CLIENT ALERT

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Fiduciary Investment Advisory Fees are Limited to the 2% Floor

The United States Supreme Court has unanimously held that deductions for investment advisory fees paid by a trust are subject to the 2% floor contained in Internal Revenue Code § 67 (*Knight v. Commissioner,* U.S. No. 06-1280, 1/16/08).

Internal Revenue Code § 67 generally provides that miscellaneous itemized deductions are allowable only to the extent that the deductions exceed 2% of the taxpayer's adjusted gross income. Where the taxpayer is a trust or estate, however, § 67(e) provides an exception to this rule. If the cost is paid or incurred in connection with the administration of the trust and would not have been incurred if the property were not held in such trust, the deduction for the expense is not limited to the 2% floor and 100% of the expense may be deducted. The recent decision by the U.S. Supreme Court results in a significant shift in the amount of investment advisory fees which may be deducted by a fiduciary.

In *Knight*, the Trustee of a 1960 Connecticut Trust hired a professional investment advisor in the year 2000 to provide advice with respect to investing the trust's assets in accordance with state law requirement that he act as a "prudent investor". In preparing the trust's 2000 fiduciary income tax return, the Trustee deducted the full amount of the fees paid to the investment advisor. The Trustee asserted the position that such fees were unique to trusts given the state law requirement to invest as a prudent investor, and therefore were exempt from the 2% floor. The Internal Revenue Service (IRS) challenged this deduction. The IRS, the Tax Court and the U.S. Court of Appeals for the Second Circuit all found that deductions for investment advisory fees paid by a trust were miscellaneous itemized deductions subject to the 2% floor and could be deducted only to the extent they exceeded 2% of the trust's adjusted gross income.

On January 16, 2008, the Supreme Court found in favor of the IRS. In rendering this decision, the Supreme Court determined that costs incurred by trusts which escape the 2% floor are those that would not commonly or customarily be incurred by individuals. When asking whether the trust's cost would not have been incurred by an individual, the Court looked to whether it would be unusual or uncommon for such fees to have been incurred by an individual. The Court determined that the Trustee did not take any action which would have been unusual or uncommon for an individual to take with respect to his or her own assets. The Court determined that this type of cost - investment advisory fees - would have been incurred whether the property were held by an individual or a trust.

This decision is noteworthy for several reasons. First, the opinion by the Supreme Court

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does not seem to recognize the unique quality of the fiduciary's duty to invest prudently. Indeed, the Trustee in this case pointed out that the mere reason that he engaged an investment advisor was to comply with the state's uniform prudent investor act. The Court's refusal to recognize that the investment advisory fees "would not have been incurred" if the property was held by an individual investor with the same objectives as the trust in handling his or her own affairs, appears to miss the point that rarely, if ever, does an individual investor have the same investment objectives as a trust, given the unique nature of the Trustee's fiduciary duty.

Second, the Supreme Court made the point that there was nothing in the record to suggest that the investment advisor charged the Trustee anything extra or treated the trust any differently than it would have treated an individual on account of the Trustee's fiduciary obligations. This point would appear to support the full deduction of investment fees if they can be shown to be attributable solely to a fiduciary. As an ongoing matter, to the extent a fiduciary can apportion fees paid for "standard" investment services and fees paid for services provided solely because of the fiduciary obligation, that portion of investment fees, arguably, could escape the 2% floor.

Third, while the Supreme Court's decision was pending, in July of 2007, the IRS released proposed regulations which provide that the 2% floor applies to all expenses of a trust or estate unless the expense is unique. According to the regulations, an expense is unique only if "an individual could not have incurred that cost in connection with property not held in a trust or estate" (Prop. Reg. § 1.67-4). This "could not" standard goes beyond the scope of the statute, which exempts an expense that would not have been incurred if the property were not held in such trust. The Supreme Court identified this distinction and it is expected that the proposed regulations will be reissued and that transitional guidance will be forthcoming. If nothing else, the timing and scope of these proposed regulations shows the extent of the IRS's aggressive position on this issue.

Finally, this case is remarkable because it is a fiduciary income tax case which made its way to the Supreme Court. The amount in controversy in this case was a tax deficiency of $4,448. However, the effect of the Supreme Court's ruling will potentially reign in a wealth of deductions which would otherwise sidestep the 2% floor.

If you have questions about this Client Alert, please contact Lawrence D. Hunt for more information.

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