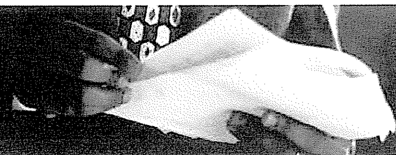
SECTION NEWS



Would (commonly) v. Could (ever)...

The Supreme Court and the IRS Tackle the Deductibility of Investment Related Advisory Fees

Sean E. Mumaw

On January 16, 2008 the U.S. Supreme Court issued a decision addressing a decade-and-a-half year old split in the circuit courts over the tax treatment of certain costs and expenses incurred by estates and trusts under Section 67 of the Internal Revenue Code.

A few months earlier, the Internal Revenue Service (IRS) had released Proposed Regulation §1.67-4 addressing the same and more.

Bottom line: most fees, for now, relating to investment advisory services will be deductible only to the extent the fees exceed two percent of a taxpayer's adjusted gross income. To the extent fees are "bundled" with one another, a taxpayer is required under the proposed regulation to allocate portions to be deducted before and after arriving at their adjusted gross income.

At issue in *Knight v. Commissioner* was whether fees charged a trust for investment advice concerning the trust assets were subject to the two percent floor applicable to most miscellaneous itemized deductions. In particular, the matter turned on the meaning of the following portion of Code §67:

> (e) Determination of adjusted gross income in case of estates and trusts— ...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.

Why is this important? When you consider that the value of assets under management by trustees in the United States is measured in trillions of dollars, and that trustees collect billions of dollars in fees, it becomes clear that there is some real money at issue.

The split in the circuit courts stemmed from the Sixth Circuit position that *all* investment management fees charged by trustees were fully deductible and the Second, Fourth and Federal Circuits' decisions that *only* those investment management fees that an individual could not or would not commonly incur were fully deductible.

The trustee taxpayer in *Knight* argued that full deductibility was proper under Code §67(e) because that section creates a straightforward causation test. The trustee contended that the proper inquiry was simply to ask whether the expense was caused as the result of the property being held in trust. The trustee further argued that the test was met because the investment advisory fee expense was directly attributable to property held in trust and that the expense was not one an individual would incur because the subject expense was paid in furtherance of the trustee's performance of its fiduciary duties.

The Commissioner, however, prevailed in the lower courts by arguing that the language of Code §67 creates an inquiry into whether the expense "could" be incurred by an individual. This position was embraced by the Solicitor General who argued that the Court of Appeals' approach represented the best reading of the statute and established an easily administrable rule.

The Supreme Court, in unanimously affirming the decision below, ended up rejecting both arguments it was presented. Relying on the text of the statute, the Court noted that the provision in question creates a two-step inquiry of whether the expense in question (1) was incurred in connection with the administration of the trust and (2) would

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be uncommon (or unusual, or unlikely) to have been incurred if the property were not held in trust.

The trustee in *Knight* had argued that the fees at issue were incurred as a result of the prudent investor rule as codified in Connecticut. The Connecticut statute (which is similar to KRS 286.3-277) required that trust assets be invested and managed in the same manner that a prudent investor would invest them. The Court did not dispute the argument that a hypothetical prudent investor would have solicited investment advice just as the trustee did. Indeed, it used the trustee's argument in postulating that it would not be unusual or uncommon for such fees to have been incurred if the property were held by an individual investor.

In affirming the lower court's decision that the subject investment advisory fees were subject to the two percent floor, the Court left open two doors on this matter, steps through which we shall no doubt see litigated in the future. The Court first noted that due to the lack of regulatory guidance, assessment of what is "common" may be difficult, thus opening the door for the Treasury Department to promulgate definitive guidance for taxpayers.

The second "open door" is the Court's recognition that:

> A trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the two percent floor.

Unfortunately, but not surprisingly, the Court did not develop discussion of what amounted to an "unusual investment objective" or any other factor that would render "comparison with individual investors...improper."

Enter Proposed Regulation §1.67-4. Issued on July 27, 2007 the regulation provides more guidance, but also promises that this issue is going to be a tough nut for taxpayers to crack.

The proposed regulation provides that if an expense incurred is "unique" to an estate or non-grantor trust (hereinafter collectively referred to as "trust"), then that expense is not subject to Code §67's two percent floor for miscellaneous itemized deductions and is fully deductible. However, if the expense is not "unique" to a trust, then deductibility is limited by application of the two percent floor. Essentially, the IRS has attempted to adopt the Second Circuit's approach to limit full deductibility to only those expenses that could not be incurred by an individual.

To its credit, the proposed regulation does provide non-exclusive lists of what the IRS considers "unique" and what it does not. Items considered to be unique include fiduciary accountings, judicial or quasi-judicial filings required as part of the administration of the estate or trust, fiduciary income tax and estate tax returns, the division or distribution of income or corpus to or among beneficiaries, trust or will contest or construction, fiduciary bond premiums and communications with beneficiaries regarding trust matters.

Products or services that are not unique include those rendered in connection with custody or management of property, advice on investing for total return, gift tax returns, the defense of claims by creditors of the decedent or grantor, and the purchase, sale, maintenance, repair, and insurance or management of non-trade or business property.

The IRS also addresses "bundled services" fees by providing that if a trust pays a single fee, commission or other expense for unique *and* non-unique items, then the trust must identify the portion of the subject expense that is unique in order to fully deduct that expense. In so doing, the taxpayer may use a reasonable method to allocate the expense, but the taxpayer's characterization will not be binding on the IRS.

Without delving into each item above, I will note one item that is missing from the "unique" list: attorney and accountant fees. While previously fully deductible, it seems that the IRS wants to require trusts to allocate fees paid to attorneys and accountants into categories for unique services rendered (will contests, advice on compliance with this regulation, etc.) and those that are non-unique (collecting on a promissory note, tax advice applicable to individuals, etc.). Additionally, advice rendered with respect to the concept of "total return" is considered non-unique, even though much of that advice centers on maximizing the benefit of a trust for both the income and remainder beneficiaries. Aren't these exactly the sort of folks whose "various interests" require "specialized balancing" as described by the Supreme Court in *Knight*?

So what does this all mean and where do we go from here? Unfortunately, I do not know. What I believe is that trustees and their advisors are going to spend a great deal of time hemming and hawing as they try to wade through this morass.

If you are curious, the amount at issue in *Knight* was the grand sum of $4,448.

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