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Knight v. Commissioner

Fiduciary's Investment Advisory Fees are Subject to 2% Floor

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The Supreme Court of the United States has held that investment advisory fees incurred by a trust or estate are ordinarily subject to the two-percent floor of Internal Revenue Code ("IRC") Section 67(a) (the "Two Percent Floor") and are not excluded from the 2% of adjusted gross income reduction by the trust and estate exception set forth in IRC Section 67(e)[1]. In so doing, the Court has decided what has been well described as "perhaps the most vexing controversy currently outstanding" in the world of fiduciary income taxation.[2]

Section 67(a) provides that "miscellaneous itemized deductions," a group consisting of all itemized deductions other than those excluded under IRC Section 67(b), are deductible only to the extent that the aggregate of those deductions exceeds 2% of adjusted gross income ('the 2% Floor"). Section 67(e) provides that the adjusted gross income of a trust or estate is to be determined in the same manner as the adjusted gross income of an individual with two exceptions:

> "(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"

which, the statute provides, "shall be treated as allowable in arriving at adjusted gross income."

There has been no difficulty at all in applying the provisions of Section 67(e)(2) regarding, respectively, the estate's or trust's personal exemption under 642(b) and the income distribution deduction allowed to a simple trust under Section 651 or to a complex trust under Section 661.

The opposite has been the case under the provisions of Section 67(e)(1), which have been the subject of serious controversy and litigation virtually since enactment as part of the Tax Reform Act of 1986.[3] The Internal Revenue Service, embracing a variety of theories and rationales, has claimed that a variety of expenses incurred by non-grantor trusts[4] and estates are deductible only to the extent that, in the aggregate they exceed the 2% Floor.

Two reviewed Tax Court cases, one district court case and one United States Court of Claims decision as well as four United States Court of Appeals' decisions resulting from the appeals in those cases have been the brightest stars in this litigation constellation[5] until the United States Supreme Court's decision in January of 2008.[6]

In a very well written and persuasive decision for a unanimous Supreme Court, Mr. Chief Justice Roberts clearly rejected the rationale of the Second Circuit Court of Appeals[7] that the only trust and estate expenses excluded from the Two Percent Floor by IRC §67(e) were those that an individual was incapable of incurring[8] and held:

> **The question whether a trust-related expense is fully deductible turns on a prediction about what would happen if a fact were changed—specifically, if the property were held by an individual rather than by a trust.** In the context of making such a prediction, when there is uncertainty about the answer, **the word "would" is best read as "express[ing] concepts such as custom, habit, natural disposition, or probability."** *Scott, supra,* at 139. *See* Webster's Third New International Dictionary 2637–2638(1993); American Heritage Dictionary 2042, 2059 (3d ed.1996). 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.**[9]

The Supreme Court, in closing its opinion, offered a narrow qualification:

> 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

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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.**[10]

In addition, the United States Treasury Department has proposed regulations concerning this matter. [11] Those proposed regulations are specifically based on the rationale explicitly rejected by the United States Supreme Court,[12] are neither final nor temporary, and embody an "unbundling obligation" of unique and uncertain dimensions. The "unbundling obligation" as proposed requires trusts and estates to separate expenses into two portions, those that are "unique" to trusts and estates and those that are not "unique" to trusts and estates. However, what is "unique" and what is not is to be determined by reference to what costs an individual is capable of incurring—again, the specific rationale explicitly rejected by the United States Supreme Court!

Certainly, preparers who are members of the bar, not to mention those that may be members of the Bar of the Supreme Court of the United States, will likely be reluctant to implement a rationale explicitly rejected by the highest court in the land of which they may themselves be officers.[13] Thankfully, the Supreme Court's decision is now the law of the land and the proposed regulations are not effective, by their own terms, except as to payments made after the date on which final regulations are published in the Federal Register.[14] Since no such final regulations have been so published, the proposed regulations are not yet effective at all.

While it cannot be said that the approach in the Proposed Regulations is forbidden by the Supreme Court's opinion, this author thinks "flies in the face of the statute" is so close to "is contrary to the statute" that it seems to me that the proposed regulations cannot be finalized as is.[15]

The result of all this may be significant uncertainty as to the proper treatment of a vast sea of trust and estate expenses under the Two Percent Floor punctuated by isolated islands of relative certainty. The AICPA has recently published guidance[16] which is especially useful in highlighting the areas of certainty. That advice can be fairly summarized as follows:

1. **Controlling Law.** During the 2008 filing season, the opinion of the United States Supreme Court is the law of the land[17] and the proposed regulations are not effective except as to payments made after the date on which final regulations are published in the Federal Register.[18] Final regulations having not yet been published, the proposed regulations are not yet effective at all.
2. **Investment Advisory Fees.** Investment advisory fees are subject to the Two Percent Floor except to the extent that the fiduciary can substantiate that it has incurred a fee or a part of fee which would be unusual for an individual to incur due, for example, to the incremental advice secured by the fiduciary above and beyond what would ordinarily be provided to individuals.
3. **Trustee Fees.** Since the Supreme Court agreed with the approach of the *Mellon* and *Scott* courts and did not itself address the deductibility of trustees' fees this year, trustees' fees should be fully deductible since those courts so held.[19] Moreover, it would be unusual or unlikely for individuals to pay trustee's fees.
4. **Tax Preparation and Accounting Fees.** Tax return preparation and accounting fees should be deductible without regard to Two Percent Floor since it would be uncommon, unusual and unlikely for individuals to incur such costs.[20]
5. **Other Costs.** Other expenses will have to be determined on a case by case basis depending on the degree to which incurring such costs by individuals is determined to be unusual or uncommon.

Indeed, the fact, though not the amount of reporting uncertainty, was actually verified by Mr. Chief Justice Roberts. In describing the approach adopted by Congress in the statute, the Supreme Court observed:

We appreciate that the inquiry into what is common may not be as easy [as] in other cases, particularly given the absence of regulatory guidance.…. **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.**[21]

Whether a preparer can conclude that his or her position will more likely than not be sustained on the merits and therefore whether or not preparer penalties may be applicable is still uncertain. Particularly given the noted "absence of regulatory guidance" and the Supreme Court's clear disapproval of the proposed regulations that are neither final nor temporary, reliance to any degree on those proposals seems treacherous at best.

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Footnotes

[1] Knight v. Comm'r, 552 U.S. ____, 76 U.S. Law Week 4048 (Docket No. 2006-1286, January 16, 2008).

[2] C. Janes, Fiduciary Administrative Expenses: How Much Is Deductible?, 32 Estate Planning 21 (Nov 2005).

[3] The O'Neill decisions (O'Neill v. Comm'r, 994 F. 2d 302 (6th Cir. 1993), rev'g 98 T.C. 227 (1992) actually regards the tax year 1987.

[4] In the case of a grantor trust under IRC Sections 671, et seq., the 2% Floor is applied at the grantor level.

[5] Compare Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149 (2nd Cir. 2006), aff'g 124 T.C. 304 (2005), aff'd sub nom. Knight v. Comm'r, supra, note 1; Scott v. United States, 328 F.3d 132 (4th Cir. 2003), aff'g 186 F Supp 2d 664 (2002); Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001), aff'g 47 FED. CL. 186 (2000); O'Neill v. Comm'r, 994 F. 2d 302 (6th Cir. 1993), rev'g 98 T.C. 227 (1992.

[6] Knight v. Comm'r, note 5, supra.

[7] Previously criticized by this author in this Journal: R. Balter, Second Circuit Holds Trust's Investment Advisory Fees are Subject to 2% Floor, 16 PHILADELPHIA EPC NEWSLETTER 13 (Winter 2006)

[8] "In applying the statute, the Court of Appeals below asked whether the cost at issue could have been incurred by an individual (footnote omitted). 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." Knight, supra, note 1, slip op. at 5-6 (emphasis supplied). And just in case the Court of Appeals error were not yet clear enough, the Supreme Court appended a footnote, footnote 4, further distinguishing the Supreme Court's reading of the statute from that of the "'would' means 'could'" adherents as follows: "In pressing the Court of Appeals' approach, the Solicitor General argues that "to say that a team would not have won the game if it were not for the quarterback's outstanding play is to say that the team could not have won without the quarterback." Brief for Respondent 19. But the Solicitor General simply posits the truth of a proposition—that the team would not have won the game if it were not for the quarterback's outstanding play—and then states its equivalent. The statute, in contrast, does not posit any proposition. Rather, it asks a question: whether a particular cost would have been incurred if the property were held by an individual instead of a trust. Knight, supra, note Error! Bookmark not defined., at slip op., page 6, footnote 4 (emphasis supplied).

[9] Id, slip op. at p. 10 (emphasis supplied).

[10] Id, slip op. at p. 13 (emphasis supplied).

[11] Section 67 Limitations on Trusts and Estates, 72 Federal Register 41243 (July 27, 2007) (REG 128224-06).

[12] See note 8, supra.

[13] Rule 5(4) of the Rules of the Supreme Court of the United States (Oct. 1, 2007) prescribes the oath an attorney must take to become a member of the Supreme Court's Bar as to conduct one's self "uprightly and according to law," meaning, it seems clear, according to law as announced by the Supreme Court, not as proposed in regulations the rational for which has been explicitly rejected by the Court. See Ex Parte Garland, 71 U.S. 333, 378 (1866) ("Attorneys and counselors are not officers of the United States; they are not elected or appointed in the manner prescribed by the Constitution for the election and appointment of such officers. They are officers of the court, admitted as such by its order upon evidence of their possessing sufficient legal learning and fair private character." This quandary applies, for example, directly to your author as a member of the Bar of the Supreme Court of the United States.

[14] Proposed Regulation §1.67-4(d), 72 Fed. Reg. 41245.

[15] See generally United States v. Mead Corp., 533 U.S. 218 (2001); M. Gans, Deference and Family Limited Partnerships: A Case Study, 2005 U. Miami Heckerling Institute on Estate Planning, Chapter 5, esp. at text accompanying note 19 (2005); M. Gans, Deference and the End of Tax Practice, 36 Real Prop. Prob. & Tr. J. 731 (2002)

[16] Deducting Trust Administrative Costs In Light of Knight v. CIR, February 8, 2008.

[17] Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803).

[18] Proposed Regulation §1.67-4(d), 72 Fed. Reg. 41245.

[19] Scott, supra, note 5, 91 AFTR 2d at 2003-2105 ("Other costs ordinarily incurred by trusts, such as fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e). Such trust-related administrative expenses are solely attributable to a trustee's fiduciary duties, and as such are fully deductible under § 67(e)."); Mellon Bank, supra, note 5, 88 AFTR 2d at 2001-5802 ("It is undisputed that trustee fees are fully deductible.); and see Rudkin, supra note 5, 98 AFTR 2d at 2006-7374 ("By contrast, costs that individuals are incapable of incurring, like "fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns," Scott, 328 F.3d at 140, are fully deductible.").

[20] See also authorities collected in note 19, supra.

[21] Knight, supra, note Error! Bookmark not defined., slip op. at p. 12 (emphasis supplied).