



American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

April 11, 2013

The Honorable Patrick J. Tiberi
House Committee on Ways & Means
Tax Reform Working Group on
Pensions/Retirement
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Ronald Kind
House Committee on Ways & Means
Tax Reform Working Group on
Pensions/Retirement
1102 Longworth House Office Building
Washington, DC 20515

RE: Pensions/Retirement Tax Reform Working Group

Dear Congressmen Tiberi and Kind:

The AICPA strongly supports the leadership taken by the House Committee on Ways & Means in studying a variety of topical areas as part of comprehensive tax reform. The proliferation of new income tax provisions since the 1986 tax reform effort has led to complex compliance hurdles for taxpayers, administrative complexity and enforcement challenges for the Internal Revenue Service. According to the National Taxpayer Advocate's 2012 Annual Report to Congress, "individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code."¹ It also noted "the costs of complying with the individual and corporate income tax requirements for 2010 amounted to \$168 billion – or a staggering 15 percent of aggregate income tax receipts."² We consistently have supported tax reform simplification efforts because we are convinced such actions will significantly reduce taxpayers' compliance costs, encourage voluntary compliance through an understanding of the rules, and facilitate enforcement actions.

We are available to assist you in this process, and will be providing comments to several of the working groups that have been established. This letter specifically provides comments on various provisions on retirement plans and trust, estate and gift tax issues. Specifically, we suggest Congress consider addressing the following areas: (1) repeal the requirement that benefits become fully vested upon a partial termination of a qualified retirement plan; (2) consolidation and simplification of the multiple types of tax-favored retirement plans and the rules governing them; (3) allowance of administrative relief for certain late qualified terminable interest property (QTIP) and qualified revocable trust (QRT) elections; (4) consistent treatment of all federal tax payments of trusts and estates; and (5) amendment of section 67(e) to simplify the law and allow estates and nongrantor

¹ [National Taxpayer Advocate's 2012 Annual Report to Congress](#), Volume One, MSP #1 "The Complexity of the Tax Code."

² *Id.*

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trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.

A brief summary of our analyses and recommendations on the topics listed above is enclosed for your consideration. We also suggest that you review the [AICPA's Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy](#) to assist you in identifying problems in the Code as well as analyzing any new proposals against the principles of good tax policy. A copy of that concept statement is also enclosed.

The AICPA is the world's largest member association representing the accounting profession with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your attention to this important matter. If you have any questions, please contact me at (304) 522-2553, or jporter@portercpa.com; or Melissa M. Labant, AICPA Director – Tax Advocacy & Professional Standards, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeffrey A. Porter". The signature is fluid and cursive, with a large initial "J" and "P".

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**Tax Reform Recommendations on
Retirement Plans and Trust, Estate and Gift Tax Issues**

**Submitted to the House Committee on Ways & Means
Tax Reform Working Group on Pensions/Retirement**

April 2013

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Proposal: Repeal the requirement that benefits become fully vested upon a partial termination of a qualified retirement plan

Present Law

Section 411(d)(3) of the Internal Revenue Code (IRC or "Code") requires qualified retirement plans to provide for full vesting upon partial plan termination. It was added by section 1012 of the Employee Retirement Income Security Act of 1974 (ERISA) and has not been amended since. The Code does not define "partial termination." The regulations provide that whether a partial termination occurs shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Treas. Reg. § 1.411(d)-2(b)(1).

Description of Proposal

Repeal the requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan.

Analysis

The partial termination rules impose significant administrative burdens due to the uncertainty of whether and when a partial termination occurs. Moreover, the benefit to participants of full vesting upon partial termination has diminished over time. The vesting schedule requirements applicable to qualified retirement plans have been greatly accelerated since ERISA was enacted. Section 411(a) originally required either 10-year cliff or 5- to 15-year graded vesting. ERISA, section 1012. The current section 411(a) requirement is 5-year cliff or 3- to 7-year graded vesting.

Conclusion/Recommendation

The requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan should be repealed to reduce employers' administrative burdens without significantly affecting employees.

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Proposal: Consolidate and simply the multiple types of tax-favored retirement plans and the rules governing them

Present Law

The Internal Revenue Code provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles, each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. The following plans are currently representative of the variety that may be sponsored by an employer: simplified employee pension (SEP), salary reduction SEP, savings incentive match plan for employees of small employers (SIMPLE), SIMPLE-401(k), profit sharing, money purchase pension, 401(k), 403(b), 457, target benefit, defined benefit, cash balance and the new defined benefit / 401(k) combination created in the Pension Protection Act of 2006 (Pub. L. 109-280). Although some consolidation of the rules governing these options has been introduced in recent years, further simplification of the confusing array of retirement savings options should be undertaken.

Description of Proposal

Possible measures for simplifying the number and complexity of the various types of retirement plan vehicles include:

1. Create a uniform employee contributory deferral type plan. Currently there are four employee contributory deferral type plans: 401(k), 457, 403(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers.
2. Eliminate the nondiscrimination tests based on employee pre-tax and Roth deferrals for 401(k) plans. They artificially restrict the amount higher-paid employees are entitled to save for retirement by creating limits based on the amount deferred or contributed by lower-paid employees in the same plan. They result in placing greater restrictions on the ability of higher-paid employees to save for retirement than those placed on lower-paid employees. Although the 403(b) plan is of a similar design, there is no comparable test on deferrals for this type plan.

There are currently two tests:

- a) The actual deferral percentage ("ADP") test which limits the amount highly compensated employees can defer pre-tax or by Roth after-tax contributions by reference to the amount deferred by non-highly compensated employees. This test applies only to a 401(k) plan.
- b) The actual contribution percentage ("ACP") test similarly limits the amount of employer matching contributions and other employee after-tax contributions

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(which are based on employee contributions) that highly compensated employees may receive. This test is applicable for both 401(k) and 403(b) plans.

Example of complexity in the rules: In the case of the traditional 401(k) plan, both the ADP and ACP tests would apply, while the same deferral and match formula in a 403(b) plan would result in only the ACP test being applicable.

3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to be used to determine basis in a distribution. For example, in a Roth individual retirement account (IRA) or 401(k), basis is considered returned first while in a traditional IRA or 401(k), basis is distributed on a pro-rata basis in the case of a total distribution, and distributed based on an algebraic formula if there are a series of payments.
4. Create a uniform rule of attribution. Currently, the rules of attribution are governed by different Code sections which each have slight subtleties and are used for different purposes under the Code:
 - a) Section 267(c) referenced and modified in determining a disqualified person under prohibited transaction rules.
 - b) Section 318 for determination of highly compensated and key employee status.
5. Create a uniform definition for terms to define owners. Currently, there are different definitions for the terms "highly compensated employee" and "key employee." A defining factor of a "highly compensated employee" is a 5 percent owner which is further defined as an individual with a direct or indirect ownership interest of more than 5 percent. The ownership rules governing a "key employee" consider the 5 percent ownership rule but also consider persons owning 1 percent with compensation of \$150,000 or more annually.
6. Eliminate the required minimum distribution rules. Participants must begin taking distributions beginning at age 70 ½ or be subject to penalties. However, there are no minimum distribution rules governing the timing of distributions related to a Roth IRA. In the case of qualified plans, a less than 5 percent owner who continues employment may defer taking distributions until his or her subsequent separation from service. Additionally, in the case of a traditional IRA, the participant is entitled to consolidate multiple accounts, subsequently taking a required minimum distribution from a single IRA; however, in a qualified plan the required minimum distribution must be taken from each plan individually and consolidation is not permitted.

If full elimination of required minimum distribution rules is not possible, the age requirement of 70 ½ should be addressed. The rules would be better served if the distributions were required to begin on a specific birthday as opposed to the computation of the "half-year birthday" for purposes of these regulations.

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7. Create uniform rules for early withdrawal penalties. There are currently different rules governing penalties depending on whether the account is an IRA or a qualified plan. An example of this complexity is a distribution for higher education expenses; for an IRA the distribution avoids the 10 percent excise tax, while a hardship distribution from a qualified plan is still subject to the excise tax. The same is true for qualified first-time homebuyer distributions and medical insurance premiums.

Analysis

Taxpayers appreciate the opportunity to fund retirement plan accounts and save current tax dollars, the benefits of which are used as a main source of income for many individuals during their retirement years. Employer-sponsored qualified retirement plans are important vehicles with which employers can assist their employees to achieve their retirement goals as taxpayers are able to contribute a larger amount of money to employer sponsored plans than to IRAs or Roth IRAs. While it is not mandatory for employers to offer retirement benefits to their employees, there are incentives such as tax deductions which are available to employers who contribute to qualified retirement plans on behalf of their employees.

When a small business grows and explores options for establishing a retirement plan, they encounter numerous alternatives subject to various rules which can become overwhelming. We feel that there are too many options available for consideration before a business can decide which plan is appropriate for them. Some plans are only available to employers with a certain number of employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings, discrimination testing, and an extensive list of notice requirements with associated penalties for failures and delays in distributing such notices to employees.

To determine which plan is right for their business, owners must consider their cash flow, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners. The choices are overwhelming, and many plans are too complex or expensive for small business owners.

Additionally, the myriad of rules surrounding these plans and the tax treatment of their benefits creates confusion among plan participants. This confusion adds to the factors which keep many plan participants from enrolling in their employer's plan and saving for retirement. With differing contribution limits and tax treatment of distributions, participants become overwhelmed. With our nations' mobile workforce, it is not uncommon for an employee to participate in multiple retirement plans during their working career, and even have multiple concurrent balances. Should these employees happen to work for differing types of employers (e.g., private-sector, not-for-profit and government entity), they will be exposed to very different rules governing their benefits. By simplifying the number of available retirement plan options as well as the rules

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surrounding those options, the decrease in level of confusion to employers will lead to increased levels of plan participation leading to healthier employee retirement savings.

In addition, Federal tax laws and regulations governing retirement plans are overly complex compounding the difficulty for employers who wish to offer retirement plan options to their employees. In order to increase the incentive to employers to set up and maintain retirement plans for their employees, it is imperative that the laws and rules governing retirement plan offerings are as simple and straightforward as possible.

One of the reasons the rules are complex is related to flexibility in employer plan design. There are different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and withdrawals, availability of loans and portability of the numerous plan types. Another reason is to ensure that retirement benefits are available to all employees and not just highly compensated employees.

While retirement plan complexity has long been a topic of discussion, not nearly enough has been done to address the issue.

Conclusion/Recommendation

The number of retirement plan choices should be consolidated and the rules governing the plans simplified, with appropriate transition rules as needed.

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Proposal: Allow administrative relief for certain late QTIP and QRT elections

Present Law

Section 9100 Relief

The IRS has the authority to provide taxpayers relief from certain missed or late elections by granting extensions of time to make those elections. This relief, known as “Section 9100 Relief,” requires the taxpayer to establish to the satisfaction of the Internal Revenue Service (IRS) Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Section 9100 Relief is available for elections, the timing of which is prescribed by regulation (Treas. Reg. § 301.9100-3(a)), rather than by statute.

QTIP election

Transfers of property interests that meet the requirements to be a qualified terminable interest property (QTIP) are eligible for the marital deduction for gift and estate tax purposes if the QTIP election is made. For QTIP transfers made when an individual dies in a year other than 2010, the QTIP election must be made by the decedent’s executor on the Federal estate tax return. For an inter vivos QTIP transfer, the QTIP election must be made on the Federal gift tax return for the calendar year in which the interest is transferred. A QTIP election, once made, is irrevocable.

Section 9100 relief has been available for failures to make a QTIP election on a Federal estate tax return for over two decades, since the deadline for making that election is prescribed by regulation (Treas. Reg. § 20.2056(b)-7(b)(4)(i)). For an inter vivos QTIP, section 2523(f)(4)(A) provides that the QTIP election shall be made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer. Because the statutory language of the gift tax and estate tax QTIP provisions is different, the IRS has determined that the deadline for making the gift tax QTIP election is statutory, and, therefore, section 9100 relief is not available. See [PLR 201109012](#) (March 4, 2011), [PLR 200314012](#) (April 4, 2003), and PLR 9641023 (July 10, 1996). The present situation imposes a hardship on taxpayers as it provides no remedy – other than a malpractice action – for a taxpayer who loses the gift tax marital deduction due to an error on the part of the taxpayer’s advisor.

QRT election

Effective with respect to estates of decedents who die after August 5, 1997, an election may be made to have certain revocable trusts treated and taxed as part of the decedent’s estate. If both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in section 645 (originally enacted as section 646), the trust is treated and taxed for income tax purposes as part of the estate (and not as a separate trust) during the election period. Section 645(c) provides that the election to

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treat a QRT as part of the decedent's estate shall be made not later than the time prescribed for filing the return of tax imposed for the first taxable year of the estate (determined with regard to extensions).

Because the time for making the election to treat the QRT as part of the estate is prescribed by statute, we believe that the IRS would take the position that it does not have the authority to grant relief for late elections. Decedent's estates that do not make the election timely have no recourse to cure the problem and are disadvantaged because of the errors committed by their tax advisors.

Description of Proposal

The IRS should be authorized to grant Section 9100 Relief for certain late or defective lifetime (i.e., inter vivos) QTIP elections and for late elections by certain QRTs to be treated as part of a decedent's estate. This could be accomplished by revising the IRC to provide that the due dates for the inter vivos QTIP election and for the QRT election to be part of the estate are treated as if not prescribed by statute. These proposals would make the same sort of statutory change in section 2523(f)(4) and section 645(c) as was done by Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) in section 2642(g)(1)(B) (and extended through 2012 by the 2010 Act), so that taxpayers would not be penalized for the errors of their tax advisors and tax return preparers in failing to make a QTIP election on the Federal gift tax return or a QRT election to be part of an estate on the estate's first Federal income tax return. The provisions would apply to requests for relief pending on or filed after the date of enactment with respect to elections due before, on, or after such date. These proposed prospective effective dates are similar to the prospective effective date provision applicable to the generation skipping transfer (GST) exemption relief in EGTRRA.

Analysis

The problems for late QTIP and QRT elections are similar to the problem that existed with the allocation of GST exemption prior to EGTRRA. There, the time for making an allocation of GST exemption was fixed by statute, and numerous taxpayers were being penalized for the failures of their tax advisors and tax return preparers to properly make the allocation. EGTRRA added section 2642(g)(1)(B) of the Code, which states "[f]or purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute." That language opened up the possibility of section 9100 relief for failed allocations of GST exemption. Given that statutory authority, the IRS has granted 9100 relief in hundreds of cases.

We note that legislation to provide administrative relief for inter vivos QTIP elections has been introduced previously and was even reported by the Senate. Specifically, in the 109th Congress, on June 28, 2006, [S. 1321](#), the Telephone Excise Tax Repeal Act of 2005, as reported by the Senate, included Section 713, Administrative Relief for Certain

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Late Qualified Terminable Interest Property Elections (see Report [109-336](#) and [JCX-28-06](#)). In addition, on July 25, 2006, [H.R. 5884](#) was introduced in the House of Representatives to authorize the Secretary of the Treasury to extend the date for making a gift tax QTIP election.

This gift tax relief is important because it would extend to the gift tax the same relief that is available for errors on estate tax returns concerning the identical issue. In addition, a QTIP election does not forgive estate or gift tax; it merely defers imposition of the tax until the death of the donee spouse. Therefore, this provision would be of minimal cost (estimated in 2006 at \$2 million over 10 years per [JCX-29-06](#)). Similarly, the QRT election does not forgive tax, it just treats the trust during the election period as part of the estate for income tax purposes, rather than as a separate trust, so we expect this proposal as well would be of minimal cost.

Conclusion/Recommendation

We urge the enactment of legislative provisions stating that the due dates for the inter vivos QTIP election and for the QRT election to be part of the estate are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for certain late QTIP and QRT elections.¹

¹ The AICPA submitted a [letter](#) requesting legislation permitting administrative relief for certain late lifetime qualified terminable interest property elections and certain late qualified revocable trust elections on November 16, 2010.

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Proposal: Treat consistently all federal tax payments of trusts and estates

Present Law

Currently, the ability of a trust or estate to allocate its tax payments to its beneficiaries is different for estimated federal tax payments, backup withholding, and regular withholding, and the different treatment becomes very confusing and unnecessarily complex to taxpayers and tax practitioners. In some instances, estimated tax payments may be allocated by the fiduciary to the beneficiaries, but only if an election to do so is made within 65 days after the close of the trust or estate's tax year. Backup withholding follows its corresponding income, and the beneficiary's share is reported to the beneficiary on the Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., which is filed with the Form 1041. Regular withholding may not be allocated to the beneficiary, but must be reported by the trust or estate even if its corresponding income is reported by the beneficiary.

Specifically, for estimated tax payments, a trust or, for its final tax year, a decedent's estate may elect under IRC section 643(g) to have any part of its estimated tax payments allocated to beneficiaries. The fiduciary makes this election by filing [Form 1041-T](#), Allocation of Estimated Tax Payments to Beneficiaries, by the 65th day (i.e., generally March 5 for calendar year taxpayers) after the close of the tax year. Absent a timely election, the estimated tax payments are reported by the trust or estate on its [Form 1041](#), U.S. Income Tax Return for Estates and Trusts, and cannot be allocated to beneficiaries on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.

For backup withholding, the tax credit under IRC section 31(c) for payments subject to IRC section 3406 (backup withholding) is allocated between the trust or estate and its beneficiaries on the basis of their respective shares of payment, which is subject to backup withholding under IRC section 643(d). Schedule K-1 (Form 1041) is used to report the beneficiaries' share of the backup withholding.

For regular withholding, the credit under IRC section 31(a) for amounts withheld as tax under chapter 24 (regular withholding) may not be allocated by the trust or estate to a beneficiary. See [Chief Counsel Advice 200644018](#) (Dec. 25, 2005), in which the Internal Revenue Service stated that neither section 643(d) nor section 643(g) is relevant to the treatment of the withholding credit under section 31(a), and neither Form 1041-T nor any other form or schedule can be used to allocate this credit, except in two situations. Those situations involve (1) a trust that is a grantor trust, in which case the credit appears on the grantor's income tax return, and (2) the recipient of income in respect of a decedent, who is entitled to any section 31 credit associated with the income taxed to the recipient. Also, the [instructions to Form 1041](#) state that withheld income tax (other than backup withholding) cannot be passed through to beneficiaries on either Schedule K-1 or Form 1041-T.

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Description of Proposal

We propose that the fiduciary of a trust or estate be permitted to allocate estimated tax payments, including payments made with extension requests, to the trust's or estate's beneficiaries on Schedule K-1 (Form 1041) attached to a timely filed Form 1041 (including extensions) and that regular withholding be treated the same as the current treatment of backup withholding. This proposal would allow estimated tax payments (including any tax payment made with an extension request) to be allocated to the beneficiary on the Schedule K-1, which would be the same way that backup and regular withholding would be reported to the beneficiaries. We believe that having all such taxes attributed to the beneficiaries reported on the Schedule K-1 would be much less confusing and reduce complexity to the fiduciaries.

With respect to regular withholding, the title of section 643(d) could be changed to "Coordination with withholding" and section 643(d)(1) could be amended to include a reference to section 31(a) so that it would read: "... (1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31(a) or 31(c) (on the basis of their respective shares of any such payment taken into account under this subchapter)...."

With respect to estimated tax payments and extension payments, we suggest that estates be added to the general rule of section 643(g)(1) with the result that section 643(g)(3) would be repealed and that amendments be made to section 643(g)(1) and (2) to read as follows:

- (g) Certain payments of tax treated as paid by beneficiary.
 - (1) In general. In the case of trust or estate—
 - (A) the trustee or fiduciary of the estate may elect to treat any portion of a payment of estimated tax (including a tax payment with an extension request) made by such trust or estate for any taxable year of the trust or estate as a payment made by a beneficiary of such trust or estate,
 - (B) any amount so treated shall be treated as paid or credited to the beneficiary on the last day of such taxable year of the trust or estate, and
 - (C) for purposes of subtitle F, the amount—
 - (i) shall not be treated as a payment of tax made by the trust or estate, but
 - (ii) shall be treated as a payment of estimated tax made by such beneficiary on the fifteenth day of the first month following the close of the trust or estate's taxable year.
 - (2) Time for making election. An election under paragraph (1) shall be made on the tax return of the trust or estate filed on or before its due date (including extensions of time actually granted) and in such manner as the Secretary may prescribe.

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Adding estates to the general rule will allow the estate's tax payments to be treated as paid by estate beneficiaries in years other than just the estate's last tax year if the executor so chooses. We believe these proposals will simplify processing for the IRS as well as taxpayers. We think that any revenue cost for this proposal would be negligible as it only deals with allocating tax payments between taxpayers.

Analysis

There are many professional fiduciaries and trust companies facing the present law inconsistency in the reporting treatment of the various types of tax payments. In addition, trusts and probate estates frequently are administered by family members or other individuals, for whom this inconsistent treatment causes great confusion and unnecessary complexity. With regard to the election for estimated tax payments, fiduciaries frequently miss making this election because of its due date. Fiduciaries often are unable to determine whether federal taxes have been overpaid by the 65th day of the next year, especially when Forms 1099 (the information returns reporting various types of income) are not available to the trust or estate until the 46th day of the next year and many Forms K-1 (the information returns reporting income from partnerships, S corporations and trusts) are not available to the trust or estate until much later in the following year, well past the 65-day period.

The treatment of regular withholding and estimated payments becomes most critical in the final year of the trust or estate. If the fiduciary misses the 65-day period for making the election for estimated tax payments, then those payments must be refunded to the fiduciary. Regular withholding payments must always be refunded to the fiduciary. Since the refund is made after the close of the trust or estate's final year, the fiduciary may already have been discharged and is no longer able to act on behalf of the entity. The fiduciary also may have closed all financial accounts in connection with the final distribution of assets so has no way to cash the check or make a further distribution.

A related issue arises with respect to federal tax payments submitted with a fiduciary's request for an extension of time to file the trust or estate's income tax return. It is not possible to allocate any of those payments to the beneficiaries, rather they can be applied only to a later year's tax or refunded to the fiduciary.

Conclusion/Recommendation

We continue to encourage Congress to pass legislation that simplifies the tax compliance burden of taxpayers. To further this mission, we request that Congress enact legislation that would permit consistent treatment of all federal tax payments of trusts and estates, including estimated tax payments, backup withholding and regular withholding. We urge Congress to enact this tax simplification and consistency proposal.

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Proposal: Amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.²

Present Law

The current law denies a deduction for the cost of complying with many fiduciary duties to the extent that their aggregate cost does not exceed 2-percent of the taxpayer’s adjusted gross income. This is known as the “2-percent floor.”

By way of background, Congress enacted section 67(a) in 1986 to limit deductions for miscellaneous itemized deductions to those in excess of 2 percent of adjusted gross income (AGI). Congress’s purpose was to reduce recordkeeping for numerous small expenditures and eliminate deductions for many, essentially personal expenditures claimed in error.³ Because estates and nongrantor trusts⁴ are taxed in the same manner as individuals, Congress provided an exception to the 2-percent floor in section 67(e) for fiduciary administrative costs that would not have been incurred “if the property were not held in such trust or estate.”

Because of the statute’s unusual wording, there have been numerous judicial battles over its meaning. In 2008, the U.S. Supreme Court held in [Knight v. CIR](#), 552 U.S. 181, 128 S. Ct. 782 (2008), that the statute allows a full deduction for “only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur.” To make that determination, the Court held that the trustee must “predict” whether a hypothetical person with the trust property would have incurred the cost. Unfortunately this interpretation imposes significant uncertainty, complexity, recordkeeping and enforcement burdens on both the trustee and the government. In short, it raises more questions than it answers.

We have worked together with the American Bankers Association, the American Bar Association, the American College of Estate and Trust Counsel and other groups to provide the IRS and Treasury input on [July 27, 2007 proposed regulations](#) section 1.67-4. On September 7, 2011, the IRS withdrew those regulations and issued a replacement set of [proposed regulations](#) section 1.67-4 attempting to implement the Supreme Court’s decision. The proposed regulations require trustees’ fees and other single commission fees to be unbundled and separated between costs that are commonly incurred by individuals and those that are not. The IRS and Treasury have been unsuccessful in drafting regulations that are clear and administrable, without subjecting nearly all administrative costs to the 2-percent floor. Doing so eliminates the exemption under

² The AICPA submitted a similar proposal on [September 8, 2008](#) to the 110th Congress.

³ [Sen. Rep. No. 99-313](#), 1986-3 C.B. Vol. 3, p. 78; [House Rep. No. 99-426](#), 1986-3 C.B. Vol. 2, p. 109.

⁴ A nongrantor trust is a trust that is treated as a separate taxable entity from its grantor or beneficiary. By contrast, a grantor trust is one whose grantor or beneficiary is treated as the owner of all or part of the trust property for income tax purposes.

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section 67(e). Expressing similar frustration over section 67(e), Chief Justice Roberts commented:

While Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, that is no excuse for judicial amendment of the statute.

Description of Proposal

The solution, in our view, is to amend the statute. We think the proposed amendment below would simplify the statute, would modernize it for the prudent investor rule,⁵ make it easier to administer, and provide a consistent definition of AGI for estates and nongrantor trusts throughout the Internal Revenue Code. We do not think the proposal would encourage individuals to create nongrantor trusts to merely avoid the 2-percent floor. The associated costs of creating such trusts would likely exceed any tax benefit. Creating a separate trust requires giving the money away, not to mention the extra management cost and liability associated with creating a separate legal entity.

As amended, the statute would provide:

67(e). DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS. For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust ~~and which would not have been incurred if the property were not held in such trust or estate,~~... shall be treated as allowable in arriving at adjusted gross income.

Analysis

We support this measure for the following reasons:

1. The present statute is overly complex and burdensome. The trustee must predict whether an ordinary individual with the same property would have incurred the same cost or a portion thereof, under the Supreme Court's reading of the statute. The trustee must then separate his/her fees into the portion an individual would have incurred (subject to the 2-percent floor) and the portion that is fully deductible. The proposed regulations indicate "any reasonable method" is to be

⁵ The prudent investor rule requires a trustee to invest trust funds as a prudent investor would for the account of another. Prior to the Uniform Prudent Investor Act of 1992, trustees were only required to follow the prudent man rule, which required the trustee to invest trust funds as he would for himself.

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used for the determination. Such recordkeeping complexity is contrary to sound tax policy.

2. A legislative change would eliminate uncertainty, inconsistencies and errors arising from the requirement to predict what individuals commonly do. Because section 67(e) requires the extraordinarily difficult task of predicting whether individuals would commonly incur a particular expense that the trust or estate incurred, it will result in uncertainty, inconsistent treatment from trust to trust, errors of judgment, and potential penalties on both the trustee and tax preparers.
3. The present statute requires extensive recordkeeping. The Supreme Court's interpretation of section 67(e) requires the trustee to keep additional records to determine whether and how its expenses are different from those incurred by hypothetical individuals with the same property. This additional recordkeeping is contrary to Congress's original purpose for section 67, which was to simplify recordkeeping and limit individuals from deducting personal expenses (i.e., safe deposit box fees, investment magazines, home office expenses, etc.).
4. The present statute is out of date. The present statute was enacted eight years before the [Prudent Investor Act \(1994\)](#) was adopted by nearly every state. The Prudent Investor Act raised the investment standard from the "prudent man" to the more demanding "prudent investor" rule, requiring many trustees to obtain specialized expertise to fulfill their fiduciary duties. Thus, the Internal Revenue Code denies a full deduction for costs incurred to comply with the Act merely because individual investors sometimes incur the same costs.
5. The present statute penalizes compliance with fiduciary duties. The present statute penalizes trustees for incurring costs to carry out their mandatory fiduciary duties. Trustees who hire professional advisors to comply with their duty to invest prudently will be denied some or all of their deductions. However, if they forgo the professional advice, they risk a breach of fiduciary duty. Such tension should not exist between the Internal Revenue Code and other regulatory acts.
6. Trusts are small taxpayers. According to IRS Statistics of Income for 2010, over 96% of all trusts report less than \$100,000 of total income, including capital gains.⁶ These trusts are often maintained for minors, disabled individuals, and the elderly. This \$100,000 threshold is significantly below the amount generally used to define "wealthy taxpayers" for whom benefits are limited. The Internal

⁶ Table 1. Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Tax Status and Size of Total Income, Filing Year 2010, *available at* <http://www.irs.gov/taxstats/article/0..id=225290.00.html>.

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Revenue Code should reflect that estates and trusts are generally small taxpayers burdened with mandatory duties that require extra costs to administer.

7. Cost of compliance does not justify the tax collected. As section 67(e) is presently interpreted, trusts and estates must determine on an item-by-item basis which costs would not customarily be incurred by a hypothetical individual in order to determine the costs not subject to the 2-percent floor. In order to avoid the cost, complexity, and recordkeeping required to determine which costs would not commonly be incurred by a hypothetical individual, many small trusts and estates might simply subject all their costs to the 2-percent floor, forfeiting their right to the full deduction because they cannot justify the compliance cost. Large trusts and estates may decide to incur the extra cost of recordkeeping in order to obtain a full deduction. The additional compliance cost for both the government and fiduciaries will likely be significant compared to the incremental revenue. Sound tax policy should not limit the availability of legitimate tax deductions to only those who can afford the cost to comply.
8. The proposed change is simple. The bill proposes to simply delete the phrase at the end of section 67(e)(1) – “and would not have been incurred if the property were not held in such trust or estate.” Such change would allow a full deduction for all costs “incurred in connection with the administration of the trust or estate.” It would be administrable, fair and consistent with Congress’s intent to simplify recordkeeping. It would also eliminate the tension between the Prudent Investor Act’s mandate to invest prudently and the Internal Revenue Code’s denial of a full deduction for the costs of complying with the Act.
9. Trustees are already heavily regulated. Trustees are heavily scrutinized on how they invest property entrusted to them compared to individuals who are free to manage their own property. Trustees must comply with the Uniform Trust Code, the Uniform Prudent Investor Act, the Uniform Principal and Income Act, and numerous other federal and state laws. These laws require them to be loyal and impartial, to diversify, to contain costs and to consider numerous other circumstances unique to a trust. Trusts and estates were not the original target of section 67(e) when Congress sought to reduce recordkeeping and deductions for personal expenses.
10. The proposed change would provide a single definition of AGI for an estate or trust in the Internal Revenue Code. The Internal Revenue Code contains two different definitions of AGI for an estate or trust. Section 67(e) provides that AGI is determined after deducting costs “paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” However, section 165(h)(4)(C) provides that AGI is determined after deducting “costs paid or incurred in connection with the administration of the estate or trust.” These two distinctly different definitions of AGI serve no purpose. The Internal Revenue Code should

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be simplified to provide a single definition of AGI for estates and trusts, which should be the definition contained in section 165(h)(4)(C).

Conclusion/Recommendation

Congress should amend section 67(e) to simplify the law and allow estates and nongrantor trusts to fully deduct the cost of complying with fiduciary duties in administering estates and trusts.