

Miscellaneous Thoughts on Miscellaneous Itemized Deductions: Updates on Federal and New York Law

By Katie Lynagh and Michael S. Schwartz

As many practitioners are aware, a newly enacted section 67(g) of the Internal Revenue Code (the “Code”) was added by the Tax Cuts and Jobs Act of 2017 (the “Act”). Section 67(g) suspends miscellaneous itemized deductions for tax years 2018 through 2025. And although there was initial uncertainty, IRS Notice 2018-61 has since confirmed that administration expenses described in section 67(e)(1) are still deductible even with the enactment of new section 67(g). However, there are still other expenses that an estate or trust could have deducted before the Act, including investment advisory fees, which an estate or trust will no longer be able to deduct pursuant to section 67(g). Adding to the complication regarding these deductions, New York State enacted a law on April 12, 2019 (but effective for 2018 tax returns), in which New York State “decouples” from the new federal treatment of these deductions, and will allow an estate or trust to deduct expenses that may not be deductible for federal purposes.

This article will summarize the new New York State law as it relates to deductibility of certain expenses so that practitioners and tax preparers can review 2018 returns to ensure no amendments should be made, and to guide the preparation of tax returns going forward. This article will also re-examine the way certain expenses (specifically “bundled” fees, such as fiduciary commissions, legal fees and accounting fees) can be treated in the most tax efficient manner in light of changes to federal and New York State law.

New York Decouples from Federal Law and the Need to Review 2018 Returns

On April 12, 2019, just days before the income tax filing deadline, New York State passed the 2020 Executive Budget, and, as a result, estates and trusts may now be able to deduct many expenses on their New York State income tax returns that are not allowed as deductions at the federal level.¹ Importantly, these changes also apply to the 2018 tax year. Specifically, New York will allow deduction of state and local real estate taxes, even if those amounts are in excess of the \$10,000 State and Local Tax (or SALT) deduction limitation which applies at the federal level following the Act.² In addition, New York will allow deductions for miscellaneous itemized deductions that are no longer allowed at the federal level as a result of the enactment of section 67(g) of the Internal Revenue Code.³

Interestingly, this decoupling was already in effect for individuals pursuant to Technical Memorandum

TSB-M-18(6)I, which was issued in December of 2018.⁴ However, that Technical Memorandum did not appear to apply to estates or trusts. Thus, many tax preparers filed 2018 income tax returns for estates and trusts prior to April 12, 2019, not deducting these expenses, as they are no longer allowable at the federal level. In addition, many of the commonly used tax preparation programs took several weeks to update to account for this change following the April 12, 2019 enactment.

Thus, it is important to review 2018 New York State income tax returns that were filed for estates or trusts in order to determine whether any additional deductions can be claimed.

Allocating “Bundled” Fees

With the enactment of section 67(g), practitioners and fiduciaries should continue to focus on reviewing estate and trust expenses in order to determine if they are being treated in the most tax efficient manner. Specifically, much of the analysis surrounding allocating “bundled” fees from the time of the issuance of Treasury Regulation Section 1.67-4 is of increased importance following the disallowance of miscellaneous itemized deductions under section 67(g) of the Act.

Common examples of trust or estate expenses that are deductible when computing the trust’s or estate’s adjusted gross income (AGI) are preparation fees for certain tax returns, including estate and generation-skipping tax returns and fiduciary income tax returns, and fiduciary commissions.⁵ These expenses, which remain deductible for both federal and New York State income tax purposes, have the effect of reducing a trust’s or estate’s taxable income dollar-for-dollar. Certain other expenses of a trust or estate, including investment advisory fees and other costs that a hypothetical individual would incur in connection with

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owning the same property (such as condominium fees or insurance for real property, if deductible and not considered personal expenses), are miscellaneous itemized deductions that are deductible in New York State only to the extent that total miscellaneous itemized deductions exceed a floor equal to 2% of AGI.⁶ These expenses are currently nondeductible for federal income tax purposes following the enactment of section 67(g). If fees that are deducted when calculating AGI are bundled with fees that are miscellaneous itemized deductions, and the bundled fee is not computed on an hourly basis, as is often the case with fiduciary commissions, the portion of the bundled fee that represents investment advisory fees (almost always a miscellaneous itemized deduction) must be separated from the remaining portion of the bundled fee (which can be taken into account when calculating AGI).⁷

In their article published in connection with the final release of Treasury Regulation Section 1.67-4 in 2014, Austin Bramwell, Elisabeth Madden, and Sharon Klein analyze a variety of methods that have the potential to be considered “reasonable methods” for purposes of Treasury Regulation Section 1.67-4 (c)(4), including the following methods:¹⁰

(1) *Comparison to other fees.* For example, the portion of the trustee’s commission allocated to investment advisory fees would be equal to the fee that an outside investment manager would charge for investment advisory services, the portion of the trustee’s commission taken into account in calculating AGI would equal the fees that would be paid to a directed trustee who takes action with respect to investments only when directed to do so pursuant to a trust instru-

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Treasury Regulation Section 1.67-4(c)(4) provides that “any reasonable method” may be used to allocate a bundled fee.⁸ The regulation adds that:

[F]acts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary’s attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.⁹

Since fiduciaries are not obligated to use a specific method of allocation, fiduciaries should consider which reasonable method or combination of reasonable methods would cause the greatest portion of a bundled fee to be allowed as a deduction in calculating AGI (and, by extension, the smallest portion of the bundled fee to be considered an investment advisory fee, which is almost always a miscellaneous itemized deduction that is subject to the 2% of AGI floor in New York State and is currently not deductible for federal income tax purposes).

ment and a state directed trust statute, or the portion of the trustee’s commission taken into account in calculating AGI would equal the cost of fiduciary liability insurance, because compensation for taking on risk of liability cannot also be considered compensation for performing the investment advisory functions of a fiduciary.

(2) *Percentage of portfolio subject to investment advice.* For example, the portion of a trustee’s commission taken into account in calculating AGI would equal the percentage of the trust that is directed to be retained by the trustee and is therefore not subject to investment discretion by the trustee (for example, a closely-held stock that the trustee has retained pursuant to a retention instruction in the trust instrument and instructions/releases from all trust beneficiaries) or the portion of the trust corpus that is invested in an asset that falls outside of normal investment classes (for example, real property held primarily for the purpose of providing a residence to a beneficiary in accordance with the trust instrument, and not for the primary purpose of generating an investment return).

(3) *Amount of time devoted to investment matters.* For example, a bank or trust company acting as trustee could consider allocating its bundled fee by analyzing how many officers devote time to the trust and the specific expertise of such officers (i.e., investment professionals vs. trust officers whose main role is to

liaise with beneficiaries) and/or, if hourly time records are maintained, the number of hours that officers spend on various aspects of the trustee function.

Conclusion

It is essential that practitioners and tax preparers familiarize themselves with the changes to the deductibility of miscellaneous itemized deductions over the last year or so, first under the Act and then by reason of the 2020 Executive Budget. Not only are 2018 New York State fiduciary income tax returns potentially in need of amendment if the trust or estate is eligible for deductions that were not claimed on the originally filed return (assuming that the tax savings would exceed the cost of preparing an amended return), but the recent changes at the state and federal level may affect how expenses should be classified going forward. Specifically, the prohibition of miscellaneous itemized deductions at the federal level increases the importance of the allocation of bundled fees between fees deductible as part of the calculation of AGI and miscellaneous itemized deductions, and fiduciaries should consider em-

ploying one or more reasonable methods of allocating bundled fees to ensure that the fees are allocated in the most tax efficient manner.

Endnotes

1. New York (State). Legislature. *FY 2020 Executive Budget*.
2. *Id.*
3. *See id.*
4. N.Y. Dep't of Taxation and Finance. Technical Memorandum TSB-M-18(6)I. *New York State Decouples from Certain Personal Income Tax Internal Revenue Code (IRC) Changes for 2018 and after* (2018).
5. Treas. Reg. § 1.67-4.
6. N.Y. Tax Law § 619(e)(2) and Internal Revenue Code § 67.
7. Treas. Reg. § 1.67-4(c).
8. *Id.* § 4(c)(4).
9. *Id.*
10. See Austin Bramwell et al., *How to Allocate 'Bundled' Fees*, LISI Income Tax Planning Newsletter #73 (July 14, 2014), at <http://www.LeimbergServices.com> (providing a comprehensive discussion on allocating bundled fees).

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