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Second Circuit Holds Trust's Investment Advisory Fees are Subject to 2% Floor

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The United States Court of Appeals for the Second Circuit has held that the two (2%) percent threshold imposed generally on miscellaneous itemized deductions applies to investment advisory fees charged to trusts and estates,[2] affirming a unanimous reviewed decision of the United States Tax Court.[3] In so holding, the Second Circuit reached a result in accord with decisions of the Fourth[4] and Federal Circuits[5] and contrary to a decision of the Sixth Circuit Court of Appeals.[6] Whether a petition for certiorari will be filed is unknown at this writing.

Because of the fiduciary obligations imposed on personal representatives and trustees, these conflicting decisions effect every trust and every estate that files an income tax return.[7] One commentator said, "In the world of fiduciary income taxation, the proper application of the 2% floor imposed by Section 67(a) on the deductibility of a fiduciary's administrative costs is perhaps the most vexing controversy currently outstanding."[8] Of the three decisions holding that a trust's or estate's investment advisory fees are subject to the two (2%) percent of adjusted gross income reduction, the Second Circuit's rationale is by far the most restrictive.[9]

Statutory Background

Section 67(a) of the Code subjects investment advisory fees, along with miscellaneous itemized deductions generally,[10] to a requirement that the deduction of such items be limited to the excess of the aggregate amount of such miscellaneous itemized deductions over two percent of adjusted gross income. Section 67(e) of the Code, the section at issue, prescribes that:

"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),[11] 651,[12] and 661,[13]
>
> "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."[14]

There is no question in any of these cases that costs were paid or incurred in connection with the administration of the estate or trust. Thus the requirements of Section 67(e)(1), Prong 1, are fully satisfied.

The question concerns the application of the requirements of the language "and **which would not have been incurred if the property were not held in such trust or estate**," so-called "Prong 2."

As originally enacted, Section 67 fully exempted estates and trusts from the two (2%) percent haircut with respect to all administrative costs.[15]

Analysis.

Of the three Courts of Appeals holding that trust investment advice expenses are subject to the two percent of adjusted gross income reduction, the Second Circuit's opinion is clearly the most restrictive. The Second Circuit held:

> "We believe the plain text of §67(e) requires that we determine with certainty that [fully deductible] costs could not have been incurred if the property were held by an individual. We therefore hold that the plain meaning of the statute permits a trust to take **a full deduction only for those costs that could not have been incurred by an individual property owner."**

The rationales articulated by the two other Courts of Appeals are significantly different. Indeed, the Second Circuit chastised the Fourth and Federal Circuits for their overly liberal statements that fully deductible costs would have to be costs "not *customarily* incurred outside of trusts,"[16] and stating that §67(e)(1) subjects "expenses *commonly* incurred by individual

continued on page 2

taxpayers to the two percent floor.[17]

> At the same time, the Second Circuit refused to examine the legislative history of §67(e) on the grounds that the statute was too clear for that sort of analysis to be appropriate,[18] albeit not quite so clear as to produce a unanimous rationale even among that three Courts of Appeal coming to the same ultimate conclusion![19]

The Second Circuit opinion seems inconsistent with itself. It seems undisputed all around that "'fees paid to trustees, expenses associated with judicial accountings and the costs of preparing and filing fiduciary income tax returns" are fully deductible."'[20]. But those concessions to full deductibility seem fundamentally inconsistent with that court's rationale: after all, like investment advisory fees, individuals incur fees for income tax preparation, fees for accounting services and the costs of filing returns.

If the fact that individuals can incur investment advisory fees was enough to bring them under the sweep of the two percent deductibility reduction, how come the fact that individuals can incur tax preparation fees, accounting fees and tax filing costs was not enough, even for the Rudkin court, to have brought them within the sweep of that reduction? Compare the Court of Appeals' language:

> "Investment-advice fees and other **costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust. 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."** 98 AFTR 2d at 2006-7374 (emphasis supplied).

Compare the opinion of the Sixth Circuit Court of Appeals in O'Neill:[21] In that case, the Sixth Circuit held that costs incurred "because the property was held in trust,"[22] distinguishing fees incurred by the individuals on the grounds that individuals "are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves."[23] The Court of Appeals for the Federal Circuit in Mellon Bank concluded that that reading of Section 67(e) rendered the second prong of the section "rendered that clause superfluous 'because any costs associated a trust will always be deductible."[24] Thus, O'Neill has been characterized as permitting deduction of any administrative cost incurred by a fiduciary.[25] The Second Circuit's rationale-that fully deductible costs must be of a kind that individuals cannot conceivably incur, seems so restrictive that, if applied strictly, it wouldn't even allow full deductibility of the costs for which that court conceded full deductibility.

Conclusions

Overall, it had been hoped that the Second Circuit Court of Appeals decision in this matter would bring some enlightenment to this area of 20-year uncertainty. The community in general had hoped that an intelligent distinction would be drawn between fully deductible fees and those not fully deductible. Instead, apparently falling victim to the maxim "that great cases, like hard cases make bad law,"[26] the Second Circuit's opinion in Rudkin is a significant disappointment in the development of the law in this area.

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2 William L. Rudkin Testamentary Trust, Michael J. Knight, Trustee v. Commissioner of Internal Revenue, _____ F.3d _____, 98 AFTR 2d 2006-7368 (CA 2, Docket No. 05-5151-ag, 10-18-2006).

3 Rudkin Testamentary Trust v. Comm'r, 124 T.C. 304 (2005).

4 Scott v. United States, 328 F. 3d 132 (4th Cir. 2003).

5 Mellon Bank, N. A. v. United States, 265 F. 3d 1275 (Fed. Circuit 2001).

6 O'Neill v. Comm'r, 994 F. 2d 302, 304 (6th Cir. 1993).

7 In Susan L. Bay v. Comm'r, T. C. Memo 1998-411 (11-16-1998), the Tax Court held that the special exemption provided by IRC §67(e) did not apply to grantor trusts. No appeal was taken.

8 C. Janes, Fiduciary Administrative Expenses: How Much Is Deductible?, 32 Est. Plan. 21 (Nov 2005).

9 The Third Circuit has not spoken on this issue to date.

10 E.g., Trustee and executor fees, administration expenses, accounting and tax preparation fees, legal fees, fiduciary travel expenses to manage assets, amortizable bond premiums on bonds purchased before October 23, 1986, excess deductions on termination of an estate or trust of which the estate or trust is a beneficiary, subscriptions to investment advisory newsletters, fees to collect income, custodial fees investment advice and clerical help and other costs of investment management.

11 This section allows a deduction for personal exemptions.

12 This section allows the deduction for income distribution deductions of a simple trust.

13 This section allows the deduction for income distributions of a complex trust.

14 Regulation Section 1.67-4T has been reserved for such regulations, but no such regulations have in fact been proposed or finalized to date.

15 H. R. 3838, 99th Cong., §67(c) (1985) (at this point, §67(e) was §67(c)) .

16 Citing Mellon Bank, supra note 5, at 265 F.3d 1281 (emphasis in Rudkin, supra note 2).

17 Citing Scott, supra note 4, at 328 F.3d 139-140 (emphasis in Rudkin, supra note 2).

18 Rudkin, supra note 2, 98 AFTR 2d 2006-7368 at 7375, slip op. at text accompanying and preceding note 4.

continued on page 3

19 And this in an area where Judge Hall once chided: "It has been said, with more than a grain of truth, that judges in tax cases these days tend to consult the statute only when the legislative history is ambiguous." Focht, 68 TC 223, 244 (Hall, J, dissenting). It should be acknowledged that Judge Hall was complaining about that trend, not seriously suggesting that it should be or is the law.

20 Mellon Bank, supra note 5, 265 F. 3d at , Scott supra note 4, 328 F. 3d at 140 as quoted in Rudkin supra note 2, 98 AFTR 2d at 2006- 7374.

21 William J. O'Neill, Jr., Irrevocable Trust v. Comm'r, 994 F. 2d 302, 71 AFTR 2d 93-2052 (6th Cir., 1993).

22 O'Neill, supra, note 21, at 71 AFTR 2d 93-2053.

23 Id.

24 As quoted in Rudkin supra note 2, at 98 AFTR 2d at 2006-7372. A similar line of thinking motivated the Tax Court opinion in Rudkin. See Rudkin supra note 3, 124 T.C. at 309-310.

25 See authorities as cited supra note 24. With all respect, that does not seem a correct reading of the O'Neill holding to this author since a distinction seems appropriate under that case between administrative expenses incurred because of the fiduciary's duties (that would be fully deductible), and those incurred in the fiduciary's discretion (that O'Neill seemed to hold were subject to reduction under §67(e)).

26 Northern Sec. Co. v. United States, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting) ("Great cases, like hard cases, make bad law").

continued on page 4