PUBLICATION

Trust and Estate Investment Advice Fees Held Subject To 2% Floor

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The United States Supreme Court has unanimously decided a question which, in its own words, determines the treatment of "deductions...that total in the billions of dollars annually." Affirming the opinion of the Court of Appeals for the Second Circuit, the Supreme Court recently held in the case of *Knight v. Commissioner* that investment advice fees incurred by trusts and estates are subject to the 2% floor on miscellaneous itemized deductions. Thus, unless an exception is applicable (see the discussion below), such fees will be deductible under the Internal Revenue Code only to the extent that they exceed 2% of the adjusted gross income of the trust or estate.

In the *Knight* case, a testamentary trust held approximately $2.9 million in marketable securities. In tax year 2000, the trust reported an adjusted gross income of $623,050 and a deduction of $22,241 for investment advice fees. The Internal Revenue Service allowed a deduction of only $9,780, the amount by which $22,241 exceeded 2% of the trust's adjusted gross income. The trustee appealed, arguing that trust and estate investment advice fees are excepted from the 2% floor on miscellaneous itemized deductions by Code Section 67(e)(1), which applies to fees which "would not have been incurred if the property were not held in such trust or estate." The trustee reasoned that the investment advice fees were caused by the property being held in trust, because state law (in this case the state was Connecticut) imposed the fiduciary obligation of a "prudent investor" upon trustees. The IRS took the position that the fees were not unique to trust administration because such fees could be incurred by an individual just as easily as a trust.

On appeal, the United States Supreme Court held that the language of Section 67(e)(1) requires a hypothetical inquiry into whether "costs," in this case investment advice fees, would be incurred if an individual held the property as opposed to a trust. The Court noted that "Section 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." The Court then concluded that investment advice fees were commonly incurred by individuals, and that Section 67(e)(1) therefore was inapplicable. In doing so, the Court rejected the trustee's argument that the fees were unique because they were incurred due to fiduciary obligations of the trustee created by state law. The Court reasoned (1) that such an argument would provide a full deduction for most or all expenses incurred by a trustee, since most or all of a trustee's actions are taken pursuant to its fiduciary duties, and (2) that the fiduciary obligation of a "prudent investor" uses as its standard a reasonable *individual* investor, which necessarily implies that fees incurred to meet the standard are commonly incurred by individuals. Finally, the Court noted that its decision applies equally to trusts and estates.

The decision was a setback for trust and estate administrators who had hoped that the Court would follow the path of the Sixth Circuit Court of Appeals which, on similar facts, had found investment advice fees fully deductible by virtue of Section 67(e)(1) in the 1993 case of *O'Neill, Jr. v. Commissioner*. Nevertheless, from the perspective of the trust or estate administrator, there are several silver linings to the Supreme Court's decision in the *Knight* case.

First, the Court rejected the approach of the Second Circuit Court of Appeals, which had found the 2% floor applicable to any cost incurred by a trust which *could* be incurred by an individual. Presumably, then, the Court's decision leaves open the possibility that trust and estate costs will arise which could be incurred by an individual, but are not *commonly* incurred by an individual. In such an instance, the costs incurred would

arguably be fully deductible. Recently proposed IRS regulations on the subject which copied the language of the Second Circuit decision will likely have to be re-proposed as a result of the Court's decision.

Second, the Court confirmed that "[s]ome 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." Thus, such *additional* charges would also arguably be fully deductible.

Third, the Court found it "conceivable" that a trust could 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 this case, the Court noted that "the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer" could be fully deductible by the trust.

Trust and estate administrators, along with investment advisory service providers, should make careful note of these exceptions enunciated by the Court in order to maximize potential deductions from trust and estate income.