



Knight Time for Investment Fees in Trusts
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Capital Asset...Or Not

The United States Supreme Court issued its opinion in the case of *Knight v. Commissioner*, a case you may have also heard referred to as *Rudkin v. Commissioner* which came down in October 2006 from the Second Circuit Court of Appeals (2006 TNT 203-4) affirming the Tax Court (124 T.C. 304) but using a different test. The Supreme Court ruled unanimously that the expenses in question were subject to the 2% of adjusted gross income limitation, but rejected the test the Second Circuit used in making that determination.

Trusts and the 2% Limit

The infamous "2% limit" arises under §67(a), limiting all deductions for individuals to the amount in excess of 2% of adjusted gross income except for those allowed in computing adjusted gross income pursuant to §62 or those itemized deductions specifically enumerated at §67(b) as being exempted from the 2%

test.

The rule also generally applies to trusts and estates, but as determined under §67(e) which provides:

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

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*, and

(2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

The “would not have been incurred” phrase is the key one at issue in this case. The Circuit Courts of Appeal arrived at different conclusions on this matter. To quote Chief Justice Roberts’ summary of those positions from the Supreme Court opinion:

The Courts of Appeals are divided on the question presented. The Sixth Circuit has held that investment advisory fees are fully deductible. *O’Neill v. Commissioner*, 994 F. 2d 302, 304 (1993). In contrast, both the Fourth and Federal Circuits have held that such fees are subject to the 2% floor, because they are “commonly” or “customarily” incurred outside of trusts. See *Scott v. United States*, 328 F. 3d 132, 140 (CA4 2003); *Mellon Bank, N. A. v. United States*, 265 F. 3d 1275, 1281 (CA Fed. 2001). The Court of Appeals below came to the same conclusion, but as noted announced a more exacting test, allowing “full deduction only for those costs that *could not* have been incurred by an individual property owner.” 467 F. 3d, at 156 (emphasis added).

Note that “emphasis” was added by Chief Justice Roberts in his opinion.

The Supreme Court would affirm the result in the case, but not the test that the Second Circuit enunciated for determining why these expenses are not exempt from the 2% limit.

As well, the IRS has proposed regulations out in this area that imposes its own test. We’ll need to look at the proposed regulation’s offering to resolve the matter as well in light of what Chief Justice Roberts writes.

You Both Got It Wrong

The Supreme Court addressed what they saw as flaws in the positions of both the Second Circuit and the taxpayer. It first addresses the flaws in the Second Circuit's position, addressing why the test is not whether an expense *could* be incurred by an individual. Chief Justice Roberts complains that:

In applying the statute, the Court of Appeals below asked whether the cost at issue could have been incurred by an individual.³ This approach flies in the face of the statutory language. The provision at issue asks whether the costs “would not have been incurred if the property were not held” in trust, *ibid.*, not, as the Court of Appeals would have it, whether the costs “could not have been incurred” in such a case, 467 F. 3d, at 156. The fact that an individual could not do something is one reason he would not, but not the only possible reason. If Congress had intended the Court of Appeals’ reading, it easily could have replaced “would” in the statute with “could,” and presumably would have. The fact that it did not adopt this readily available and apparent alternative strongly supports rejecting the Court of Appeals’ reading.⁴

The Court also lectures that the Second Circuit's proposed reading ignores the first clause in §67(e)(1), and the Court does not believe Congress meant that to be a meaningless phrase:

Moreover, if the Court of Appeals’ reading were correct, it is not clear why Congress would have included in the statute the first clause of §67(e)(1). If the only costs that are fully deductible are those that *could* not be incurred outside the trust context—that is, that could *only* be incurred by trusts—then there would be no reason to place the further condition on full deductibility that the costs be “paid or incurred in connection with the administration of the . . . trust,” §67(e)(1). We can think of no expense that could be incurred exclusively by a trust but would nevertheless *not* be “paid or incurred in connection with” its administration.

But although the Court rejects the Second Circuit's test, it also does not except the position of the taxpayer either. The Court comments:

The Trustee argues that the exception in §67(e)(1) “establishes a straightforward causation test.” Brief for Petitioner 22. The proper inquiry, the Trustee contends, is “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.” *Ibid.* Investment advisory fees incurred by a trust, the argument goes, meet this test because these costs are caused by the trustee's obligation “to obtain advice on investing trust assets in compliance with the Trustees’ particular fiduciary duties.” *Ibid.* We reject this reading as well

The Court argues that this test would render all expenses exempt from the 2%

limitation. Chief Justice Roberts writes:

On the Trustee's view, the statute operates only to distinguish costs that are incurred by virtue of a trustee's fiduciary duties from those that are not. But all (or nearly all) of a trust's expenses are incurred because the trustee has a duty to incur them; otherwise, there would be no reason for the trust to incur the expense in the first place. See G. Bogert & G. Bogert, *Law of Trusts and Trustees* §801, p. 134 (2d rev. ed. 1981) ("[T]he payment for expenses must be reasonably necessary to facilitate administration of the trust").

The taxpayer attempted to argue this was not the case—that its reading didn't render all costs exempt from the 2% limitation. But the Court wasn't impressed with the example the taxpayer gave, indicating the expense in question was again one the trustee was required to incur:

As an example of a type of trust-related expense that would be subject to the 2% floor, the Trustee offers "expenses for routine maintenance of real property" held by a trust. Brief for Petitioner 23. But such costs would appear to be fully deductible under the Trustee's own reading, because a trustee is obligated to incur maintenance expenses in light of the fiduciary duty to maintain trust property. See 1 Restatement (Second) of Trusts §176, p. 381 (1957) ("The trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property").

The Court clarifies its view about the problems with this position to resolve the matter as the opinion continues:

Indeed, the Trustee's formulation of its argument is circular: "Trust investment advice fees are caused by the fact the property is held in trust." Brief for Petitioner 19. But "trust investment advice fees" are only aptly described as such because the property is held in trust; the statute asks whether such costs would be incurred by an individual if the property were not. Even when there is a clearly analogous category of costs that would be incurred by individuals, the Trustee's reading would exempt most or all trust costs as fully deductible merely because they derive from a trustee's fiduciary duty. Adding the modifier "trust" to costs that otherwise would be incurred by an individual surely cannot be enough to escape the 2% floor.

The Opinion goes on to complain that this reading renders the second clause of §67(e)(1) irrelevant, the same sin the Court believes was committed by the Second Circuit but this time just reversing the part rendered irrelevant.

How to Read §67(e)

The Court goes on then to describe the way it believes the statute should be read. The Court outlines a general rule in concluding its complaints about the taxpayer's position:

The Trustee's reading is further undermined by our inclination, "[i]n construing provisions . . . in which a general statement of policy is qualified by an exception, [to] read the exception narrowly in order to preserve the primary operation of the provision." *Commissioner v. Clark*, 489 U. S. 726, 739 (1989). As we have said, §67(e) sets forth a general rule for purposes of the 2% floor established in §67(a): "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." Under the Trustee's reading, §67(e)(1)'s exception would swallow the general rule; most (if not all) expenses incurred by a trust would be fully deductible. "Given that Congress has enacted a general rule . . . , we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception." *Ibid*.

The Court indicates that it believes there is no simple litmus test against which to compare expenses in this area, and blames that on the statute itself:

More to the point, the statute by its terms does not "establis[h] a straightforward causation test," Brief for Petitioner 22, but rather invites a hypothetical inquiry into the treatment of the property were it held outside a trust. The statute does not ask whether a cost was incurred *because* the property is held by a trust; it asks whether a particular cost "would not have been incurred if the property were not held in such trust," §67(e)(1). "Far from examining the nature of the cost at issue from the perspective of whether it was caused by the trustee's duties, the statute instead looks to the counterfactual question of whether *individuals* would have incurred such costs in the *absence* of a trust." Brief for Respondent 9.

The Supreme adopts the test proposed by the Fourth and Federal Circuits in their cases on the matter—that the issue is whether the expenses are of a type that would not *commonly* or *customarily* be incurred by individuals. The Court defends this reading in light of the taxpayer's objections to it:

The Trustee objects that the statutory text "does not ask whether expenses are 'customarily' incurred outside of trusts," Reply Brief for Petitioner 15, but that is the direct import of the language in context. The text requires determining what would happen if a fact were changed; such an exercise necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. Thus, in 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.

How Do Investment Fees Fare Under This Test?

The taxpayer takes the position that the fees were incurred because of the

trustee's fiduciary duties under the Connecticut Uniform Prudent Investor Act. The Court looks at what the "prudent investor" standard requires to deal with this issue and notes:

To satisfy this standard, a trustee must "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust." §45a-541b(a) (emphasis added). The 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.

The Court goes on to note that, given this view of the prudent investor rule and its reading of §67(e)(1), the question pretty much answer itself:

And we have no reason to doubt the Trustee's claim that a hypothetical prudent investor in his position would have solicited investment advice, just as he did. Having accepted all this, it is quite difficult to say that investment advisory fees "would not have been incurred"—that is, that it would be unusual or uncommon for such fees to have been incurred—if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs.

The Court notes that the fact that their opinion (and that of the Fourth and Federal Circuits) denies us a "bright line" test is both required under the statute and not that unusual in tax law.

We appreciate that the inquiry into what is common may not be as easy in other cases, particularly given the absence of regulatory guidance. But once you depart in the name of ease of administration from the language chosen by Congress, there is more than one way to skin the cat: The Trustee raises administrability concerns in support of his causation test, Reply Brief for Petitioner 6, but so does the Government in explaining why it prefers the Court of Appeals' approach to the one it has successfully advanced before the Tax Court and two Federal Circuits. Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, but that is no excuse for judicial amendment of the statute. The Code elsewhere poses similar questions—such as whether expenses are "ordinary," see §§162(a), 212; see also *Deputy, Administratrix v. Du Pont*, 308 U. S. 488, 495 (1940) (noting that "[o]rdinary has the connotation of normal, usual, or customary")—and the inquiry is in any event what §67(e)(1) requires.

And, to make the point, the Supreme Court even posits that you can't even conclude absolutely that all investment fees would be subject to the 2% limitation given their ruling. The Court notes:

As the Solicitor General concedes, 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.” Brief for Respondent 25. There is nothing in the record, however, to suggest that Warfield charged the Trustee anything extra, or treated the Trust any differently than it would have treated an individual with similar objectives, because of the Trustee’s fiduciary obligations. See App. 24–27. It 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.

The Court notes, however, that in this particular case these sorts of facts aren’t what we are facing, so the taxpayer’s investment advice expenses will be subject to the 2% of adjusted gross income limitation imposed by §67.

What appears clear from the case, though, is that the prudent investor rule itself will not generally serve as justification for the expenses being of a sort not “commonly” or “customarily” incurred by individuals.

For those advisers that have continued to deduct these expenses without regard to the 2% limitation imposed by §67 based on the analysis in the Sixth Circuit’s *O’Neill* case (994 F.2d at 304-305), this ruling is going to require a change in handling the issue for the taxpayers they advise. As well, such advisers likely need to advise clients that have taken this position in the past that the position on open returns is one that would not survive challenge, and they may want to consider the advisability of amending those returns.

However, the good news is that the extremely restrictive view imposed by the Second Circuit Court of Appeals also does not apply. Many had expressed concern that the “cannot be incurred” test would have rendered virtually every trust expense not allowed by §62 in computing adjusted gross income as subject to the 2% limitation. So while it appears difficult for investment advisory fees to get around the 2% limitation, the matter is still in question for other types of expenses.

IRS Proposed Regulations

On July 27 of last year, the IRS issued proposed regulations that had the stated objective of resolving the split in the Circuits. The proposed regulations create a “uniqueness” test [Prop. Reg. §1.67-4(a)]. In fact, in the original decision that started the saga that ended in the Supreme Court’s *Knight* decision, the Tax Court specifically used the word “unique” to describe the type of expenses that would be exempt from the 2% test, defining unique by reference to the Fourth and Federal Circuit holdings noted above—expenses not commonly or

customarily incurred by individuals.

However, the regulations go on to define “unique” in a way that sounds much like the Second Circuit’s more restrictive position in *Knight*, providing in Prop. Reg. §1.67-4(b):

(b) Unique. For purposes of this section, 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. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant. A non-exclusive list of products or services that are unique to an estate or trust includes those rendered in connection with: 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 estate or trust matters. A non-exclusive list of products or services that are not unique to an estate or trust, and therefore are subject to the 2-percent floor, includes 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, insurance or management of non-trade or business property.

The proposed regulations attempt to provide what appears to the type of “bright line” test that the Supreme Court rejected in *Knight*. In fact, the Court comments in footnote 3 to the opinion that “indeed, after the [Second Circuit] Court of Appeals’ decision, the Commissioner adopted that court’s reading of the statute in a proposed regulation.” That would suggest that the IRS might not find that the proposed regulation would fare well in front of the Supreme Court if it were to be made final without revisions to the “uniqueness” definition noted above.

However, we should be aware that the Proposed Regulation does deal with another issue that likely would not be impacted by the Supreme Court’s reading—that of attempting to get around the issue by creating a bundled fee. Proposed Regulation §1.67-4(c) provides:

(c) “Bundled fees”. If an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

It would seem reasonable to presume that, should the IRS modify their “uniqueness” definition to comply with the *Knight* decision, the Supreme Court wouldn’t take issue with this provision. As such, we need to be aware that “mixing” fees into a single charge is not likely going to be a viable method of responding to *Knight*.