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Washington, DC 20036

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Phoebe A. Papageorgiou
Counsel
Center for Securities, Trust
and Investments
202-663-5053
Phoebep@aba.com

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 Association¹ (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 its 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.

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

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.

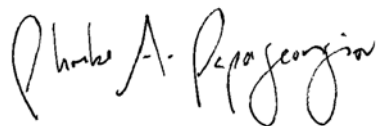
EFFECTIVE DATE OF THE PROPOSED RULE

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,

A handwritten signature in black ink that reads "Phoebe A. Papageorgiou". The signature is written in a cursive, flowing style.

Phoebe A. Papageorgiou
Counsel
Center for Securities, Trust and Investments
American Bankers Association