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Supreme Court and IRS Take on Deductibility of Trust Investment Management Fees

Over the summer, both the Supreme Court and the IRS took on an issue that will affect millions of trusts and estates in the United States—whether an estate or a non-grantor trust may take a full income tax deduction for investment management fees incurred in the investment of its assets. On June 25, 2007, the U.S. Supreme Court granted *certiorari* in the case of *Knight v. Comm'r.*, U.S. No. 06-1286 (formerly known as *Rudkin v. Comm'r.*,), thereby agreeing to provide a judicial resolution to the issue. Yet shortly thereafter, on July 26, 2007, the IRS issued proposed regulations regarding the same issue. As trusts and estates in the U.S. currently administer more than $1 trillion in assets and incur billions in investment management fees, the ultimate resolution of this issue will have a significant financial impact on both fiduciaries and beneficiaries.

THE ISSUE

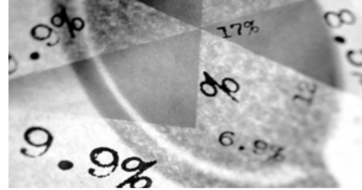
Under Internal Revenue Code ("Code") §67(e), an estate or a trust may only deduct for income tax purposes miscellaneous itemized deductions to the extent that the total deductions exceed 2% of its adjusted gross income (the "2% limitation"). Section 67(e)(1), however, provides an exception to this limitation for deductions that meet the following requirements:

1) The deductions are for costs that were paid or incurred in connection with the administration of the estate or trust, and
2) Such costs would not have been incurred if the property were not held in the estate or trust.

At issue is whether the above exception allows a trust or an estate to deduct all of the investment management fees incurred in the investment of its assets without regard to the 2% floor.

CONFLICTING JUDICIAL INTERPRETATIONS

Several courts have addressed this issue in the context of trust deductions, resulting in three different interpretations regarding the application of §67(e) to investment management fees:



- **Liberal Interpretation.** The Sixth Circuit, in William J. O'Neill Jr. Irrevocable Trust v. Comm'r, held that a trust's full deduction for such fees should be allowed, since the costs were "incurred because of the trustee's duty" to invest the trust assets prudently.

- **More Restrictive.** The Fourth and Federal Circuits, in *Mellon Bank, N.A. v. U.S.* and *Scott v. U.S.*, respectively, allowed a trust to take full deductions only for costs that are unique to the administration of a trust and are "not customarily or commonly incurred by individuals." Since individuals commonly incur investment advisor fees, the 2% limitation would apply to a trust's deduction for such fees.

- **Strict Interpretation.** The Second Circuit, in *Rudkin v. Comm'r* (now *Knight v. Comm'r*), held that trusts may deduct fully only those costs that individuals "are incapable of incurring." The court used the same examples provided in *Scott* to indicate the types of expenses individuals are incapable of incurring (making such expenses fully deductible), including expenses related to judicial accountings, the preparation of fiduciary tax returns and trustee fees. Since individuals can incur almost all other costs, the Second Circuit's decision limits the full deductibility of many common trust expenses.

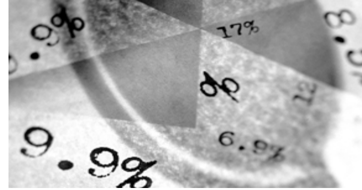
Thus, the Supreme Court likely granted *certiorari* in the *Knight* case, at least in part, in order to resolve this split among the circuits.

PROPOSED REGULATIONS

Strict Interpretation. Prior to the Supreme Court's acceptance of the *Knight* case, the IRS had announced in its 2006-2007 Priority Guidance Plan that it intended to issue guidance in this area. In fulfillment of its promise, on July 26, 2007, the IRS issued Prop. Reg. §1.67-4 ("Proposed Regulations"), providing that only costs that are "unique" to an estate or a trust are fully deductible under §67(e)(1). The IRS classifies a cost as "unique" if "an individual could not have incurred the cost in connection with property not held in an estate or trust," essentially adopting the Second Circuit's standard for determining the deductibility of fiduciary expenses.

Non-Exclusive Lists. In order to illustrate the types of fiduciary costs the IRS considers unique, the Proposed Regulations provide "non-exclusive" lists of unique and non-unique costs:

Unique Costs. Include costs incurred in connection with:
- Fiduciary accountings;
- Judicial or quasi-judicial filings regarding estate or trust administration;
- Fiduciary income and estate tax returns;
- The division or distribution of income or principal to or among beneficiaries;
- Trust or will contests or construction proceedings;
- Fiduciary bond premiums; and
- Communications with beneficiaries regarding trust or estate matters.



Non-Unique Costs. Include costs incurred in connection with:

- Custody or management of property;
- Advice on investing for total return;
- Gift tax returns;
- Defense of claims by creditors of the decedent or grantor; and
- The purchase, sale, maintenance, repair, insurance or management of any non-trade or business property.

Accordingly, the Proposed Regulations will subject investment management fees to the 2% floor for deductibility.

Allocation of Bundled Fees. Bundled fees generally involve a fiduciary who performs and charges a single flat "fiduciary" fee for all administrative tasks, including investment management. Many corporate fiduciaries charge fees in this manner. The preamble to the Proposed Regulations, however, specifically states that:

> whether costs are subject to the 2% floor on miscellaneous itemized deductions depends on the type of service provided, rather than on taxpayer characterizations or labels for such services. Thus, taxpayers may not circumvent the 2% floor by "bundling" investment advisory fees and trustees' fees into a single fee.

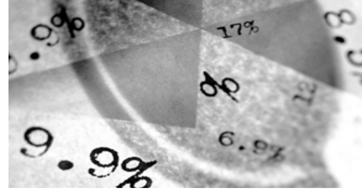
The Proposed Regulations provide that, if an estate or a trust pays a single fee that consists of both unique and non-unique costs, then the estate or trust must "identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other" expense that is unique, using "any reasonable method to allocate" the bundled fee between the unique and non-unique costs.

Effective Date. The Proposed Regulations will apply to expenses paid after the publication of the final regulations in the Federal Register.

IMPLICATIONS

Financial Impact. Trusts and estates spend approximately $10 billion in investment management fees alone, not to mention accounting fees, legal fees, custody fees, etc. Thus, a significant amount of money is at stake here for both the IRS and trusts and estates. Denying a full deduction for the majority of these fees will significantly increase the after-tax cost to taxpayers of fiduciary services, causing a corresponding reduction in the amount that will pass to the beneficiaries of trusts and estates.

Administrative Burden. Although the courts have generally allowed a full deduction for a single fiduciary fee, the Proposed Regulations will no longer allow such a deduction. Now, fiduciaries must not only categorize fiduciary costs as unique (trustee fees) and non-unique (investment management



fees), but they must also determine what portion of legal, accounting or other fees incurred is attributable to a unique cost (fiduciary tax return preparation), as opposed to a non-unique cost (closing costs incurred on the sale of trust property). This requirement imposes a significant administrative burden on fiduciaries who will need to request and review itemized bills from service providers and attempt to use a "reasonable method of allocation" to make the determination. Furthermore, many corporate fiduciaries do not have billing systems or fee schedules in place to address this allocation requirement and may incur considerable expense when trying to comply with the Proposed Regulations. This expense, of course, will be passed down to the consumer.

WAIT AND SEE

The IRS has scheduled a public hearing on the Proposed Regulations for November 14, 2007. Comments regarding the regulations must be sent to the IRS by October 25, 2007. Additionally, the IRS has included the issuance of final regulations in this area as part of its 2007-2008 Priority Guidance Plan.

As for the *Knight* case, on August 23, Petitioner Michael Knight filed his Merits Brief with the Supreme Court, accompanied by the American Bankers Association's Amicus Brief (signed by several state banking associations representing states from which approximately one-half of all estate and trust income tax returns are filed—California, Florida, Illinois, Massachusetts, Missouri, New York, North Dakota, Ohio, Pennsylvania, and Texas). Additional briefs are expected in September and October, with oral arguments scheduled for December 2007. Based on this timeframe, we are unlikely to see a final resolution of this matter before the end of 2007.

Thus, fiduciaries in the Fourth, Sixth and Federal Circuits may seek to continue their reliance on the standards promulgated in the decisions of those circuit courts. Given the potential tax implications, however, all fiduciaries and return preparers will want to closely monitor future developments regarding the *Knight* case and the Proposed Regulations.

*Cites: Code §67(e); Prop. Reg. §1.67-4; Fed. Reg. Doc. E7-14489 (REG-128224-09); William L. Rudkin Testamentary Trust v. Comm'r, 124 T.C. 304 (2005), aff'd 467 F.3d 149 (2nd Cir. 2006), cert. granted sub nom. Knight v. CIR (S. Ct. Doc. No. 06-1286); Mellon Bank, N.A. v. U.S., 265 F.3d 1275 (Fed. Cir. 2001); Scott v. U.S., 328 F.3d 132 (4th Cir. 2003); O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993); Steve Leimberg's Estate Planning Newsletters #1154 (July 30, 2007) and #1167 (August 26, 2007) at http://www.leimbergservices.com.

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