Case at a Glance

Should investment advice fees incurred by trusts be fully deductible or only partially deductible? Many nontrust investors pay for investment advice. How is their situation different from that of trust investors? Should trusts be more encouraged than individuals to seek investment advice, or less? There is a conflict in the circuits, and the United States Department of the Treasury has raised the ante by proposing a regulation.

Is the Cost of Investment Advice to Trusts Fully Deductible from Trust Taxable Income?

by Joel S. Newman

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Joel S. Newman is a professor of law at Wake Forest University in Winston-Salem, North Carolina. He can be reached at newmanjs@wfu.edu or (336) 758-5712.

Say I want to invest my own money in stocks and bonds. Would it be prudent of me to pay for some advice? Probably. If I don't get any advice and I lose all my money, will I be unhappy? Sure. But can anyone sue me? No—it was my money, and I blew it.

Say I'm a trustee, and I want to invest trust assets in stocks and bonds. Would it be prudent of me to pay for some advice? You bet. If I don't get any advice and I lose all the money, will I be unhappy? Sure. Can anyone else sue me? You bet. The beneficiaries can sue, and probably will.

Of course it's a good idea for me to get some help when I invest my own assets. But it is a much better idea to get some help when I invest someone else's assets. In fact, it may be downright necessary. If I pay for expert advice in investing trust assets and the trust loses anyway, I still may be sued. But at least I can say that it wasn't my fault.

The difference is that in the first instance, it's my money and that in the second, it's other people's money. Does that difference make the cost of the advice only partially deductible in the first case, but fully deductible in the second? That's what this case is about.

Issue

Are investment-management advice fees incurred by a trust costs "which would not have been incurred if the property were not held in such trust" within the meaning of Internal Revenue Code § 67(e)?

Facts

The William L. Rudkin Testamentary trust (the Trust) was established in 1967 and funded with proceeds from the sale of Pepperidge Farm to the Campbell Soup Company. In 2000, when the Trust assets ranged in value between $2.2 million and $3.4 million, the trustee paid some $22,000 to Warfield Associates, Inc. for investment-management advice. In its tax return, the Trust deducted these fees in full. After audit, the Commissioner of Internal Revenue only allowed the deduction to the extent that the fees exceeded 2 per-

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cent of the Trust's adjusted gross income. As a result, there was a tax deficiency of $4,448.

The Tax Court unanimously upheld the commissioner, and the Second Circuit affirmed. The Supreme Court granted certiorari due to a conflict in the circuits. This summer, Treasury promulgated a proposed regulation that, of course, took the position of the government in this case.

Case Analysis

Congress has enacted many thresholds under tax deduction provisions. For example, medical expenses are deductible only to the extent that they exceed 7.5 percent of adjusted gross income. The threshold, or floor, effectively makes the deduction available to far fewer taxpayers, thus simplifying the Code and minimizing potential abuse.

Section 67 is a similar provision, placing a 2 percent of adjusted gross income floor on a host of "miscellaneous itemized deductions." One of those deductions is investment advice. However, § 67(e) provides that the 2 percent floor need not be subtracted from "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."

Both sides agree that the exception to the 2 percent floor in § 67(e) has two requirements:

1) the cost must be paid in connection with the administration of an estate or trust; and
2) the cost must be one which "would not have been incurred if the property were not held by such trust or estate."

All agree that the first requirement was met in this case. The dispute concerns the second.

In similar cases, the Sixth Circuit held for the trusts—that the second requirement was met. The Federal, Fourth, and Second Circuits have held for the commissioner. However, the Federal and Fourth Circuits so held because these investment advice fees were "customarily" or "commonly" incurred by individuals, while the Second Circuit so held because the fees "could" have been incurred by individuals.

The petitioner in this case is the trustee who argues that the second requirement establishes a causation test—that the expenses are fully deductible only if they were caused by the fact that the property was held in trust. That fact, in this case, meant that the trustee had fiduciary obligations to the beneficiaries. Moreover, the trustee was subject to Connecticut's version of the Uniform Prudent Investor Act, an act that has been adopted in 44 states. Failure to invest trust assets properly would have subjected the trustees to liability. Even though individuals may well have incurred similar expenses, they had no comparable obligations or potential liabilities. Therefore, only the trustee's expenses could have been caused by the trust's status. Thus, according to the trustee, the expenses should have been fully deductible.

Moreover, the petitioner argues that trust assets are not always invested the same way that individual assets are invested. For example, under modern portfolio theory, individuals should invest to maximize "total return," regardless of whether that return emphasizes current income or future growth. Trustees, however, must often balance current income and future growth, since the current income would benefit one class of trust beneficiaries, while the future growth would benefit a different class. Therefore, since trust assets are not invested the way individual assets are, the deductibility of their expenses should be different as well.

The respondent-commissioner argues that there are only three linguistically permissible interpretations of the second requirement. The first would require an individualized assessment to determine whether *these* individuals owning *these* assets would not have paid for investment advice if the assets had not been held in trust. Neither side will argue for this individualized, unworkable rule. That leaves two permissible interpretations.

The first remaining interpretation is that the costs definitely would not have been incurred if there had been no trust. Pursuant to this interpretation, only those expenses that are "unique" to trusts are fully deductible. This interpretation, respondent argues, would be easier to administer. The second remaining interpretation is that only those expenses that individuals would not customarily or commonly incur can be fully deductible.

The respondent argues that, under either of the two remaining interpretations, the commissioner wins. As to the first interpretation, investment advice fees are not unique to trusts. Therefore, they cannot be fully deductible. As to the second interpretation, individuals do commonly incur investment advice fees. Therefore, they cannot be fully deductible.

Both sides would prefer to think that the statute is clear on its face. If the statute is clear, it should be unnecessary to refer to legislative history. However, in case the statute is not found sufficiently clear, both sides also argue with commendable caution that legislative history supports their interpretation.

Both sides agree that Congress enacted § 67(c) to address certain abuses of "pass-through entities." Both sides agree that the second

(Continued on Page 102)

prong of § 67(e) was enacted to prevent the restrictions of § 67(c) from going too far. However, petitioner of course claims that this legislative history proves that Congress wanted these investment advice fees to be fully deductible, while respondent argues that it doesn't.

To make matters worse, in July of this year, the secretary of the Treasury issued a proposed regulation on § 67(e). The proposed regulation takes the position that only those costs that are "unique" to the estate or trust will satisfy the exception, and that costs are "unique" only if an individual could not have incurred them. Note that this "uniqueness" requirement coincides with the first of the respondent's two remaining interpretations. Further, the proposed regulation specifies that, if the estate or trust pays a "bundled fee" to the trustee, which fee includes standard annual trustee fees (clearly subject to the exception) and investment advice fees (perhaps not subject to the exception), then these fees must be unbundled, and analyzed separately.

SIGNIFICANCE

In the United States, it is estimated that over $1 trillion in assets are held in trusts and estates. These assets generated over $85 billion in gross income in 2005, reported on almost four million tax returns. Billions of dollars are spent by these trusts and estates for investment advice. In fact, investment advice fees constitute the largest expenditure by these entities.

If investment advisor fees were less than fully deductible to the trust, then fewer trustees would incur this expense. Of course, all of us would hope that trustees will invest trust assets carefully, and that trust beneficiaries will be fully protected. Therefore, all else being equal, trustees should be encouraged to get help when making investment decisions.

However, there still would be strong incentives for trustees to get help, even if the help were not fully tax deductible. Trustees will still be well advised to be careful, lest they be sued for breaching their fiduciary obligations. Moreover, most trustees are subject to some version of the Uniform Prudent Investor Act. Additionally, in most states, including Connecticut, the activities of trustees are monitored by the state, with requirements for regular accounting and reporting to the authorities. But are these protections enough?

Many large corporate trustees such as banks have investment expertise in-house. They charge one fee to the trusts, which bundles the trust administration and investment advice services. If the Court holds that trust investment advice fees are fully deductible, then bundling is irrelevant. However, if the Court holds that trust investment advice fees are not fully deductible, then bundling might be a problem.

Imagine a large trust, which can afford to hire a large, corporate trustee. The trust pays one large annual fee, to compensate the trustee for both trust administration and investment advice services. The trust argues that the entire annual fee is one that "would not have been incurred if the property were not held by such trust or estate." Therefore, it argues, the fee is fully deductible.

Now imagine a small trust—too small to afford hiring a corporate trustee. The individual trustee, probably a family relative of the trust settler, does the administrative work herself. However, she pays an outside expert for investment advice. Would this investment advice fee be only partially deductible? If so, then the larger trusts, which can afford the bundled services of the large, corporate trustees, will have an unfair advantage. However, if the position of the proposed Treasury regulation is upheld, then such fees will be unbundled, and all trusts, and all trustees, will be in the same boat.

ATTORNEYS FOR THE PARTIES

For Petitioner Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust (Peter J. Rubin (202) 662-9388)

For Respondent Commissioner of Internal Revenue (Paul D. Clement (202) 514-2217)

AMICUS BRIEFS

In Support of Petitioner Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust

American Bankers Association and New York Bankers Association (Gregory F. Taylor (202) 663-5028)

Tax Section of the Florida Bar (Angela C. Vigil (305) 789-8900)