Deductibility of Estate Planning Fees: An Old Strategy Revisited

By Louis S. Harrison and John M. Janiga

As client pressure to minimize legal fees continues to mount, estate planning lawyers must reexamine their billing practices. Increased computer capability has led to drafting efficiencies, which have allowed estate planners to focus more on estate tax planning and less on actual drafting. This approach affects a traditional strategy used to mitigate the burden of estate planning fees:

deducting a portion of those fees for income tax purposes.

For estate planning services not directly linked to business planning (for which a substantial portion of the fees are billed directly to the business and are deductible as business expenses), the strategy relies solely on the deductibility of tax advice and assistance in the management of investment assets under Internal Revenue Code § 212. Reconsideration of this strategy is appropriate in light of the current economics in the estate planning field.

The usefulness of the strategy will depend on:

- the extent to which the client benefits economically from an income tax deduction; and
- whether any portion of the estate planning fee can be reasonably allocated to services that support such a deduction.

Economic Benefit to the Client

Deductible estate planning fees are characterized as "miscellaneous itemized deductions" and, therefore, would appear on Schedule A of Form 1040. Miscellaneous itemized deductions are subject to a 2% of adjusted gross income (AGI) floor under Code § 67(a). If miscellaneous itemized deductions do not exceed this floor, they produce no tax savings. For example: Mr. and Mrs. Green file a joint federal income tax return for 1993 on which they compute an AGI of $100,000. During 1993 they paid deductible estate planning fees of $1,500 and other miscellaneous itemized deductions (e.g., professional organization dues, income tax return preparation fees and a fee for a safety deposit box used for storing documents related to taxable investment assets) of $450. On these facts, the total miscellaneous itemized deductions ($1,950) do not exceed 2% of AGI ($2,000) and no tax savings result from the miscellaneous itemized deductions.

The taxpayer's miscellaneous itemized deductions in excess of the 2% AGI floor, when added to all other itemized deductions, must exceed the taxpayer's standard deduction. Otherwise, the taxpayer will use the standard deduction in computing taxable income. In this event, none of the itemized deductions, including any deductible portion of estate planning fees, will produce a tax savings. For example: Assume the same facts as in the previous example except that the other miscellaneous itemized deductions total $2,000. The total miscellaneous itemized deductions of $3,500 exceed 2% of the AGI by $1,500 (the amount of the deductible estate planning fees).

If the Greens have $4,600 of other 1993 itemized deductions (e.g., state income and real estate taxes paid, home mortgage interest and charitable contributions), their itemized deductions will total $6,100 ($4,600 plus $1,500), which is less than their 1993 standard deduction of $6,200 (both of the Greens are under 65 and neither is blind). The $6,100 of itemized deductions will produce no tax savings because the Greens will use the standard deduction in computing their 1993 taxable income.

If, however, the Greens have $6,200 of other itemized deductions, their total itemized deductions of $7,700 ($6,200 plus $1,500) will exceed their 1993 standard deduction by $1,500 (the amount of the deductible estate planning fees) and they will itemize their deductions. In this case, the $1,500 fee should produce a tax savings equal to $1,500 multiplied by the Greens' marginal tax rate(s). If, for example, their 1993 taxable income is determined to be $86,000, their marginal tax rate of 28% produces a tax savings of $420 ($1,500 times 28%). The after-tax cost of the deductible estate planning fee is $1,080 ($1,500 less $420).

Miscellaneous itemized deductions are one of the types of itemized deductions subject to cutback under Code § 68. For example, in 1993, the cutback adjustment for joint returns is 3% of AGI in excess of $108,450 (limited to 80% of cutback itemized

deductions). Relative to miscellaneous itemized deductions, the cutback adjustment is applied after taking into account the 2% of AGI floor.

For example: Mr. and Mrs. Smith file a joint federal income tax return for 1993, on which they compute an AGI of $288,450. During 1993 they had miscellaneous itemized deductions (including deductible estate planning fees) in excess of the 2% AGI floor of $2,300 and other itemized deductions (e.g., state income and real estate taxes, home mortgage interest and charitable contributions) of $20,000. AGI in excess of the threshold amount, $180,000 ($288,450 minus $108,450), times 3% results in a cutback adjustment of $5,400. The 80% limitation does not apply because it exceeds $5,400 ($22,300 in itemized deductions subject to cutback times 80% equals $17,840). As a result, only $16,900 ($22,300 less the $5,400 cutback adjustment) of itemized deductions is permitted on the Smiths' 1993 tax return.

Deductibility of Estate Planning Fees

Estate planning fees are not automatically deductible. Because the Code does not contain a provision that specifically addresses the deductibility of estate planning fees, certain estate planning related services will more likely give rise to a fee deduction than others. The estate planner should be aware of the distinctions drawn by the IRS and the courts when planning an estate and preparing the billing memorandum.

The statutory authority to claim a deduction for certain estate planning fees is found in the broad language of § 212, Expenses for Production of Income, which states that:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year -
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

Certain estate planning services may fit within one or more of these three categories; others clearly do not.

Planning Tax Strategies

With substantial estates, a large portion of the estate planning fees are attributable to tax advice. Whether estate planning fees attributable to tax advice are deductible depends on the meaning of the phrase "in connection with the determination . . . of any tax" in § 212(3). If the phrase refers strictly to the determination of tax for completed tax years, these estate planning fees will not be deductible. If the phrase also includes the determination of tax for future tax years, those fees should be deductible because through such planning a taxpayer can affect (i.e., determine) future tax liability. The case law and administrative pronouncements are encouraging but not conclusive.

The regulations to § 212 provide that "expenses paid or incurred by a taxpayer *for tax counsel* or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible" (emphasis added). The phrase "for tax counsel" would seem to refer to planning advice, an interpretation impliedly accepted by the IRS.

For example, Revenue Ruling 72-545, 1972-2 C.B. 179, addressed three independent fact situations in which the taxpayer engaged a law firm for advice regarding his divorce. In the first situation, the firm provided advice about the federal income tax consequences of a proposed property settlement and release. In the second situation, the firm provided advice regarding the tax consequences of establishing a trust to discharge a state law support obligation and certain nontax advice. In the third situation, the firm provided advice about the taxpayer's right to claim his children as dependents in post-divorce tax years and certain nontax advice. The fees in the second and third situations were properly allocated on the billing statements between the tax and non-tax advice.

In considering whether the fee attributable to the tax advice was deductible, the IRS stated:

> In order for an expense to be deductible under [§] 212(3) . . . it must relate solely to tax counsel. If such expense is incurred in connection with any activity that is not solely concerned with tax matters, the expense for tax counsel must be properly allocated and substantiated.

Based on the facts, the IRS then held that the fees attributable to the tax advice were deductible under § 212(3) in all three situations.

The seminal case interpreting § 212(3) is *Merians v. Commissioner*, 60 T.C. 187 (1973). Services provided by a law firm consisted of substantial tax planning, including the creation of marital deduction estate plan documents and an irrevocable trust. The estate planner's bill, however, did not provide an explicit allocation of his fee to the tax planning work. The taxpayers took the position that the estate planner's entire fee was deductible under § 212(3). They relied on the testimony of the practitioner that he did a "great deal of tax work," and that the estate plan was done "for tax implications only." Id. at 188. The IRS took the position that none of the fee was deductible. Although admitting that it was probable that some of the fee represented services deductible under § 212(3) (i.e., the tax advice), the IRS contended there was no evidence on which to base an allocation to such advice.

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Although the Tax Court majority rejected the taxpayer's deduction for the entire fee, it allowed a partial deduction. At the outset of its opinion, the court referred to Rev. Rul. 72-545 and then stated that "we consider that the [IRS] agrees that any portion of the legal fee *which can be found to be attributable to tax advice*, irrespective of its nature, is deductible and that the only issue before us is one of allocation" (emphasis added). Id. at 188. The court then acknowledged that the estate planner's testimony established that a significant portion of his services involved tax advice. Nonetheless, the court concluded that the vagueness of the estate planner's testimony and the estate planner's lack of specificity about the tax-related portion of the services should be "weighted heavily against the [taxpayers]." Id. at 190. For this reason, the court held that only 20% of the fee should be allocated to tax advice.

There are troubling aspects to *Merians*. The majority did not address the specific tax planning services that support a deductible fee. The majority provided minimal direction other than to state that "[w]e also recognize 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." Id. at 189.

Several judges disagreed with the majority's assumption that § 212(3) provides a deduction for estate planning fees attributable to tax advice. The court issued four separate concurring opinions and two separate dissenting opinions. Taken together, the concurring and dissenting opinions suggest that a large number of Tax Court judges concluded that estate planning fees related to tax planning do not fall within the scope of § 212 and, therefore, are not deductible. For example, Judge Withey stated in his dissent that "[a]s I construe section 212(3) and the correlative regulation, I would find that the deductibility of expenses for tax counsel 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." Id. at 196.

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

Discussing and Drafting Estate Planning Documents

A properly implemented estate plan may require several documents. The most commonly used 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, is not deductible under § 212. These costs are not for "the production or collection of income" or "for the management, conservation or maintenance of property held for the production of income," or for the "determination, collection or refund of any tax." See, e.g., *Contini v. IRS*, 76 T.C. 447 (1981) (documents drafted to achieve the future disposition of property are for personal purposes not related to any investment function).

The part of the fee related to the tax aspects of the will, however, should be deductible under § 212(3). *Carpenter v. United States*, 64-2 U.S.T.C. ¶ 9,842 (Ct. Cl. 1964); *Merians*, supra. See also Treas. Reg. § 1.212-11(l) ("expenses paid or incurred by a taxpayer for tax counsel" are deductible). This would include, for example, the allocable portion of the fees related to drafting a formula bequest designed to achieve maximum estate tax savings and deferral and tax planning for the generation-skipping transfer tax or gift tax.

The estate planner's billing memorandum for the will should detail the nontax and tax components of each activity. This provides the taxpayer with written evidence on that portion of the fee that may give rise to an income tax deduction. A sample of a provision to include in the billing memorandum is set forth on page 36.

• **Living Trust.** For deductibility purposes, the services provided in discussing and drafting a lifetime revocable trust (living trust) can be separated into multiple components. In the case of a living trust that will be funded only with non-income-producing assets (e.g., personal and vacation residences), the estate planner's fee should be allocated between

Estate Planning Billing Memorandum

For estate planning services rendered:

(1) Wills: draft of wills, conferences with clients, and advice for the disposition of property (excluding tax aspects, separately listed below)

eight hours

$_____ a/

(2) Tax Advice: draft of tax provisions of wills and trusts, draft of generation skipping transfer tax trusts, including extensive perpetuities provisions, 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 tax formulae to use; conference to discuss generation skipping transfer tax regulations; draft, aspects of plan; work on drafting formulae and inclusion of corresponding provisions to ensure accuracy of formulae; review of specific items in proposed generation skipping transfer tax regulations; draft, review and make revisions to extensive flowchart demonstrating tax aspects of plan; follow-up telephone conference to discuss operation of formulae and funding mechanisms; draft of required tax language to correspond to formulae used; work on reallocation of assets for tax funding purposes

30 hours

Total $_____ b/

$_____

a/These amounts are not deductible for federal income tax purposes.

b/The costs of tax advice may be deductible for federal income tax under Code § 212. To the extent deductible, such costs are treated as a miscellaneous itemized deduction.

"If practitioners make allocations, they should advise clients that a deduction for such fees is uncertain and may be disallowed if reviewed or challenged by the IRS. Clients should also understand that they will bear the burden of proving a deduction, and that reliance on the estate planner's allocation may be insufficient to sustain this burden."

two components—tax and nontax—as is the case with a will. The nontax aspect of the fee is not deductible under § 212; the tax aspect of the fee should be deductible under § 212(3).

In the case of a living trust that will be funded with income-producing assets, the estate planner's fee should be allocated among three components: tax, lifetime management of income-producing assets (lifetime management) and nontax/non-management. The tax component should be deductible under § 212(3). The nontax/non-management component is not deductible under § 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." Accordingly, the portion of the fees associated with discussing and 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 § 212(2). *Bagley v. Commissioner*, 8 T.C. 130 (1947).

In *Bagley*, the taxpayer paid fees to her lawyers for various services, including advice on the merits of various estate plans that proposed substantial changes, including the creation of inter vivos trusts, to the taxpayer's entire estate of income-producing properties. The Tax Court held that the fee was deductible under § 23(a)(2) (the predecessor to current § 212(2)).

After *Bagley*, courts have been relatively restrictive in their interpretation of what constitutes management of income-producing assets under § 212(2). Two cases that illustrate this point are *Epp v. Commissioner*, 78 T.C. 801 (1982) and *Luman v. Commissioner*, 79 T.C. 846 (1982).

In *Epp*, the taxpayer paid $2,000 to the Institute of Individual Religious Studies for materials and advice to establish a family trust. Later, the taxpayer transferred two parcels of real property to the trust. The taxpayer testified that she created the trust "to protect" the real properties.

The Tax Court held that the $2,000 fee was a nondeductible personal expenditure. Specifically addressing § 212(2), the court stated that "even if the . . . property was held for the production of income, the [taxpayer] has failed to meet her burden of proving that the payment . . . in any way related to the management, conservation, or maintenance of such property."

In *Luman*, the taxpayers paid $20,000 to Educational Scientific Publishers for materials and advice to establish a family trust. They transferred a ranch and virtually all of their other properties to the trust. Apparently, the taxpayers created the trust to keep the ranch in the family "for as long as possible" and to provide, on their deaths, an orderly transfer of the properties to their children.

The Tax Court held that the $20,000 was not deductible under § 212(2). In reaching this conclusion, the court cited *Epp* for the proposition "that an expenditure for rearranging title to income-producing property, for planning one's personal and family affairs (such as establishing trusts for family members or making gifts), or for retaining ownership of property is not deductible under section 212(2) but are nondeductible personal expenditures within the meaning of section 262."

Significantly, *Bagley* remains good law except to the extent it conflicts with *Epp*. An analysis of *Bagley* and *Epp* reveals no apparent inconsistencies, given the underlying factual differences. Accordingly, to the extent that legal expenses in the creation of a trust relate to "investment advice for the management of income-producing property," those expenses should still be deductible under the holding in *Bagley*. As a result, the tax practitioner may make a demonstrable allocation of part of the fee to the lifetime management component and should reflect this allocation on the client's bill.

If practitioners make allocations, they should advise clients that a deduction for such fees is uncertain and may be disallowed if reviewed or challenged by the IRS. Clients should also understand that they will bear the burden of proving a deduction, and that reliance on the estate planner's allocation may be insufficient to sustain this burden.

• **Living Wills.** Unlike living trusts and ordinary wills, a living will and a power of attorney for health care are documents that express health care directives. The fees associated with discussing

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and drafting these documents fail to meet the requirements of § 212 and therefore are not deductible.

• **Powers of Attorney.** Fees for drafting a power of attorney for property, which is a document that provides a means to manage an individual's property under certain circumstances, are often not taken as deductions. The fees associated with discussing and drafting the power should be minimal in comparison to the fees associated with the other aspects of the estate plan and arguably would be deductible, but only to the extent allocable to that portion of the power that will involve income-producing assets. Nonetheless, practitioners should advise clients that, as with living trusts, the IRS may question the deductibility of these fees on audit.

Establishing a Reasonable Allocation: A Case Study

The practitioner is responsible for determining whether any portion of the estate planning fee is attributable to services that may justify a deduction and, if so, should detail this information in the client's billing memorandum. This responsibility is a major challenge because, although it is generally easy to track the total time spent on a client's estate plan, it is more difficult to determine with specificity the time spent performing the particular services that may support a fee deduction. Practitioners must therefore use an approximation technique to establish a reasonable fee allocation.The following example illustrates one such technique as applied to the development of a couple's estate plan.

The plan involved a typical marital deduction plan, creating a credit shelter trust and deferring estate tax until the second spouse's death. In addition, the lawyer drafted generation-skipping trusts to continue as long as possible under the rule against perpetuities. The time spent discussing, drafting and implementing the plan was 38 hours, of which 10 hours were for conferences with the clients and 28 hours were attributable to the drafting of documents.

Initially, the lawyer isolated the portion of the fee attributable to the generation-skipping tax advice, because that part of the plan and the creation of the trusts were done for tax purposes. The detailed drafting around the rule against perpetuities was done only to continue the trusts as long as possible with the notion that the continuation from generation to generation would be free of transfer tax. The creation and segregation of two trusts for the children, one free of generation-skipping tax and one that would incur estate tax, were done solely for tax purposes.

To determine the amount of time spent on this part of the plan, counsel compared the total drafting hours, including correspondence and flowcharts, to the total drafting hours typified by a basic credit shelter/ unlimited marital deduction plan with trusts for children, including correspondence and flowcharts and found a difference of about 15 hours. Accordingly, counsel allocated these 15 hours to tax advice.

For the remaining 13 hours, counsel compared the hours in drafting and implementing that part of the plan with the drafting of a nontax plan in which a basket trust or separate trusts are set up for children at the surviving spouse's death, along with the correspondence and flowchart. That type of plan typically takes four hours of drafting and explanation; accordingly, the lawyer attributed an additional nine hours to tax planning matters regarding the drafting of the credit shelter provision formula and related provisions, the explanation of this provision and the explanatory letter, the description of the tax impacts on the flowchart, and calculations of projected estate tax.

The lawyer compared the 10 hours spent in conferences with the client to the amount of time spent on a nontax estate plan, which is typically four hours. Accordingly, the lawyer allocated six of these conference hours to the tax planning advice. The billing memorandum is reproduced on p. 36.

Conclusion

The fees incurred by clients for estate planning services are often substantial. The actual burden to the client can be mitigated to the extent that these fees are deductible and result in a tax savings. To lend support to a client's fee deduction claim, practitioners must provide a billing statement that clearly reflects the specific services provided for the portion of the fee that may be deductible.

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