Supreme Court Limits Certain Income Tax Deductions for Estates and Trusts

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A recent unanimous decision by the United States Supreme Court has limited the income tax deduction for certain expenses incurred by trustees in connection with the administration of trusts. In *Knight v. Commissioner of Internal Revenue Service*, (No. 06-1286) 467 F. 3d 149, affirmed. (2008), the Court held that investment advisory fees incurred by a trustee in managing the trust were subject to the provision contained in section 67(a) of the Internal Revenue Code that allows certain deductions only to the extent they exceed 2% of a taxpayer's adjusted gross income for the year (referred to as the "2% floor"). For example, if a taxpayer's adjusted gross income was $100,000 for 2007, only those miscellaneous itemized deductions in excess of $2,000 may be deducted by the taxpayer in determining taxable income, upon which the income tax is imposed. Only deductions defined as miscellaneous itemized deductions are subject to this 2% "floor" rule. Some deductions, such as those incurred for real estate taxes and interest (to the extent otherwise deductible), are not subject to the floor because they are not miscellaneous itemized deductions.

The Supreme Court appears to have adopted a rule that expenses incurred by a trustee (or executor) are subject to the 2% floor if those expenses are of a type "customarily or commonly" incurred by individuals. The court stated that "it is not uncommon or unusual for individuals to hire an investment adviser" and, therefore, ruled that the fees for such an adviser paid by the trustee in the *Knight* case were deductible only to the extent they (coupled with any other miscellaneous itemized deductions incurred by the trust) exceed 2% of the trust's adjusted gross income. The Supreme Court held that whether a trust-related expense is fully deductible "turns on a prediction of what would happen if a fact were changed – specifically, if the property were held by an individual rather than by a trust." But the Supreme Court offered no guidance as to how trustees must go about making such predictions.

The Supreme Court acknowledged that some trust investment advisory fees may be fully deducted if the advisor imposes a special, additional charge only on its fiduciary accounts. It also indicated that the fees might be fully deductible to the extent they are incurred to help the trust achieve an "unusual investment objective" or to the extent the trust requires a specialized balancing of the interests of various parties. If the colloquy during the oral argument is any indication, a trustee's ordinary balancing of income and remainder interests (which certainly were present in *Knight*) would not be sufficient. It is interesting to note that a linchpin of the Supreme Court's rejection of the taxpayer's argument that a trustee is constrained by the Prudent Investor Rule, thus making investment advice rendered to a trustee distinctive, is the Court's interpretation of the Prudent Investor Rule as requiring a trustee to invest as a prudent individual would with the same objectives as the trust.

Therefore, the Supreme Court did not view the Prudent Investor Rule as a two part requirement: first part, invest in the same manner as a prudent individual investor (in other words, no speculation or undue risk), and second part, take into account the objectives of the trust including consideration of the purposes, terms, distribution requirements and other circumstances of the trust. Rather, the Supreme Court in effect viewed it as a unitary requirement implying that typical individual and trust investing are pretty much the same. The Supreme Court may well be right that if you compared individual and trust investment portfolios with the same risk tolerance, the two portfolios (if under the management of the same advisor) likely are indistinguishable. That being the case, it would take an unusual trust to fall outside the scope of the 2% floor for investment advice. Yet the meaning of the court's use of the word "specialized" is not at all clear. It also seems that the investment advisory fees involved to achieve the unusual investment objective or accomplish the specialized balancing must be reflected in an additional charge by the adviser.

The court did not deal with other expenses commonly incurred by a trustee or executor in connection with the administration of a trust or estate, such as trustees' commissions, attorney and accountant fees, court costs, preparation of fiduciary income tax returns and advising beneficiaries about their rights and interests. It is, however, quite certain that these other expenses will be dealt with in final regulations that are expected to be issued by year end and provide some clarity on which expenses (or which part of expenses) are subject to the 2% floor. Those regulations almost certainly will be prospective only and, therefore, will not apply for 2007.

So trustees, executors and their tax advisors need to determine the extent to which investment advisory fees are deductible without regard to the 2% floor and which, or the extent to which, any other expenses incurred by an estate or trust in connection with the administration of the entity are subject to the 2% floor. It seems that there is at least a reasonable basis to take the position that no expense other than investment advisory fees incurred by an estate or trust is subject to the floor. Other courts, including two that also used the "customarily and commonly" test the Supreme Court adopted, have indicated that trustees' commissions, for example, are fully deductible. Although the proposed regulations dealing with the 2% floor rule for trusts and estates would limit some of these other expenses, proposed regulations do not have the force of law. The Supreme Court admits that because the statute requires a prediction about a hypothetical situation it "inevitably entails some uncertainty." Although this statement does not go so far as to label the statute "ambiguous," it does leave the door generously ajar for clarifying regulations. It would seem, though, that those regulations ought to be consistent with the jurisprudence that established the "customarily and commonly" test, rather than following the extreme "impossibility" test supported only by the Second Circuit opinion in *Rudkin* below, and expressly rejected by the Supreme Court. Perhaps, a more difficult situation for trustees and executors arises where the fiduciary believes a portion of investment advisory fees are deductible without

regard to the 2% floor on account, by way of example from the Supreme Court's decision, of an usual investment objective or some special balancing of interests.

The bottom line is that trustees and executors will need to consider obtaining professional tax advice in determining which, if any, expenses, other than investment advisory fees may be deducted without regard to the 2% floor and what, if any, portion of investment advisory fees may be so deducted as well. Those who prepare the fiduciary income tax returns and those who provide advice about it need to consider their obligations under section 6694 of the Internal Revenue Code, as fleshed out in recent IRS Notice 2008-13.

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