

Tax Topics

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Trust investment fees not fully deductible – again. Last fall, the Second Circuit Court of Appeals dealt another blow to the full deductibility of a trust's investment-advisory fees by affirming the Tax Court's 2005 decision in *Rudkin v. Commissioner* (467 F.3d 149, *aff'g* 124 T.C. 304). What really concerned practitioners, however, was that the decision seemed to raise the bar even higher for what constitutes a fully deductible trust expense: i.e., unless a cost "is peculiar to trusts and one that individuals are incapable of incurring," it is subject to the 2% floor for miscellaneous itemized deductions. So after that rousing beginning, what *are* we talking about?

Some background. In general, you calculate a trust's income tax the same way you calculate an individual's income tax. Simply stated, you subtract the trust's exemption and deductions from its gross income to arrive at its taxable income. How you calculate the deduction for investment advisory fees is the issue. The rule is that you can't deduct them unless they exceed 2% of the trust's adjusted gross income (the "2% floor"), subject to the following exception: you can fully deduct the expenses if they "would not have been incurred if the property were not held in such trust." (For tax mavens, the relevant statute is IRC Sec. 67(e)(1).) Different courts have interpreted this language differently. Here is a quick rundown on these prior decisions:

- ***O'Neill v. Commissioner***, 994 F. 2d 302 (6th Cir. 1993) – in *O'Neill*, the Sixth Circuit Court of Appeals reversed the Tax Court, and held that the investment advisory fees the trust paid were fully deductible. The trustees of this Ohio trust argued that they never would have agreed to serve without professional investment advice, and that the "prudent person rule" imposed a fiduciary obligation on them to seek such guidance. The Sixth Circuit agreed, and refuted the Tax Court's rationale that the fees shouldn't be fully deductible because individual investors "routinely incur" them. The Sixth Circuit noted that individuals

are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

Because these investment advisory fees would not have been incurred if the property had not been held in trust, the Sixth Circuit held, they were fully deductible.

- ***Mellon Bank v. The United States***, 265 F.3d 1275 (Fed. Cir. 2001) – in *Mellon*, the Federal Circuit Court of Appeals affirmed a 2000 decision of the Federal Claims Court (47 Fed. Cl. 186) that investment advisory fees are subject to the 2% floor. Mellon Bank had hired outside investment advisors for the trusts in question. Mellon argued that no services are "unique" to trusts, since they are all required under Pennsylvania's fiduciary law. Therefore if a trustee incurs expenses in executing its fiduciary duty, those expenses should be fully deductible, just like a trustee's commission. Mellon relied on *O'Neill*. The court rejected Mellon's argument, saying that this approach would make every trust expense fully



deductible, and would render superfluous the requirement that the expense “would not have been incurred if the property were not held in such trust.” The court held that this language meant that expenses must be “unique to the administration of a trust and not customarily incurred outside of trusts.” Although the court acknowledged that different legal obligations apply to assets held in trust, it stated that “[i]n construing the federal income tax code...we are not bound by the fiduciary standard established by state law, and must instead defer to Congress and the plain meaning of the statute.”

- **Scott v. United States**, 328 F.3d 132 (4th Cir. 2003) – in *Scott*, the Fourth Circuit Court of Appeals upheld the 2002 decision of a federal District Court in Virginia (186 F. Supp. 2d 664) that the trust’s investment advisory fees were subject to the 2% floor. As in *O’Neill*, the trustees pointed out that because they had no investment expertise, they would not have served without hiring a professional investment advisor. Accordingly, since the investment advisory fees would not have been incurred if the property had not been held in trust, the fees should be fully deductible. The government argued, and the Fourth Circuit concurred, that because wealthy individuals commonly seek investment advice, the trust’s costs for this didn’t arise because the property was held in trust. In addition, because Virginia offered immunity to fiduciaries that invested pursuant to its published “legal list,” Virginia law did not require a trustee to seek professional investment advice. “Put simply,” the court stated, “trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers.” There was no need to look at the legislative history of the statute because it was “clear and unambiguous.” In criticizing the Sixth Circuit’s opinion in *O’Neill*, the court explained:

Of course, trustees often (and perhaps must) seek outside investment advice. But [the statute] does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred *outside* the administration of trusts.

...which brings us to Rudkin. Here were the facts: the Rudkin Trust was established in 1967, under the will of Henry Rudkin (Rudkin’s family helped found Pepperidge Farm, the food products company that was sold to Campbell Soup Company in the early 1960’s; the Trust was initially funded with the proceeds of this sale). The trustee hired an investment management company for the Trust and during 2000, paid the firm over \$22,000 for its services. The Trust took a full deduction for the expense on its 2000 income tax return; in late December 2003, the IRS issued a deficiency notice for about \$4,400. The Trust took the case to the Tax Court, where it argued, à la *O’Neill*, that because of the fiduciary duties imposed on trustees (this was a Connecticut trust), the investment advisory fees were fully deductible since they would not have been incurred if the property hadn’t been held in trust.

The Service argued that 1) because individuals regularly incur such fees, they were not incurred because the property was held in trust, and 2) neither state law nor Rudkin’s will imposed a legal obligation on the trustee to obtain professional investment services. Not surprisingly, the Tax Court ruled against the Rudkin Trust; it looked to the same rationale it set forth in *O’Neill*: to be fully deductible, an expense must be “unique” to trusts (as mentioned above, the Sixth Circuit rejected this holding and reversed the Tax Court in that case).

The Rudkin Trust appealed to the Second Circuit Court of Appeals. The Trust argued that the Sixth Circuit's *O'Neill* decision correctly construed the tax law, and that the Federal and Fourth Circuits (in *Mellon* and *Scott*, respectively) interpreted it inconsistently with its plain language and legislative history. That is because Sec. 67(e)(1) creates a "but for" test – meaning that the only administrative costs subject to the 2% floor are those that would have been incurred *even if* there were no trust. In addition, the statute's legislative history indicated that Congress only meant to preclude from full deductibility administrative costs incurred by pass-through entities (such as partnerships) in which a trust invested.

The Second Circuit rejected both arguments. It stated that when 67(e)(1) talked about a trust's administrative fees, it was speaking generically. In other words, the statute focuses on "the hypothetical situation where the assets are in the hands of an individual," and not whether the costs are commonly incurred in trust administration or because of a *particular* trustee's fiduciary duty. The court stated the statute's plain meaning "excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust." The court continued:

We...join the Federal and Fourth Circuits in holding that § 67(e)(1) does not exempt from § 67(a)'s two-percent floor investment-advice fees incurred by trusts. We disagree, however, with their statement that costs "not *customarily* incurred outside of trusts" are the ones not subject to the floor...[emphasis in original], because, as explained above, we believe § 67(e)(1) is more restrictive than that. While the Federal and Fourth Circuits' approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of § 67(e) requires that we determine with certainty that 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* [emphasis added].

As to the statute's legislative history, the Second Circuit said that it was unnecessary to address it because the statute was "clear and unambiguous." Nevertheless, in addressing that history, the court concluded that it didn't support the Trust's interpretation of the statute, and instead supported a conclusion that, subject to limited exceptions, Congress intended to tax trusts in the same manner as individuals.

The Trust asked the Second Circuit to rehear the case; the request was denied. At the end of March, the Trust filed a petition for *certiorari* with the Supreme Court. As of this writing, it is unknown whether the Court will agree to hear the case.

Comments. *Rudkin* is a big deal, particularly because of its language that says a trust can only take a full deduction for costs that *could not* have been incurred by an individual. Short of trustee commissions, which only trusts incur, it would seem that most administrative costs, be they legal fees, tax and accounting fees, etc., can also be incurred by an individual. In other words, in the Second Circuit, which covers New York, Connecticut and Vermont, a literal reading of *Rudkin* would mean that most trust administrative expenses are subject to the 2%

floor, and are not fully deductible. What's ironic about this is that if the trustee of the trust is a corporate fiduciary that manages the trust's assets itself and doesn't hire outside investment advisors, those fees are fully deductible – even though a portion of them represent costs for investment management.

And what about the statutory language that trust administration expenses are fully deductible if they “would not have been incurred if the property were not held in such trust”? How can courts read such purportedly “clear and unambiguous” language so differently?

It is clearly a function of interpretation. In *O'Neill*, the Sixth Circuit read the statute to mean that costs are fully deductible if they are incurred *because* the property is held in trust, regardless of whether individuals may incur the same costs. In *Rudkin*, *Scott* and *Mellon*, the Second, Fourth and Federal Circuits, respectively, essentially read the statute to mean that the costs are fully deductible *only if* they are unique to trusts.

Which position is correct? That depends on your point of view. If you assume that the Prudent Investor Act and the investment acumen that courts regularly demand of fiduciaries mean that a trustee has no choice *but to* hire professional investment advisors, you would say that those expenses “would not” have been incurred if the property had not been held in trust – no ifs, ands, or buts about it. But suppose you're a fiduciary in a state where there's a “legal list,” as Virginia had in *Scott*? Since the state gives you immunity for investing pursuant to that list, regardless of whether the choices make sense, you're not *required* to hire an investment professional. In that case, it's not that you “*would not*” have incurred the cost, it's that you “*might not*” have incurred it. Or if you conclude that Congress basically intended to tax trusts as individuals with only limited exceptions, you would probably agree that most trust administration expenses are subject to the 2% floor.

It will be interesting to see if the Supreme Court takes the case. This is the classic “split in the circuits” that prompts the Court's review. So what's a trustee to do? If you're fortunate enough to be in the area covered by the Sixth Circuit's *O'Neill* decision – i.e., you're the trustee of a Michigan, Ohio, Kentucky or Tennessee trust – you can comfortably take a full deduction for the trust's investment advisory fees. If, as mentioned above, you are within the ambit of *Rudkin* and the Second Circuit (New York Connecticut and Vermont) not only are your investment advisory fees subject to the 2% floor, there is now a question about whether most of the trust's administrative expenses, other than trustee's commissions, are also subject to that 2% floor. If you are within the ambit of *Scott* and the Fourth Circuit (West Virginia, Virginia, Maryland, and North and South Carolina), the investment advisory fees are subject to the 2% floor.

What about the rest of the country? The instructions to the Form 1041, a trust's income tax return, clearly state that investment advisory fees are subject to the 2% floor. If you take a contrary position, you can be sure of a fight with the IRS, as the weight of authority is on their side. Nevertheless, *O'Neill* is still authority for taking a full deduction. What you do probably depends on how strong your stomach is.

p.s. What about changing the law? Given the disputes that have arisen about this issue, wouldn't it be nice if Congress clarified the law? Indeed, in 2000, the Federal Court of Claims (the lower court in *Mellon*) made the following point:

...it is the responsibility of Congress, and not the courts, to establish tax policy. In cases such as [this], the task of the courts is limited. Where the wording of the statute is plain and unambiguous and the result is not "absurd"...the court is obliged to apply the statute as written....Here, applying the statute as written hardly can be characterized as providing an "absurd" result in that it furthers the purpose, articulated in the legislative history and described above, of promoting fairness in tax policy. To the extent that plaintiffs or amicus wish to argue that...fairness comes at too high a price, they should present such arguments to Congress and seek an appropriate amendment to I.R.C. section 67(e)(1).

While that is a good suggestion, it is surely easier said than done.

...a final note: The difficulty here is the underlying inequity the Sixth Circuit raised in *O'Neill*: trustees face very real liability if beneficiaries are unhappy with how they manage trust assets. Although individuals also may hire investment advisors, they don't have to, and can stuff their money under their mattress if they choose – without being sued. Given that, why *can't* trusts fully deduct the fees of a professional investment advisor? Because according to the majority of courts that have addressed the issue, that's just not what the statute says.

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May 7520 rate issued. The IRS has issued the May 2007 applicable federal rates: the May 7520 rate is still 5.6%, the same as April's rate. The May short-term rates are slightly down, however: the annual rate is 4.85%, the semiannual rate is 4.79%, the quarterly rate is 4.76% and the monthly rate is 4.74%. (The April annual rate was 4.90%, its semiannual rate was 4.84%, its quarterly rate was 4.81% and its monthly rate was 4.79%.)

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