Allocation of Estate Planning Fees Can Save Taxes

This article explains when estate planning fees are deductible and what practitioners can do to help taxpayers support such a deduction.

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Fees incurred before death for estate planning services may be deductible for income tax purposes. A deduction is significant because (1) it may save the client taxes, and (2) the savings may partially offset the practitioner's fee. To maximize deductibility, practitioners need to be aware of the statutory, administrative, and case law in the area, with particular focus on which services justify a deduction, the steps that can be taken to support the deduction, and how it is treated on Form 1040.

The Code contains no provision that specifically addresses the deductibility of estate planning fees. If a deduction is available for such fees, it is under the authority of Section 212, which allows a deduction for ordinary and necessary expenses paid or incurred:

1. For the production or collection of income.
2. For the management, conservation, or maintenance of property held for the production of income.
3. In connection with the determination, collection, or refund of any tax.

Whether estate planning fees fall into one or more of these three categories depends on the specific services provided by the practitioner. For purposes of the discussion below, estate planning services are divided into (1) planning the tax strategies implemented by the underlying estate planning documents, and (2) discussing and drafting these documents.

Planning tax strategies

The deductibility of the practitioner's fee for tax advice in connection with estate planning services depends on the meaning of "in connection with the determination...of any tax" in Section 212(3). The issue is whether this phrase refers strictly to the determination of tax for completed tax years, or also includes the determina-

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tion of tax for future years. If it includes the latter, estate planning fees allocable to tax advice clearly should be deductible because a taxpayer can affect or "determine" future tax liability through such planning.

Regulation 1.212-1(l) allows a deduction for expenses for tax counsel or expenses in connection with the preparation of returns or proceedings involved in determining tax liability. Although "for tax counsel" seems to refer to planning advice, the Service took a contrary view before 1972. In *Rev. Rul.* 72-545,[1] the Service reversed its position and held that fees relating to tax planning advice are deductible provided they relate "solely to tax counsel" and, if incurred in a context not solely concerned with tax matters, are properly allocated and substantiated. Although the Ruling dealt with tax advice in connection with a divorce, it appears equally applicable to tax advice related to estate planning.

Tax Court view. The leading case interpreting Section 212(3) is *Merians,*[2] a reviewed opinion. The taxpayer engaged a law firm to prepare an estate plan for himself and his wife and the services consisted of substantial tax planning, including the creation of marital deduction estate plan documents and an irrevocable trust.[3] The practitioner's bill, however, did not explicitly allocate his fee to the tax planning work. To support their position that the entire fee was deductible under Section 212(3), the taxpayers relied on the practitioner's testimony that he did a "great deal of tax work," and that the estate plan was done "for tax implications only." In arguing that none of the fee was deductible, the Service admitted that some of the fee probably represented payment for tax advice under Section 212(3), but contended that there was no evidence on which to base an allocation.

The Tax Court allowed a partial deduction. The court relied on *Rev. Rul.* 72-545 as establishing the Service's position that any portion of the legal fee attributable to tax advice, regardless of its nature, would be deductible, and that the only unresolved issue was allocation. While the practitioner's testimony established that a significant portion of his services consisted of giving tax advice, the court concluded that the vagueness of his testimony and his lack of specificity concerning the tax-related portion of the services should be "weighted heavily against the [taxpayers]." For this reason, the court held that only 20% of the fee was allocable to tax advice. The Service has acquiesced in *Merians.*

In *Wong,*[4] the taxpayer also failed to produce records to support an allocation and the Tax Court again allowed a 20% deduction for tax advice, citing *Merians* at length. The court found that the creation of marital and nonmarital trust provisions in the taxpayer's estate plan indicated that the practitioner considered the tax implications of his actions. Again, however, the vagueness of the evidence weighed against a larger deduction.

Practioners should inform taxpayers as to the portion of the fee that may be deductible by providing a detailed billing memo.

There are several troubling aspects to *Merians.* One problem is that the court did not address the specific tax planning services that support a deductible fee. It provided minimal direction in this area other than to state that "in establishing an estate plan, choices made for personal nontax reasons may have tax implications, but the consideration of such implications does not convert into tax advice the advice given concerning nontax problems." In addition, several judges disagreed with the majority's assumption that Section 212(3) provides a deduction for estate planing fees attributable to tax advice. The four concurring opinions and two dissents suggested that estate planning fees related to tax planning do not fall within the scope of Section 212 and therefore are not deductible. For example, one dissent concluded that "the deductibility of expenses for tax coun-

1 1972-2 CB 179.
2 60 TC 187 (1973).
3 See Hardman and Misckhe, *Marital deduction: less to spouse may reduce overall tax,* 21 TL 42 (Jul/Aug 1992).
4 TCM 1989-683.

sel for services and advice on tax matters is limited to the computation or contest of an actual or existing tax liability for completed tax years or periods with taxing authorities[,] ... not a molding of future events to reduce taxes."

Despite the unsettling aspects of the case, *Merians* is significant in two ways. First, the Tax Court assumed that estate planning fees related to tax advice are deductible under Section 212(3). In addition, the court's reasoning suggests that had the practitioner made a specific, reasonable allocation of his services to tax planning, the court would have respected it.

Detailed records are required to support time spent discussing and drafting tax aspects of an estate plan.

Thus, practitioners need to keep detailed time records and save underlying documents, such as client communications and case file notations to support the time spent discussing and drafting the tax aspects of an estate plan. The practitioner should then inform the client as to the portion of the fee that may be deductible under Section 212 by providing a detailed billing memorandum. (Exhibit I on page 221 provides a sample memo.)

Discussing and drafting documents

A properly implemented estate plan may require several documents. The most common are wills, living trusts, living wills, and powers of attorney for health care and property.

Wills. The services provided in discussing and drafting a will can be broken down into tax and nontax components. The part of the fee associated with discussing and drafting the nontax aspects of the will, such as the dispositive provisions not affected by tax considerations, are not deductible under Section 212 because they are not for the production or collection of income, the management, conservation or maintenance of property held for the production of income, or the determination, collection, or refund of any tax. For example, in *Contini,*[5] documents affecting the future disposition of property served personal purposes and were not related to any of the deductible categories under Section 212.

The part of the fee related to discussing and drafting the tax aspects of the will, however, should be deductible under Section 212(3).[6] This would include provisions relating to marital bequests, for example, the allocable portion of the fees related to drafting a formula bequest designed to achieve maximum estate tax savings and deferral, or tax planning for the generation skipping transfer tax or gift tax.

The practitioner's billing memorandum for the will should detail the various activities performed, as well as the tax and nontax components of each activity. This provides the taxpayer with written evidence of the portion of the fee that may give rise to an income tax deduction.

Trusts. The services provided in discussing and drafting a lifetime revocable trust, or "living trust," can be similarly separated into multiple components.[7] For a living trust that will be funded only with non-income-producing assets (*e.g.*, personal and vacation residences), the practitioner's fee should be allocated between tax and nontax components, as with a will. The nontax portion is not deductible under Section 212.

For a living trust that will be funded with income-producing assets, the practitioner's fee should be allocated between three components: (1) tax, (2) lifetime management, and (3) nontax/non-management. The tax component should be deductible under Section 212(3). The nontax/non-management component is not deductible under Section 212. The treatment of the lifetime management component is less clear.

To the extent that income-producing assets will be transferred to the trustee of a living trust, the trust itself has been established, at least in part, for the management, conservation, or maintenance of property held for the production of income under Section 212(2). Thus, the portion of the fees associated with discussing and

5 76 TC 447 (1981).
6 See *Carpenter,* 338 F.2d 366, 14 AFTR2d 5897, 64-2 USTC ¶9842 (Ct. Cls., 1964).
7 See Pozzuolo and Mittleman, *Living trusts may provide tax benefits,* 22 TL 43 (Jul/Aug 1993).
8 8 TC 130 (1947).
9 78 TC 801 (1982).
10 79 TC 846 (1982).

drafting the lifetime management provisions of the living trust, such as trustee investment powers, retention of stock, lifetime distributions of income, voting of stock, and related considerations, should be deductible under Section 212(2).

Additional support for this proposition can be found in *Bagley*,[8] in which the Tax Court allowed a deduction under Section 212(2) for legal advice concerning estate plans that proposed substantial changes, including the creation of inter vivos trusts, to the taxpayer's estate of income-producing properties. Subsequent to *Bagley*, however, courts have been relatively restrictive in their interpretation of what constitutes management of income-producing assets under Section 212(2).

In *Epp*,[9] the taxpayer paid $2,000 for materials and advice to establish a family trust and subsequently transferred two parcels of real property to the trust. She contended that she created the trust "to protect" the property. The Tax Court held that the $2,000 fee was a nondeductible personal expenditure. Specifically addressing Section 212(2), the court stated that even if the property was held for the production of income, the taxpayer failed to meet her burden of proving that the payment in any way related to the management, conservation, or maintenance of the property. Similarly, in *Luman*,[10] the taxpayers paid $20,000 for materials and advice to set up a family trust to which they transferred a ranch and virtually all of their other properties. They apparently created the trust to keep the ranch in the family for as long as possible and, on their deaths, to provide an orderly transfer of the properties to their children. The Tax Court held that the fee was not deductible under Section 212(2), citing *Epp* for the proposition that costs of rearranging title to income-producing property for planning personal and family affairs (such as establishing trusts for family members or making gifts), or for retaining ownership of property are not deductible under Section 212(2). Rather, they are nondeductible personal expenditures.

The Tax Court in *Luman* stated that *Bagley* would no longer be followed to the extent that it was inconsistent with the court's later decision in *Epp*. An analysis of *Bagley* and *Epp* reveals no apparent inconsistencies given the underlying differences in facts. Accordingly, to the extent that legal expenses for the creation of a trust relate to investment advice for the management of income-producing property, those expenses should still be deductible under *Bagley*. Practitioners therefore should make a supportable allocation of part of the fee to the lifetime management component of services provided and should reflect this allocation on the tax-

EXHIBIT I

Sample Estate Planning Billing Memorandum

For estate planning services rendered:

1. Wills: Draft of wills, conferences with clients, and advice with respect to the disposition of property (excluding tax aspects, separately listed below).
   ________ hours $________ *
2. Trusts: Draft of living trust, conferences with clients, and advice (excluding tax and lifetime management aspects, separately listed below).
   ________ hours $________ *
3. Living will: Draft of living wills, conferences with clients, and advice.
   ________ hours $________ *
4. Tax advice: Draft of tax provisions of wills and trusts, conferences with clients, and advice involving tax advice/planning, including discussion of marital credit shelter formula bequest and explanation as to operation; conference regarding specific formula to use; work on drafting formula and inclusion of corresponding provisions to ensure accuracy of formula; draft of flowchart demonstrating tax aspects of plan; follow-up phone conference to discuss operation of formula and funding mechanisms; draft of required tax language to correspond to formula used.
   ________ hours $________ **
5. Lifetime management advice: Draft of lifetime management aspects of living trust, including Articles xx through xx; conferences with clients and advice to enable management, conservation, and maintenance of income-producing properties.
   ________ hours $________ **

Total $________

* Not deductible for Federal income tax purposes.
** The cost (1) of tax advice, and (2) for the management, conversation, or maintenance of property held for the production of income may be deductible for Federal income tax purposes under Section 212. To the extent deductible, they are miscellaneous itemized deductions.

payer's bill. If this allocation is made, practitioners should advise taxpayers that a deduction for such fees is uncertain and may be disallowed if reviewed or challenged by the Service. Taxpayers also should understand that they will bear the burden of proving a deduction, and that reliance on the practitioner's allocation may be insufficient to sustain this burden.

Living wills and powers. A living will and a power of attorney for health care are documents that express health care directives. As such, fees associated with discussing and drafting these documents fail to meet the requirements of Section 212 and are not deductible.

In contrast, the fees associated with discussing and drafting a power of attorney for property, which should be minimal in comparison to fees associated with the other aspects of the estate plan, arguably are deductible, but only to the extent allocable to the portion of the power that will involve income-producing assets. To the extent that an allocation is made, practitioners should advise taxpayers that, as with the costs of setting up living trusts, the Service may question the deductibility of these fees.

Tax return treatment

Estate planning fees are deducted on Schedule A of Form 1040 as a miscellaneous itemized deduction and therefore are subject to the 2%-of-AGI floor under Section 67(a). If miscellaneous itemized deductions do not exceed this floor, they produce no tax savings.

Example. Husband and Wife file a 1993 joint return with AGI of $100,000. In that year, they paid deductible estate planning fees of $1,500. Other miscellaneous itemized deductions, totaling $450, were for professional organization dues, income tax return preparation fees, and a fee for a safety deposit box to store documents related to income-producing investments. Since total miscellaneous itemized deductions of $1,950 do not exceed 2% of AGI ($2,000), no tax savings result.

In addition to passing the 2%-of-AGI test, the taxpayer's miscellaneous itemized deductions in excess of the 2% floor, when added to all other itemized deductions, must exceed the standard deduction. Otherwise, the taxpayer uses the standard deduction in computing taxable income, and any benefit of the potentially deductible portion of estate planning fees is lost. In addition, even if the 2% floor is surmounted, the tax savings under the regular tax system may be abridged under the AMT rules.[11]

Further, miscellaneous itemized deductions are subject to the overall limitation under Section 68(a), which was made permanent by RRA '93.[12] Under Section 68(a), if AGI exceeds $108,450 ($54,225 for married taxpayers filing separately) for 1993, itemized deductions are reduced by the lesser of (1) 3% of the excess of AGI over the threshold, or (2) 80% of the itemized deductions otherwise allowable for the tax year. The thresholds are $111,800 and $55,900 for 1994. Any adjustment under Section 68 is applied after taking into account the 2%-of-AGI floor.

Conclusion

Fees incurred by taxpayers for estate planning services are often substantial and the burden can be mitigated by tax deductions. To support a deduction for these fees, practitioners must provide a billing statement that clearly indicates the portion of the fee that may be deductible. ◆

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11 See Rook, *AMT rules under RRA '93 are good news for corporations,* 22 TL 158 (Nov/Dec 1993).

12 See *Rev. Rul.* 93-75, IRB 1993-35, 4.