incorrectly implies that all ownership costs associated with property are subject to the two percent floor. However, if a trust owns rental property, ownership costs related to

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[5] Proposed 26 CFR 1.67-4 (c)(3).

that property would be fully deductible.[6] The proposal continues to misapply section 67(e) by citing real estate taxes – which are not miscellaneous itemized deductions – as an example of real estate ownership costs covered by Section 67(e). Second, the proposal states that the cost of preparing the decedent's final individual income tax return is not subject to the two percent limitation. However, the proposal implies in the next sentence that this exception would not extend to the cost of preparing the decedent's final gift tax return. There is no reason for treating a decedent's two final returns differently. Third, the description of investment advisory services mistakenly assumes that an individual *would* incur costs to balance the "varying interests of current beneficiaries and remainderman" in his or her investment account. In fact, such an investment strategy would be an "unusual investment objective" for an individual who is presumably investing for himself or herself only.

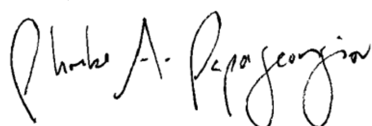
Conclusion

ABA appreciates this opportunity to provide comments on the new proposed regulation under Section 67(e). We strongly believe for the following reasons that this proposal is not warranted:

- The Code, as well as judicial precedent regarding Section 67(e), clearly supports the full deductibility of fiduciary fees. No regulation interpreting the statute is necessary.
- "Unbundling" could expose the fiduciary to potential liability. The trustee and executor's role, by its unique nature, comprises specific responsibilities and duties that, when taken together, represent more than the sum of its parts. Therefore, it is not possible to suggest a "reasonable method" to identify investment advice in an attempt to segregate that responsibility from the rest of the components that make up that role.

Please feel free to write or call the undersigned if you wish to discuss these comments further.

Sincerely,



Phoebe A. Papageorgiou
Senior Counsel

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[6] Section 62(a)(4) – rental property ownership costs are not a miscellaneous itemized deduction, because they qualify as an expense for trade or business

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May 9, 2008

Mr. Douglas Shulman
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20044

Re: Section 67 Limitations on Estates and Trusts; REG-128224-06; 72 Federal Register 41243 (July 27, 2007); IRS Notice 2008-32 (February 27, 2008).

Dear Mr. Shulman:

The American Bankers Association[1] (ABA) appreciates the opportunity to provide additional comments on the Internal Revenue Service's (IRS) proposed amendments to regulation 26 CFR 1.67. In their fiduciary capacity, many ABA banks and thrifts provide fiduciary and related services to individual and institutional clients, such as trust and estate administration, investment management, and custody of assets.[2] In exchange for providing these and other services, banks typically charge a fiduciary fee that would be subject to the proposed amendments. As a result, ABA and it members are very concerned about the proposal and the effect it would have on trusts and estates, their beneficiaries, and the banks that serve as fiduciaries for these accounts.

As stated in our previous letter, on October 31, 2007, ABA respectfully opposes the proposal and urges the IRS to abandon its pursuit of "unbundled" fiduciary fees.[3] Not only does the proposed unbundling requirement go beyond the statute and case law, but also it is administratively difficult and extremely costly to implement in a consistent and fair manner. Furthermore, it is questionable whether the revenue gained by such a proposal is worth the increased expense and the complexity it adds to the compliance and enforcement of the Internal Revenue Code (IRC).

Lastly, we question whether the IRS has given the public adequate opportunity to comment on the actual proposal under consideration as required by the Administrative Procedure Act. According to the Department of the Treasury's Spring 2008 Semiannual Regulatory Agenda, the IRS expects to issue final rules in June 2008, within a month of the deadline for comments on a proposal that does not even contain the necessary changes in light of the Supreme Court's decision in *Knight v. Commissioner of the*

[1] The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

[2] As of the end of 2007, approximately 1800 banks held more than $19 trillion in fiduciary assets for both retail and institutional customers in 19 million accounts. FDIC Call Report Data, December 2007. As used in this letter, the term "banks" includes banks, savings associations, and trust companies that act in a fiduciary and related capacity.

[3] As used in this letter, the term "fiduciary fee" includes trustee and executor fees.

Internal Revenue. We find it difficult to understand how the IRS can consider all the public comments and draft a final rule within this short period.

UNBUNDLING NOT REQUIRED UNDER SECTION 67(e)

The recent Supreme Court decision in *Knight v. Commissioner of Internal Revenue,* following the reasoning in several appellate court decisions, stated that generally outside investment advisory fees incurred by a trust or estate are subject to what is known as the "2 percent floor." However, neither the *Knight* decision nor the appellate decisions addressed a situation in which the fiduciary directly provided the investment management services to the trust or estate.

Indeed, the opinions of the Federal Circuit in *Mellon Bank, NA v. U.S.*[4] and the Fourth Circuit in *Scott v. U.S.*[5], both of which the Supreme Court cited with approval in *Knight*,[6] implicitly rejected the idea of unbundling by explicitly acknowledging the full deduction of trustee fees as opposed to other fees paid by the trust. In the Federal Circuit case, the court straightforwardly held: "It is undisputed that trustee fees are fully deductible."[7] Similarly, in the Fourth Circuit case, the court stated: "Other costs ordinarily incurred by trusts, such as fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e)."[8]

In addition to the reasoning of the Court, nothing in the statute itself requires the burdensome task of "unbundling" a so-called "Bundled Fiduciary Fee."[9] The statute simply poses the question of whether a particular expense would have been incurred if not held in a trust or estate. Fiduciary fees by their nature are not imposed on individuals but on trusts and estates by trustees and executors. Under a reasonable reading of the statute, fiduciary fees are not "commonly" or "customarily" incurred by individuals, and, therefore, are fully deductible and need not be unbundled to determine their components.

We, therefore, strongly urge the IRS to heed the opinions of the two appellate courts upon which the Supreme Court relied, as well as a reasonable reading of the statute, and abandon the proposal. The proposal directly conflicts with valid case law and, further, will lead to increased legal confusion. ABA hopes that the IRS and the Department of the Treasury would want to avoid such conflict and confusion that will likely spur additional litigation.

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[4] 265 F.3d 1275 (Fed. Cir. 2001).

[5] 328 F.3d 132 (4th Circuit 2003).

[6] The Supreme Court reasoned: "This brings us to the test adopted by the Fourth and Federal Circuits: Costs incurred by trusts that escape the 2% floor are those that would not "commonly" or "customarily" be incurred by individuals. … We agree with this approach." (pages 9-10).

[7] 265 F.3d 1275, 1279.

[8] 328 F.3d 132, 140.

[9] The "Bundled Fiduciary Fee" is an IRS term created specifically to implement the proposal. Indeed, this term does not reflect the true nature of the business, because these fees were never "bundled" in the first instance. Trustees and executors charge these fees in exchange for fulfilling the singular and unique duties that the fiduciary relationship requires. These fees are not the sum of separately imposed fees for distinct services.

PROPER TEST AND SCOPE UNDER SECTION 67(e)

Both the Supreme Court in its *Knight* decision and the IRS have interpreted the meaning of the phrase "would not have been incurred if the property were not held in such trust or estate."[10] The IRS proposed rule follows the rejected Second Circuit Court of Appeals' test in its *Rudkin Testamentary Trust v. C.I.R.* opinion: a full deduction is only allowed for expenses that "an individual *could* not have incurred" if the property were not held in trust [emphasis added].[11] However, as the Supreme Court notes in its *Knight* opinion, the true test of whether a particular expense is subject to the 2% floor is best expressed in *Mellon Bank* and in *Scott*. The courts in these cases did not ask, as the IRS proposed rule does, whether an individual *could* incur the expense, but whether, as a predictive matter, an individual *would* commonly or customarily incur it:

> The provision at issue asks whether the costs "would not have been incurred if the property were not held" in trust …, not, as the [Second Circuit] Court of Appeals would have it, whether the costs "could not have been incurred" in such a case…. The fact that an individual could not do something is one reason he would not, but not the only possible reason. If Congress had intended the Court of Appeals' reading, it easily could have replaced "would" in the statute with "could," and presumably would have. The fact that it did not adopt this readily available and apparent alternative strongly supports rejecting the Court of Appeals' reading.[12]

Following the reasoning above, ABA respectfully requests that the IRS acknowledge the proper test as interpreted by the Supreme Court. Similarly, the IRS should abandon its categorization of particular costs as either "unique" or "not unique" and heed the Supreme Court's language of costs that an individual would not "customarily" or commonly" incur.

PROPOSAL MUST ACKNOWLEDGE UNUSUAL INVESTMENT MANAGEMENT SERVICES

The proposed rule should acknowledge the flexibility of Section 67(e) with respect to investment management services that are particular to a trust or estate situation. As the Supreme Court significantly noted in its opinion, "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."[13]

Under the Supreme Court's flexible standard, investment management services provided by a bank fiduciary would indeed require "specialized balancing of the interests of various parties…. beyond what would normally be required for the ordinary taxpayer…." These specialized investing requirements are dictated by the laws, regulations and examination assessments of the Office of the Comptroller of the Currency

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[10] 26 USC §67(e).

[11] Proposed 26 CFR 1.67-4 (b).

[12] *Knight v. C.I.R.*, 552 U.S. __ (2008). (page 6)
[13] *Id.*, page 13.

(OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the state banking regulators, as well as by state fiduciary laws.

Under this unique regulatory framework, bank fiduciaries, as opposed to non-bank investment managers, must institute and follow particular investment policies and procedures to fulfill their fiduciary duties. As a result of bank examiner comments and assessments, as well as fiduciary responsibilities, banks often establish complex committee structures to review the investment management of fiduciary accounts. For example, at one large institution, five specialized committees (Administrative and Investment Review Committee; Business in Trust Committee; Collective Investment Funds Committee; Investment Policy Committee; and the Trust Real Property Committee) report to the overseeing Trust Policy Committee on all the investment decisions made for the institution's fiduciary accounts.[14] The Trust Policy Committee in turn reports to the bank's board of directors.

The investment management services provided by this intricate system of reviewing committees surely exceed the less structured services provided to an individual outside of the fiduciary context. Therefore, under the Supreme Court's flexible test, investment management services provided by the bank fiduciary are fully deductible.

Costs and Benefits of Compliance and Enforcement

According to the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, Congress added Section 67 to the Internal Revenue Code to *simplify* the complex process for deducting miscellaneous itemized expenses. The previous process not only required taxpayers to keep extensive recordkeeping, but also imposed significant burdens on the IRS.

> The Congress concluded that the prior-law treatment of … miscellaneous itemized deductions fostered significant complexity …. For taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive record-keeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service.[15]

Unfortunately, in contrast to the stated intent of Section 67, the IRS proposal with its unbundling requirement would *complicate* compliance with the law and would increase not decrease the IRS's enforcement problems.

Assuming the final rule acknowledges the proper test under *Knight*, the requirement to separate the "customarily" or "commonly" incurred components of trust fees is a time-consuming and very burdensome exercise. Because of the highly specialized nature of trust administration and significant fiduciary liability incurred, many institutions have a multiplicity of fee schedules for various types of trust accounts. In other words, two trust accounts of a similar size and type could be charged two different fees depending on several factors, including complexity of family situation, type and quality of assets held in trust, trust terms, number of beneficiaries, and structure of

[14] It is not uncommon for institutions to have as many as 10 committees and subcommittees reporting up to one supervisory committee which in turn reports to the bank's board of directors.

[15] Joint Comm. on Taxation, JCS-10-87 NO 4, 1987 WL 1364648, page 48 (May 4, 1987).

mandatory versus discretionary payments of income or principal. In addition, many banks have acquired from other institutions numerous trust accounts with legacy fiduciary fees set decades before. In other cases, courts, trust documents, or statutory fee schedules imposed by state law have set the applicable fiduciary fee. Hence, even within one institution, fiduciary fees could vary considerably.

How then would the bank systematically and accurately determine the portion of fees that are not "commonly" or "customarily" incurred by individuals for any two trust accounts? Such an allocation is far from a standardized process and would likely require extensive and costly individual determinations. Trust department employees do not allocate their time based on their activities as is the practice at law firms and accounting firms. Furthermore, any such an allocation would likely leave the fiduciary vulnerable to costly and time-consuming litigation by beneficiaries unhappy with the results. The potential legal costs to fiduciaries would be significant.

Unfortunately, "safe harbors" would not provide any appropriate relief from this burdensome situation. Due to the imposition of *state* fiduciary laws, a trustee or executor would still need to determine on a case by case basis whether the "safe harbor" was indeed in the best interest of the trust or estate versus an individualized "unbundling" of the fiduciary fee as required under the proposal. A federal tax regulation would not preempt those state law fiduciary obligations.

In the end, not only does the proposal make compliance exceedingly complex and costly for trust departments, but also raises the level of complexity and costs for the IRS to review and enforce. Each institution would execute the proposal's requirement in very different ways, leaving the IRS with inconsistent filings and application of federal tax law. To ensure the consistent application of and compliance with the proposal, the IRS would need to review a significant number of highly individualized trusts and their supporting documents to assure the proper "unbundling" of the fiduciary fee. Such an examination would be quite complex, time-consuming, and costly.

Particular Concerns with the Proposed Rule

The meaning of the term "investing for total return" is vague and potentially misleading. In the industry, this phrase is commonly used to describe state statutes that permit trustees of income trusts to pay income beneficiaries more than trust accounting income. Does the proposal refer to investment advice relating to one of these state trust statutes? If so, the proposed regulations are equating "investments made pursuant to a state total return statute" and "investments customarily made by individuals." These terms are definitely not coterminous.

Alternatively, the phrase may mean "investing in a way that seeks to maximize return with no distinction between principal and income return." However, this second meaning does not recognize a trustee's fiduciary duty to assess risk and comply with appropriate fiduciary and banking laws. As a practical matter, most irrevocable trusts are split-interest trusts, with different interests held by income and principal beneficiaries. Under state law, the trustees of split-interest trusts *must* invest in a manner that constantly balances the interests of income and principal beneficiaries. This balancing of the interests is not the type of investment advice commonly or customarily sought by individuals. Hence, such fees would be fully deductible and should be removed from the proposal's list of "not unique" products and services.

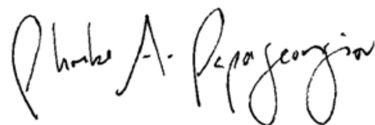
Effective Date of the Proposed Rule

ABA strongly believes that informational technology vendors would need at least a year after final promulgation of a rule to create, test, and customize the proper software for bank trust departments. For that reason, the effective date should be no earlier than the first taxable year beginning 12 months after the promulgation of the final regulations, i.e. January 1, 2010, for calendar year taxpayers. Requiring trustees to start "unbundling" fees on January 1, 2009, or in the middle of 2008 would lead to significant administrative difficulties, further disrupting the financial industry. An immediate effective date (i.e., "for fees incurred on and after issuance of the final regulations") would be absolutely unworkable.

Conclusion

In conclusion, ABA appreciates this second opportunity to offer comments on the Section 67 proposal. We strongly urge the IRS to abandon this proposal, as it goes beyond the requirements of Section 67(e) and imposes significant administrative and fiduciary burdens for little benefit. Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053 or Lisa Bleier at (202) 663-5479.

Sincerely,



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October 24, 2007

Ms. Linda E. Stiff
Acting Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20044

Re: Section 67 Limitations on Estates and Trusts; REG-128224-06; 72 Federal Register 41243 (July 27, 2007).

Dear Ms. Stiff:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Internal Revenue Service's (IRS) proposed amendments to regulation 26 CFR 1.67. The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Many ABA members provide fiduciary and related services to individual and institutional clients. As of the end of 2006, approximately 1800 banks and thrifts held more than $19 trillion in fiduciary assets for both retail and institutional customers in 19 million accounts.[1] In their fiduciary capacity, these banks provide a number of services to customers of all kinds, such as trust administration, investment management, custody of assets, tax preparation and accounting. While acting as a fiduciary or trustee, banks must follow strict duties of loyalty, prudence, and care to the trust and its beneficiaries and are subject to liability for failure to comply with their fiduciary responsibilities. In exchange for providing trust and fiduciary services, banks charge fees that would be subject to the proposed amendments. As a result, the banking industry is very concerned about the proposal and the potential deleterious impact it would have on trusts and estates, their beneficiaries, and the banks that serve as fiduciaries for these accounts.

BACKGROUND

Generally when computing a taxpayer's taxable income, miscellaneous itemized deductions are allowed only to the extent that they exceed 2 percent of the adjusted gross income (AGI). However, Section 67(e) of the Internal Revenue Code (Code) makes an exception for certain costs that are incurred in connection with the

[1] FDIC Call Report Data, December 2006. As used in this letter, the term "banks" includes banks, savings associations, and trust companies that act in fiduciary and related capacities.

administration of an estate or trust, which would not have been incurred if the property were not held in such estate or trust. Under this exception, these expenses may be deducted in full from the AGI. Recently, this exception has been the subject of several court challenges.

The courts have interpreted Section 67(e) in various ways.[2] The Sixth Circuit in *O'Neill v. Commissioner* concluded that the investment management component of a trust fee is fully deductible by trusts, because it "would not have been incurred if the property had not been held in trust." The Federal Circuit and Fourth Circuit have reached the opposite result, each holding that Section 67(e) of the Tax Code does not permit the full deduction of separate investment management fees, because these expenses are commonly incurred outside of the trust context. Finally, the Second Circuit advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that *could not* have been incurred by an individual property owner." [Emphasis added]. The Supreme Court of the United States will hear an appeal of the Second Circuit's decision, *Knight v. Commissioner of Internal Revenue*, on November 27, 2007.

Shortly after the Supreme Court granted certiorari to review the Second Circuit's decision in *Knight*, the IRS proposed revisions to its existing Section 67 implementing regulation that would, if adopted, provide that full deductibility of trust expenses would turn on whether or not the expenses incurred were "unique" to the administration of a trust or estate. Under the proposal, only those expenses regarded as "unique" may be deducted in full, whereas those expenses not regarded as "unique" would remain subject to the 2 percent floor. In addition, the regulation would require that an estate or non-grantor trust "unbundle" fees into unique and non-unique portions to facilitate the deductions allowed under the proposal.

For several reasons, ABA respectfully opposes the proposal and urges, at a minimum, that the IRS delay any consideration of regulatory action until after the Supreme Court has decided the matter. First, the proposal misinterprets the plain meaning of Section 67 and which expenses may be deducted in full. Second, the proposal ignores the significant and extensive fiduciary responsibilities imposed on trustees by state laws and the governing trust instruments that require trustees, in performing their fiduciary responsibilities, to consider investment management services. Third, not only is the proposal administratively difficult and costly to implement, but it also is likely to be harmful to beneficiaries.

PLAIN MEANING OF SECTION 67(e)

As mentioned above, Section 67 of the Code provides an exception to the general rule that miscellaneous itemized deductions are subject to the 2 percent floor. In particular, Section 67(e) allows the full deduction of costs incurred when

[2] It is important to note that while none of the four court of appeals cases involved trustee or executor commissions or fees directly, the court opinions assume that these types of expenses are fully deductible. In *Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149, 154 (2d Circuit 2006), the opinion, picking up on language used in the *Scott* opinion, stated: "fees paid to trustees ... are fully deductible." *See*, *Scott v. U.S.*, 328 F.3d 132, 140 (4th Circuit 2003). A similar statement appears in the *Mellon Bank, NA v. U.S.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001): "It is undisputed that trustee fees are fully deductible."

administering the trust or estate that "would not have been incurred if the property were not held in such trust or estate."[3] By the plain meaning of this phrase, those costs, such as the costs for investment advice, that were incurred *because* the assets were in a trust and subject to fiduciary constraints would be fully deductible. The proposal as written only allows the full deduction of expenses that "an individual could not have incurred" if the property were not held in trust.[4]

The court in the *O'Neill* case properly interpreted this statutory section. In *O'Neill*, the Sixth Circuit reasoned that "[e]xpenses such as trustee fees, costs of construction proceedings and judicial accountings are examples of expenses peculiar to a trust and, therefore, are subject to the Section 67(e) exception. Similarly, the investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the Section 67(e) exception and not subject to the base of two percent of adjusted gross income."[5] The *O'Neill* court also acknowledged that there are times when a trustee must seek outside investment advice to manage the trust assets, because "fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust."[6]

FIDUCIARY RESPONSIBILITIES OF TRUSTEES

The proposal ignores the extensive state fiduciary duties legally imposed on trustees, as well as the particular requirements commonly specified in the governing trust instruments. Trustees, particularly bank trust departments, take their fiduciary responsibilities extremely seriously. In fulfilling their fiduciary responsibilities under state law, institutional trustees charge fees, a portion of which may represent reimbursement of fees paid by the trustee for investment services, or investment advice provided by a third-party advisor. However, under the proposal, legally necessary expenses, such as those commonly incurred for investment advice, are characterized as not unique to the administration of a trust and therefore subject to the 2 percent floor.

In all states, these fiduciary requirements concerning investment management have been codified in either the state's version of the Uniform Prudent Investor Act (UPIA) or in a statute that allows the trustee to consider the prudence of a particular investment with regard to the entire investment portfolio.[7] Among other things, the UPIA requires that the trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[8] Depending on the assets held in

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[3] 26 USC §67(e).

[4] Proposed 26 CFR 1.67-4 (b).

[5] *O'Neill v. C.I.R.*, 994 F.2d 302, 304 (1993).

[6] *Id.*

[7] Before the enactment of these prudent investor rules, trustees had been governed for over a hundred years by the far more conservative investing requirements of the "prudent man rule."

[8] UPIA, Section 2(a).

trust, trustees may find it prudent or legally necessary to seek the help of specialized professional investment advisers.

By contrast, individuals are not subject to these statutes. And while an individual may wisely incur expenses for investment advice, no law or other governing authority *requires* that an individual seek such advice.

Over the past twenty years, the states have either adopted the UPIA or a similar law in reaction to advancements in financial and investment theory. In particular, under modern portfolio theory, an investor can moderate the risk inhering in any particular investment or asset class through diversification of the portfolio's investments. The UPIA freed trustees of the constraints of the previously governing "prudent man" standard, and allowed trustees to consider the risk tolerance of beneficiaries, as well as the general purposes of a trust in constructing an investment portfolio. Prudent investor laws also allow trustees to invest the assets for total return without having to invest separately for income beneficiaries and remaindermen. With the liberalization of fiduciary investment rules, trustees are now able to, and may be expected to, invest in any number of investments, from stocks and bonds to far more sophisticated and complex alternative investments. With this plethora of alternative investments available, trustees may have a fiduciary obligation to seek the advice of professionals who specialize in these particular investments.

In managing investments, trustees are accountable to trust beneficiaries for the proper performance of their fiduciary duties. Individuals managing their own investments do not act as fiduciaries and are consequently free of the strictures constraining fiduciaries. Courts of equity may surcharge trustees, but not individual investors, for failing to adequately balance and diversify portfolios in their care.

Clearly, there are legal differences between trustees who owe duties to beneficiaries and individuals who remain accountable solely to themselves. The former are frequently required to seek outside investment advice whereas the latter are not subject to such requirements. These differing legal requirements make it appropriate to regard investment management fees as having been incurred by virtue of the fiduciary relationship under Section 67(e).

PRACTICAL CONCERNS AND ADMINISTRATIVE AND INDUSTRY BURDENS

The proposal, which would require bank trust departments and others to "unbundle" the fees charged to administer trust accounts, would be impractical and very costly to implement. Typically, banks charge each trust account a single fee for its administration. This fee covers fiduciary administrative services, including custody, tax return preparation, as well as investment services.

Separating the "unique" components of trust fees is a time-consuming and very burdensome exercise. Because of the very specialized nature of trust administration and significant fiduciary liability incurred, many institutions have a multiplicity of fee schedules for various types of trust accounts. These numerous fees schedules reflect the highly customized services offered and the specific needs of the beneficiaries. In other words, two trust accounts of a similar size and type could be charged two different fees depending on several factors, including asset mix,

complexity of family situation, trust terms, number of beneficiaries, and structure of mandatory versus discretionary payments of income or principal. How then would the bank systematically and accurately determine the portion of fees that are "unique" for the two trust accounts? Such an allocation is far from a standardized process, and would likely require extensive individual determinations. Individual determinations, in turn, may lead to the inequitable treatment of trust accounts and thus cannot be supported from a fiduciary standpoint.

Furthermore, assuming that compliance with the proposal is possible through a computerized process, the expense of that compliance would be significant. Invariably, bank trust departments would have to create yet another computer system to track, calculate, and separate the fees that are deductible from those that are not.[9] This system must be tested to ensure that it properly tracks the information, as well as periodically adjusted to accommodate new or different services the bank offers to each trust. Furthermore, the bank must institute on-going training programs for employees. All of these expenses would result in a significant cost for all institutions. This expense is especially burdensome for the hundreds of smaller institutions[10] that offer trust and fiduciary services and typically employ fewer than twenty full-time employees. Often these institutions employ no more than a handful of personnel in the trust department.

In addition to fulfilling their tax accounting and reporting duties, these trust department employees would now need to spend their time "unbundling" trust fees for the previous tax year. This complex and time-consuming activity, especially for smaller institutions with few employees, will likely delay other necessary tax reporting activities, such as issuing Schedule K-1s to trust beneficiaries. This delay could in turn cause those taxpayers to ask for an extension in their tax filings. Trust tax returns and tax information sent to beneficiaries must be completed in an extremely short amount of time – especially when trustees must wait for records from partnerships. Under the proposal, the amount of time available to compile the necessary tax forms would be further shortened if trustee institutions were required to comply with complex unbundling requirements. In the end, this requirement will not only burden trusts and estates and the bank trustees that serve them, it will also make the tax compliance system less efficient.

All of these practical concerns with implementing the proposed regulation would very likely lead to an increase in the fees for administering the trust. This increase in fees would incorporate the additional time and expense of training staff, creating new records systems, and making labor-intensive decisions about how to "unbundle" the fees properly. The costs associated with unbundling trust and estate fees will be passed on to the trust beneficiaries. We further submit that even under the proposal, the costs associated with "unbundling" would be fully deductible from the trust income, as they would be incurred as a result of the assets being held in trust.

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[9] The most popular computer systems used by bank trust departments are not capable of "unbundling" and tracking the trust fees.

[10] According to the FDIC Quarterly Banking Profile for 2006, 400 banking institutions with assets under $100 million exercise fiduciary powers, such as acting as a corporate trustee.

In the end, we question who is helped by this proposal; certainly not the bank trustees who must spend resources to unbundle their fees, nor the beneficiaries that will incur higher fees to compensate trustees for their labors. We question how much the U.S. Treasury will benefit if our position is correct that costs associated with unbundling fees would be fully deductible.

EFFECTIVE DATE OF THE PROPOSED RULE

For the reasons stated above, the proposal should not be promulgated. However, if the IRS decides to go through with the proposed regulation, we must highlight a final, but extremely important, practical concern involving the proposal's effective date. As drafted, the proposed regulation applies to payments made after the final regulation is published in the Federal Register. We believe that it is only logical and fair for the regulation to apply to charges and expenses paid in the first taxable year starting after the regulations become final. Otherwise, it would be a logistical nightmare to split the year into charges and expenses paid in the months prior to the effective date and charges and expenses incurred in the months following the effective date. Any final regulation should be restricted to charges paid in taxable years beginning after the final publication.

CONCLUSION

In conclusion, ABA appreciates the opportunity to offer our comments on the Section 67 proposal. At a minimum, the IRS should not move forward with this proposal until the Supreme Court has had an opportunity to rule on the merits of the case before it. In addition, we would strongly urge the IRS to abandon this proposal, as it ignores the significant fiduciary duties of trustees and leads to far greater burdens than benefits.

Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053 or Lisa Bleier at (202) 663-5479.

Sincerely,

Phoebe A. Papageorgiou