Deductibility of Legal Fees for Estate Planning and Administration

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Help the client plan, then help the client deduct!

The legal fees incurred for estate planning and administration can be considerable. It is incumbent on advisers to do their best to make sure that these fees are deductible. This article reviews the rules for deductibility, offers practical suggestions for improving the chances of deducting given expenses, and points out the traps waiting for the unwary.

Allowability of Administration Expenses Depends on State Law • Section 2053(a) of the Internal Revenue Code
(“Code”) allows deductions from a decedent’s gross estate for “such amounts...for administration expenses...as are allowable by the laws of the jurisdiction...under which the estate is being administered.” (All section references are to the Code unless otherwise indicated.)

**Legal Fees**

The willingness of clients to pay legal fees can be increased and their pain in so doing decreased if they can obtain a tax deduction for their payment. Both legal fees and fiduciary commissions incurred in estate administration are deductible in computing the taxable estate for federal estate tax purposes. Ordinarily, an estate’s largest administration expenses are executor’s commissions and attorney’s fees. These must be for post-death services and are shown on Schedule J of Form 706. Alternatively, they may be deducted for income tax purposes on the estate’s fiduciary income tax return.

Legal fees for pre-death services are debts of the estate, deductible under section 2053(a)(3) and reportable on Schedule K. Furthermore, they may also be deductible as deductions in respect of a decedent (under section 691(b)) on the estate’s fiduciary income tax return.

A portion of those fees deducted for income tax purposes may be disallowed. The portion disallowed will be equal to two percent of the estate’s adjusted gross income. §67(a). To the extent the fees are passed through to the beneficiaries (other than trust entities) a portion may also be subject to this two percent rule.

The deductibility of legal fees in estate planning is largely governed by section 212. It allows “a deduction [for] 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.”

This has been construed as allowing a deduction of expenses for the production of income for a portion of the fees incurred in estate planning. Merians v. Commissioner, 60 T.C. 187 (1973), acq. 1973-2 C.B. 2, the principal authority for the deduction for tax advice in estate planning, allowed a section 212(3) deduction for legal fees allocable to such advice. But the court permitted deduction of only the portion (20 percent) of the taxpayers’ estate planning fees it considered attributable to tax advice. The relatively small portion considered to be for tax advice was due to the lack of specific records, although taxpayers’ attorney testified that most of his time was spent on tax matters. However, the court found no other evidence (such as an itemized bill for legal services) on which to base a deduction for his entire fee.

There were several concurring and dissenting opinions. One concurrence stated that the case should be reopened to allow the taxpayers to prove what portion of their legal fee would be deductible under section 212(2). Another said that expenses incurred for estate planning tax advice are ordinary and necessary management expenses and thus deductible under section 212(2). The remaining concurring opinion and two dissenting ones would have allowed a section 212(3) deduction solely for legal expenses incurred in the preparation of gift tax returns, reasoning that this section addresses deductions for tax counsel for settled events, not for planning future ones. Thus, the dissents would not permit a deduction for legal expenses incurred in estate planning, because there is no current tax liability.

The entire deduction for legal advice attributable to estate planning and general business advice was disallowed when the taxpayer failed to produce evidence as to the amount, if any, of his legal fees for the above-mentioned categories. McDonald v. Commissioner, 52 T.C. 82 (1969). Similarly, when there was no showing of the fee allocable to estate planning and a will, the deduction was denied. Schultz v. Commissioner, 50 T.C. 688, aff’d per curiam on other issues,
Legal fees for services and advice in connection with the merits and legal aspects of plans submitted to a taxpayer by a firm of estate planners for the rearrangement and reinvestment of her entire estate were deductible. Bagley v. Commissioner, 8 T.C. 130 (1947), acq. 1947-1 C.B. 1.

Wong v. Commissioner, 58 T.C.M. (CCH) 1073 (1989), cited Merians and held that 20 percent of legal fees for estate planning services was deductible as tax advice under section 212(3). However, the Tax Court found no portion of it deductible under sections 212(1) or (2), because nothing was incurred for the production or collection of income. Furthermore, the taxpayers did not itemize the time spent on the services performed.

Citing Luman v. Commissioner, 79 T.C. 846 (1982), the court held that the expenses incurred for rearranging title to income-producing property, for planning personal and family affairs, or for retaining ownership of property were section 262 nondeductible personal ones. Id., at 856; Epp v. Commissioner, 78 T.C. 801, 804-805 (1982).

Creation of a trust was held not to have been done to obtain investment advice nor for the management of taxpayers’ income-producing property; thus no portion of their legal expense was deductible under section 212(2).

A deduction is probably not permissible for preparation of a nonfunded revocable trust and certainly not for a testamentary trust. However, it could be argued that a funded revocable trust is a protective arrangement for the management and conservation of property and therefore deductible under section 212(2). But, when an irrevocable trust is created and property is irrevocably transferred to the trust for the benefit of others, the origin of the transfer would seem to be personal and, therefore, nondeductible. Mathews v. Commissioner, 61 T.C. 12 (1973), rev’d, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976). See William P. Streng, 800 T.M., Estate Planning, pages A-201 and 202.

### Suggested Way To Obtain Deduction for Pre-Death Legal Fees

To obtain a deduction for any legal fee, itemize the bills in such a way that the tax-deductible portions are shown as such.

### Break Bill for Pre-Death Fees into Three Categories

In both Merians and Wong, there were three distinct categories of legal fees charged for estate planning:

- Those incurred to prepare wills and other testamentary documents, which are not allowable as deductions;
- Those incurred for tax advice and return preparation, which are deductible; and
- Other estate planning expenses the deduction of which will probably be disallowed by the IRS, but might be sustained by a court, thus placing them in a gray area. The argument for their allowance is that they are section 212(2) expenses incurred for arranging for the management, conservation, or maintenance of income-producing property that will be in the taxpayer’s estate at death and, under section 212(3), were incurred in connection with the determination (minimization) of the taxpayer’s future tax liability.

### Allocation of Fees

In billing clients for estate planning, allocate legal fees to the above three categories, preparing one or possibly two or even three separate bills. The allocation need not be strictly on a time basis. The preparation of a will and other testamentary type documents is not worth as much to the client or as difficult for the lawyer to prepare as documents in the gray area of deductibility. The fully deductible work for the management of income-producing property (such as creating a funded trust and in connection with current tax planning and property management) is more difficult to do and worth more to the client.
Deductions of Administration Expenses Are limited to Necessary Ones Allowed Under State Law

Section 2053(a) allows deductions from a decedent’s gross estate for “such amounts...for administration expenses...as are allowable by the laws of the jurisdiction...under which the estate is being administered.” The regulations limit administration expenses to those “actually and necessarily incurred in the administration of the decedent’s estate.” Treas. Reg. §20.2053-3(a). Deductions either for debts or administration expenses may only be taken if, under the local law governing estate administration, they are allowable. Treas. Reg. §20.2053-1(a). But even a state court decree allowing a claim or expense will be followed only if the court actually decided “the facts upon which deductibility depends,” and it appears that the claim was decided upon its merits. Treas. Reg. §20.2053-1(b)(2). Decrees entered by consent of the parties are acceptable only if there was a bona fide recognition of the claim by the consenting parties and the court accepted this on its merits. Id. Nevertheless, a court decree is not per se necessary to establish the deduction. Id. The cases suggest, however, that while a state court decision as to allowability under local law will ordinarily be accepted, it is not conclusive. See Hibernia Bank v. U.S., 581 F.2d 741 (9th Cir. 1978).

Fees earned after death cannot be deducted on both the estate and income tax returns. Those deducted on the estate tax return that were incurred in administering property not subject to claims should be listed on Schedule L, instead of Schedule J. In all cases, the names and possibly the addresses of the lawyers to whom they were paid should be shown.

CONDITIONS FOR DEDUCTIBILITY OF FIDUCIARY COMMISSIONS • Those commissions which have actually been paid, agreed upon, or even estimated, so long as they are expected to be paid, are deductible.

Court Decree Unnecessary

Even if they have not been fixed by court decree (the usual case at the time of most federal estate tax audits), the deduction of fiduciary commissions will ordinarily be allowed.

Supporting Data May Be Required

Executor’s commissions may need to be supported by fee affidavits or even time records, particularly when they are in addition to substantial professional fees.

Three Conditions To Satisfy

Treas. Reg. §20.2053-3(b)(1) provides that for an executor’s commission to be deductible, three conditions must be met:
• The District Director (now called the Territorial Director) is reasonably satisfied that the commissions claimed will be paid;
• The claimed deduction would be allowable under local law; and
• The amount claimed is in accordance with the usually accepted practice in the jurisdiction for estates of similar size and character.

Personal Representatives’ Fees Must Meet the Requirements of Both Local Law and Section 2053

Finding an expense allowable under state law is simply a threshold requirement that must be satisfied before considering section 2053’s federal requirements for allowability. Estate of Grant v. Commissioner, 294 F.3d 352 (2d Cir. 2002), aff’g, 78 T.C.M. (CCH) 900 (1999) (and cases cited therein from the Fourth, Fifth, Sixth, Ninth and Eleventh Circuit Courts of Appeal). For an expense to be deductible under section 2053, it must qualify as an administration expense under both applicable state law and federal law as delineated in Treasury Regulations. Id.

The Tax Court in Grant, 78 T.C.M. (CCH) 900 (1999), found that most of the personal representatives’ time was spent handling trust assets, rather than probate property. Because the