Trusts and Estates Law

ALERT

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Knight v. Commissioner — U.S. Supreme Court Rules On Important Issue Regarding Income Taxation of Trusts

U.S. Supreme Court decisions relating to income tax are rare. Rarer still are Supreme Court decisions involving the income taxation of trusts. The Supreme Court's recent decision in *Knight v. Commissioner*, which resolved a significant controversy concerning the income taxation of trusts, requires trustees, both corporate and individual, to understand the decision and its implications. Also, recently released proposed regulations address the same issue. This Client Alert summarizes the Supreme Court decision and the proposed regulations, discusses what trustees need to do to comply with the decision and the proposed regulations, and describes what can be done to plan for the best tax result possible in view of the decision.

Legal Background. *Knight v. Commissioner* addressed the deductibility, for income tax purposes, of investment advisory fees paid by a trust. Like individuals, trusts compute their income received from all sources, and then are entitled to deduct expenses to arrive at taxable income. Certain expenses are deductible in full, and certain expenses are only partly deductible (these partly deductible expenses are referred to as "miscellaneous itemized deductions"). Miscellaneous itemized deductions are deductible only to the extent they exceed two percent (2%) of the taxpayer's adjusted gross income (this 2% limitation is referred to as the "2% floor"). For example, if a trust has $1,000,000 in adjusted gross income and incurs miscellaneous itemized deductions of $45,000, the trust can deduct only $25,000 of such deductions (the excess of $45,000 over $20,000 – the 2% floor). If the trust had no other deductions or exemptions, the trust would owe tax on $975,000, with the result that $20,000 of expense was nondeductible (and assuming a 35% marginal tax rate, the trust would owe $7,000 more in tax – 35% of the nondeductible $20,000 expense).

The tax law defines miscellaneous itemized deductions to include "investment advisory fees," thereby subjecting those fees to the 2% floor and potential loss of deduction for such fees. However, an exception to the 2% floor (which is itself an exception to the general rule of full deductibility) for miscellaneous itemized deductions provides that miscellaneous itemized deductions such as investment advisory fees incurred by a trust "which would not have been incurred if the property were not held in such trust," are not subject to the 2% floor. Thus, a trust may deduct an investment advisory fee (in full) if the fee **would not** have been incurred if the property **were not held** in trust.

Translating the double negative into plain English, the question is whether an individual would incur such costs. If it is common or expected that an individual would pay for investment advisory fees, then such fees are subject to the 2% floor when incurred by a trust. However, if individuals would only rarely, if ever, incur such fees, then such fees would not be subject to the 2% floor. The Supreme Court formulated the issue in this manner in *Knight v. Commissioner*, and decided that the investment advisory fees incurred by the trust in that case were subject to the 2% floor.

Facts. The fact pattern in *Knight* is fairly common. Michael J. Knight, as trustee of the William L. Rudkin Testamentary Trust, hired an investment advisor with respect to

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investing the trust's assets. The trust had approximately $2,900,000 in marketable securities, and it paid the advisor $22,241 in investment advisory fees for the 2000 taxable year. On its fiduciary income tax return for 2000, the trust reported income of $624,816, and it deducted the advisory fee in full. On audit, the IRS determined that this fee was a miscellaneous itemized deduction and subject to the 2% floor. The IRS allowed the trust to deduct the advisory fees only to the extent that they exceeded 2% of the trust's adjusted gross income. The discrepancy resulted in a tax owed by the trust of $4,448.

The trustee appealed the IRS determination and lost in the lower courts. The Supreme Court agreed to hear the case to resolve a split among the lower courts. Although the majority of lower courts had held that investment advisory fees incurred by a trust were subject to the 2% floor, at least one court held that under certain circumstances, such fees were not subject to the 2% floor.

Decision. The Supreme Court framed the issue of deductibility of investment advisory fees by a trust as a prediction as to whether an individual would incur such investment advisory fees. If the facts were changed and the funds held by an individual (instead of in trust), would the individual incur such fees? If individuals commonly incur such expenses (and therefore would likely incur the advisory fee), then the expense was subject to the 2% floor.

The Court rejected any other reading of the statute, especially the argument that because trusts were unique and had to incur investment advisory fees to satisfy the trustee's fiduciary duty to invest prudently on behalf of all beneficiaries, those fees would not be incurred by individuals. Under this argument, holding funds in a trust effectively mandated the use of an investment advisor and payment of fees. In contrast, an individual does not have to hire an investment advisor, and does not have a fiduciary duty to invest prudently.

The Court rebuffed this argument and noted that, under the "prudent investor rule", trustees are required to invest in the manner that intelligent people invest. There is no additional standard specially imposed on a trustee. Accordingly, since an individual would probably have incurred such fees (so as to invest in a prudent manner), the expense was subject to the 2% floor.

The Court acknowledged that making the prediction as to what expense an individual would commonly incur made the administration of the 2% floor difficult to administer. In each case, the trustee will have to inquire as to whether an individual would likely incur an expense to determine whether the expense is subject to the 2% floor. However, the Court noted that such difficult tests were common in the tax law, and the Court's test must be applied to comply with the language of the Internal Revenue Code.

As a sort of postscript to its decision, the Court noted that the "commonality" test (*i.e.*, if costs are commonly incurred by an individual, they are subject to the 2% floor) did leave open the door for trusts to deduct fees paid to an investment advisor for "specialized advice" applicable only to trusts. According to the Court, if a trust had an unusual investment objective, or required a specialized balancing of the interests of the beneficiaries, then the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.

Proposed Regulations. In addition to considering the impact of *Knight* in deciding the deductibility of investment advisory fees, a trustee should consider the proposed regulations applicable to this issue. Due to the split between the courts on this issue prior to the *Knight* decision, the Treasury Department issued a proposed regulation that provides that only costs "unique" to a trust may be deducted in full. A cost is unique if an individual **could not** have incurred that cost in connection with property not held in trust. This "could not" test differs from the Supreme Court's "commonality" test, and is more likely to disallow deductions.

Although it is likely that the proposed regulation will be modified to conform to the Supreme Court's commonality test, the regulation is important for another reason. The proposed regulations set forth a specific rule most applicable to corporate trustees that charge a single fee for trustee services and investment advice. Under the regulations, if a trust pays a single fee for both trustee services (that are unique to trusts) and investment advice (that individuals commonly incur), then the trust must identify the portion (if any) of the fees that are unique to trusts and not subject to the 2% floor. The balance of such fees would be subject to the 2% floor. Under the regulation, the taxpayer **must** use a reasonable method to allocate the

single fee, commission or expense between the costs subject to the 2% floor and those not subject to the 2% floor.

Compliance Issues. Trustees who separately incur investment advisory fees that are of the type paid by individuals may not deduct those fees in full. Both under *Knight* and the proposed regulations, those fees are subject to the 2% floor. Individual trustees, who most often will incur investment advisory fees, will be immediately impacted by the decision and will have to consult with their counsel and accountants to deal with reporting on a prospective basis. It is not clear what retroactive effect the decision will have on past years if the trustee deducted such fees in full.

Compliance Guidance. The proposed regulations (which once finalized will have the force of law) list the following expenses that are unique to trusts, and would not be subject to the 2% floor:

- fiduciary accountings;
- judicial or quasi-judicial filings required as part of the administration of the trust;
- fiduciary income tax and estate tax returns;
- the division or distribution of income or corpus to or among beneficiaries;
- trust or will contest or construction;
- fiduciary bond premiums;
- communications with beneficiaries regarding trust matters.

Under the regulation, the following expenses are not unique to a trust, and are subject to the 2% floor:

- custody or management of property;
- advice on investing for total return;
- gift tax returns;
- the defense of claims by creditors of the decedent or grantor;
- the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

In light of this guidance, trustees should immediately review their expenses to determine the deductibility of such expenses.

Planning. The Supreme Court left a small door open in terms of planning to avoid the 2% floor by indicating that if an investment advisor charged a special fee relating to trusts, then such incremental fee would not be subject to the 2% floor. Because the special fee would apply only to trusts and their special needs, it would not be incurred by individuals and would qualify for the exception to the 2% floor. If a trustee is incurring a fee for investment advice, the trustee should ask the advisor to label the portion of the fee relating to specialized trust advice as such, and the trustee may be able to deduct such portion.

A planning technique that apparently will not work is the "bundling" of investment advisory fees and trustees' fees into a single fee. The proposed regulations provide that, if a trust pays a single fee that includes both costs that are unique to trusts (trustee fees for recordkeeping, beneficiary communications, and trust interpretation) and costs that are not (investment advisory fees of the type sought by individuals), then the trust must use a reasonable method to allocate the single fee between the two types of costs. Once the proposed regulations are final, trustees will need to review them to determine how to allocate their fees between the portion subject to the 2% floor and the portion not subject to the 2% floor.

It may be possible to ameliorate the effect of the proposed regulations and *Knight* by distributing income to trust beneficiaries. If a trust can distribute enough income to reduce the trust's taxable income to zero, the loss of the deduction to the trust will not be as significant. However, such distributions may have the effect of increasing the beneficiaries' adjusted gross income and thereby rendering more of the beneficiaries' miscellaneous itemized deductions subject to the 2% floor. Of course, distributing additional trust income may cause other problems in administering a trust that requires the trustee to exercise discretion before making such distributions.

IRS Action. The IRS is actively involved in reviewing the returns of trusts to determine if investment advisory fees are being correctly reported. The proposed regulations, once finalized, will require trustees that charge a single fee to "unbundle" such services in order to properly report that fee for tax purposes. Much is at stake, and this area is apparently a priority for the IRS. Because of the IRS attention to this matter, which will only be heightened after the government's victory in *Knight*, trustees should review their options relating to the deductibility of investment advisory fees.

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