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LEGAL PROCESSING DIVISION
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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

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[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.

[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

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