

Good “Knight” to Full Deduction of Investment Advisory Fees—Or Is It?

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In rendering its decision in the case of *Knight v. Commissioner*,¹ the United States Supreme Court has changed the way in which investment advisory fees on estates and trusts are deducted on fiduciary income tax returns. The case centered on the filing of the William Rudkin Testamentary Trust’s fiduciary income tax return for the 2000 tax year. William Knight, as trustee of that trust, had hired Warfield Associates, Inc. to provide investment advice regarding investing the trust assets, which were approximately \$2.9 million in value at the time. Warfield’s investment advisory fees for 2000 were \$22,241, which the trustee deducted in full on the trust’s fiduciary income tax return. After audit, the Commissioner ruled that the investment advisory fees were miscellaneous itemized deductions subject to the two percent (2%) floor, resulting in a tax deficiency to the trust of \$4,448.²

Thereafter, Mr. Knight appealed to the United States Tax Court requesting review of this assessment, arguing that such fees should be fully deductible because the trustee had a duty under the Connecticut Uniform Prudent Investor Act to act as a prudent investor, which required the trustee to hire an investment advisor to meet such duty and to pay for such services. Therefore, he argued, such fees were unique to the trust and should be fully deductible under Internal Revenue Code (I.R.C.) § 67(e)(1). The Tax Court did not accept that argument, and sided with the Internal Revenue Service (IRS) to hold that such fees are commonly incurred by individuals as well, and were, therefore, not unique to a trust and were subject to the two percent (2%) floor.³

The trustee proceeded to the Court of Appeals for the Second Circuit. The Second Circuit, in again ruling in favor of the Commissioner, came up with new reasoning for such determination, and held that since the costs were of a type which *could* be incurred if the property were held by an individual instead of a trust, the deduction of such fees was not unique to a trust and, therefore, subject to the 2% floor under I.R.C. § 67. Undeterred, the trustee pursued his case to the Supreme Court. As there had been some conflict among the Circuits on this issue, the Supreme Court granted *certiorari*.

I. History

At the time that *Knight* was heard, the issue of the deductibility of investment advisory fees had been considered in several other Circuits.

A. Sixth Circuit: Full Deductibility Allowed

In the Sixth Circuit, in *O’Neill v. Commissioner*,⁴ the co-trustees argued that because they had an obligation to meet the prudent investor standard under Ohio law, and because none of them would have agreed to serve as co-trustee until an investment advisor was hired, payment of investment advisory fees by the co-trustees was warranted and should be fully deductible. The Sixth Circuit, in holding in favor of the trustees and ruling that the investment advisory fees were fully deductible on the fiduciary income tax return, stated, “The trustees here lacked experience in investing and managing large sums of money and, therefore, sought the assistance of an investment advisor. Without WPHA’s management, the co-trustees would have put at risk the assets of the Trust. Thus, the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees.”⁵

B. Federal and Fourth Circuits: Partial Deductibility Allowed

The Federal Circuit case, *Mellon Bank v. United States*,⁶ involved thirteen irrevocable trusts which had been created for the Mellon family. The trustee argued that if a trustee incurs costs as part of its efforts to satisfy its fiduciary obligations under state law, then those expenses constitute fiduciary fees and should not be treated as miscellaneous deductions subject to the 2% floor, regardless of whether such costs would have been incurred in a non-fiduciary context if the funds were not held in trust.⁷ In ruling against the trustees, the Court held that under the Pennsylvania prudent investor statute trustees were charged with making decisions as an individual would. Thus, it was “simply not reasonable to conclude that fees for investment advice incurred by a trustee pursuant to its statutory trust obligations would always constitute fees ‘which would not have been incurred if the property were not held in such trust.’”⁸

A similar decision was reached in the Fourth Circuit in *Scott v. United States*.⁹ The trust at issue in the case had approximately \$25 million in assets with three co-trustees who had paid approximately \$250,000 in investment advisory fees over two years. The fees had been fully deducted on the fiduciary income tax returns, but the IRS, after audit, determined that the investment advisory fees were miscellaneous itemized deductions subject to the 2% floor.¹⁰ The district court

held in favor of the IRS, and the Fourth Circuit, in affirming the district court's finding, stated that investment advisory fees would be treated as fully deductible only if they were "unique to the administration of a trust and not customarily incurred outside of trusts. Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers."¹¹ The Court held that because such fees are those which would be commonly incurred outside of trust administration, by an individual, they are subject to the 2% floor.

II. Proposed Regulation

Following the Second Circuit's decision, but prior to the Supreme Court granting *certiorari*, on July 27, 2007, the U.S. Treasury issued Proposed Reg. § 1.67-4, which stated that the only costs not subject to the 2% floor were costs incurred by an estate or non-grantor trust which were *unique* to the estate or trust.¹² Further, in reiterating the Second Circuit's findings, the proposed regulation goes on to state that "a cost is unique to an estate or a non-grantor trust if an individual *could* not have incurred that cost in connection with property not held in an estate or trust."¹³ There are also some examples in the proposed regulation of products or services that are and are not unique to an estate or trust, as well as a discussion of "bundled fees," some of which the regulation makes clear, are unique to an estate or trust and some of which are not, and of those which are not, the regulation makes clear, are subject to the 2% floor.¹⁴

III. Reasoning of the Supreme Court in *Knight*

Although the Supreme Court ultimately upheld the Second Circuit's decision in *Knight*, it did not agree with the Second Circuit's reasoning, particularly the Second Circuit's insertion of "could" instead of "would" in I.R.C. § 67(e)(1).¹⁵ I.R.C. § 67(e)(1) states the following: "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."¹⁶

In discussing this very issue, Justice Roberts, who delivered the opinion of the Court, stated that the Second Circuit's interpretation in asking "whether the cost at issue *could* have been incurred by an individual . . . flies in the face of the statutory language."¹⁷ The Court went on to state that if Congress had intended the statute be read as the Court of Appeals suggested, Congress could have replaced "would" in the statute with "could," which it had not.¹⁸ The trustee argued that "whether a particular expense of a particular trust

or estate was caused by the fact that the property was held in the trust or estate" was the proper inquiry in determining whether or not such an expense is fully deductible and that investment advisory fees incurred by the trust met this test because these costs were caused by the trustee's obligation "to obtain advice on investing trust assets in compliance with the trustees' particular fiduciary duties."¹⁹ In response to this argument, the Court stated that "[i]n asking whether a particular type of cost 'would *not* have been incurred' if the property were held by an individual, § 67(e)(1) excepts from the 2% floor only those costs that it would be *uncommon* (or unusual, or unlikely) for such a hypothetical individual to incur."²⁰

The trustee also argued that because he had a fiduciary duty to act as a prudent investor under the Connecticut's Uniform Prudent Investor Act, it was necessary to hire an investment advisor to allow him to meet his fiduciary duties under the Act. The Court went on to discuss the Act and stated that, "[t]he prudent investor standard plainly does not refer to a prudent *trustee*; it would not be very helpful to explain that a trustee should act as a prudent trustee would. Rather, the standard looks to what a prudent investor with the same investment objectives handling his own affairs would do—i.e., a prudent individual investor."²¹ The Court did, however, leave at least a small window open when it noted that "some trust-related investment advisory fees may be fully deductible 'if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts.'"²² The Court went on to state that "[i]t is conceivable, moreover, 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 2% floor."²³ Unfortunately, in *Knight*, the trustee had not made such an argument.

IV. Response by Accountants

Following the issuance of the *Knight* decision, and in response to the proposed regulation which had been issued prior to the Supreme Court decision in *Knight*, the American Institute of Certified Public Accountants (AICPA) sent a letter to the IRS requesting that the proposed regulation be withdrawn and a new proposed regulation be issued, since the proposed regulation appeared to follow the Second Circuit's reasoning which the Supreme Court had rejected in *Knight*.²⁴ The AICPA also requested that the comment period be lengthened and the IRS issue interim guidance for trustees and tax preparers for preparation of 2007 fiduciary income tax returns on the bundled fees issue which was part of the proposed regulation. Finally, on the unbundling issue, AICPA requested that the Treasury Department and the

IRS reconsider the proposal to require unbundling of fiduciary fees in cases where the fiduciary fees charged were reasonable compared to state law guidelines for trustee's commissions and common practice. It also requested that the rule allow a one to two year transition period to allow fiduciaries the time to determine whether the fees should or could be fractured. The letter went on to give numerous examples to be considered in determining the meaning of "commonly" and "customarily" incurred by trusts. The letter ends with an analysis by AICPA of fifteen separate fact patterns and discussion of whether the investment advisory fees would be fully deductible under the scenarios presented.

In apparent response to this letter, the IRS issued Notice 2008-32 which was supposed to provide guidance on the "bundled fees" issue addressed in the proposed regulation. Notice 2008-32 stated that "[t]axpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2-percent floor under § 67 for any taxable year beginning before January 1, 2008. Instead, for each such taxable year, taxpayers may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2-percent floor. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee." The Notice goes on to extend the comment period on the proposed regulation until May 27, 2008, and to request comments on "whether safe harbors would be helpful and request suggestions on how the safe harbors may be formulated. Comments are specifically requested on reasonable estimates of the percentage(s) of the total costs of administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor including, but not limited to, costs for investment management and advice. Comments are also requested on whether the safe harbors should reflect the nature or value of the assets in the nongrantor trust or estate, and/or the number of beneficiaries of the nongrantor trust or estate."

V. Conclusion

Where do we go from here? The answer is not entirely clear. Based on *Knight* it is clear that investment advisory fees are now subject to the 2% floor, unless and until companies providing these services establish different rates for individuals and trusts, as that appears to be one small window the Court left open. In the absence of that, if a trustee can establish that the trust has an "unusual investment objective" or requires "specialized balancing of the interests of various parties" as the Court pointed out in *Knight*, the trustee may be able to have full deductibility of investment advisory fees. However, it would appear that the IRS will

be examining such requests closely, and trustees will have the burden of proving that the fees paid were for the purposes discussed above, which may be very difficult to do, especially on less complex trusts. It will also be instructive to see the final version of the regulation when it is issued, perhaps, sometime this summer.

Endnotes

1. 128 S. Ct. 782 (2008).
2. *Id.* at 786.
3. *Id.*
4. 994 F.2d 302 (6th Cir. 1993).
5. *Id.* at 304.
6. 47 Fed. Cl. 186 (Fed. Ct. 2000).
7. *Id.* at 189.
8. *Id.* at 191.
9. 328 F.3d 132 (4th Cir. 2003).
10. *Id.* at 136.
11. *Id.* at 139-140.
12. Proposed Regulation § 1.67-4(a) (emphasis added).
13. Proposed Regulation § 1.67-4(b) (emphasis added).
14. Proposed Regulation § 1.67-4(b) and (c).
15. 128 S. Ct. 787.
16. I.R.C. § 67(e)(1) (emphasis added).
17. 128 S. Ct. 787.
18. *Id.*
19. *Id.* at 788.
20. *Id.* at 789.
21. *Id.* at 790.
22. *Id.* at 791.
23. *Id.*
24. See Letter from Jeffrey R. Hoops, Chair, Tax Executive Committee of American Institute of Certified Public Accountants, to Catherine Veihmeyer Hughes dated February 8, 2008, which is available on the AICPA website at www.aicpa.org.

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