Is a Horse not a Horse When Entities Incur Investment Advisory Fees?

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Deductions under Section 67 for Investment Expeneses

A colleague of mine, John Janiga, of the School of Business Administration at Loyola University Chicago, and I have analyzed the debate that continues to rage over the deductibility of trust investment advisory fees (IAFs). An individual that incurs these fees will deduct these as a miscellaneous itemized deduction (MIDs) -- deductible only to the extent that they exceed 2% of a trust's adjusted gross income (AGI), often referred to as the "2%-of-AGI floor."[1] The issue involves whether an entity that incurs these fees -- in this case trusts-- changes the nature of the expense from an MID to an above the line business deduction.

The key cases in this area - *O'Neill*,[2] *Mellon Bank*,[3] *Scott*,[4] and *Rudkin*[5] -- have different and competing holdings of the relevant Code section, Section 67(e)(1). On June 25, 2007, the Supreme Court granted a writ of certiorari (Writ) in *Knight v. Comm'r*[6] (formerly *Rudkin v. Comm'r*) to resolve the dispute among jurisdictions. The Court will likely decide whether Section 67(e)(1) permits a full deduction for investment management and advisory services provided to trusts and estates.[7] Here's John and my prediction, understood in the context of the *Knight* case.

Knight Background

Michael J. Knight served as the trustee (Trustee) of the William L. Rudkin Testamentary Trust (Rudkin Trust), a trust established under the will of Henry A. Rudkin (Henry).[8] Initially, the trust was funded primarily with the proceeds from the sale of Pepperidge Farm, a company that Henry's family was involved in founding, to Campbell Soup Company.

Under the terms of the Rudkin Trust, which were contained in Henry's will, the trustee was given broad authority in the management of the trust assets, including the authority "to invest, and

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[1] *Ibid*. This distinction may be relevant for both regular tax purposes and AMT purposes. For a discussion of the potential impact for both regular tax and AMT purposes, see Janiga & Harrison, *supra* note 3, at p. 42 and Endnotes 5-6 on p. 48-49.

[2] *O'Neill v. Comm.*, 994 F.2d 302 (6th Cir. 1993) (*O'Neill II*), *rev'g O'Neill v. Comm.*, 98 T.C. 227 (1992) (*O'Neill I*).

[3] *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001), *aff'g Mellon Bank, N.A. v. U.S.*, 47 Fed Cl. 186 (2000).

[4] *Scott v. U.S.*, 328 F.3d 132 (4th Cir. 2003), AFTR 2d 2003-2100, (*Scott II*) *aff'g Scott v. U.S.*, 186 F. Supp. 2d 664 (2002).

[5] *Rudkin v. Comm.*, 467 F.3d 149 (2d Cir. 2006) (*Rudkin II*), *aff'g Rudkin v. Comm.* 124 T.C. 304 (2006) (*Rudkin I*).

[6] U.S. No. 06-1286.

[7] *Ibid.*

[8] *O'Neill I*, at 305

reinvest the funds of my estate or of any trust created hereunder in such manner as they deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agent, experts and counsel."[9]

Pursuant to the terms of the Rudkin Trust, the Trustee engaged Warfield Associates, Inc. (Warfield), to provide investment management services for the trust. During the taxable year 2000, the Trustee paid $22,241.31 for such services. On its 2000 Federal income tax return, the Rudkin Trust fully deducted these fees.[10]

The IRS determined that the IAFs paid to Warfield were not fully deductible but were instead a MID. Consequently, it issued to the Rudkin Trust a statutory notice of deficiency in the amount of $4,448.[11]

Knight **in the Courts**

Knight originated in the Tax Court.[12] There, consistent with its decision in *O'Neill I*, the court held that IAFs are MIDs.[13] In doing so, it initially quoted its language from *O'Neill I* that "the thrust of the language of [S]ection 67(e)[(1)] is that only those costs which are *unique* to the administration" of a trust are fully deductible.[14] Since "[i]ndividual investors routinely incur [IAFs] . . . it cannot be argued that such costs are somehow unique to the administration of . . . [a] trust simply because a fiduciary might feel compelled to incur such expenses in order to meet the prudent person standards imposed by State law."[15] Then, it rejected the Sixth Circuit's reasoning in *O'Neill II* that costs - including IAFs - attributable to the trustee's fiduciary duty, not required outside the administration of the trust are fully deductible.[16] Instead, it expressed support for the positions espoused by the Federal Circuit in *Mellon* and the Fourth Circuit in *Scott*, stating that "the second requirement of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trust. Instead, it asks whether costs are commonly incurred *outside* the administration of trusts. As the Federal Circuit decided in *Mellon Bank*, [IAFs] are commonly incurred outside the administration of trusts, and they are therefore [MIDs.][17]

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[9] *Ibid*, at 305-306.

[10] *Ibid*, at 306.

[11] *Ibid*.

[12] *Rudkin I*, *supra* note 8.

[13] *Ibid*, 304.

[14] *Ibid*, at 230 (emphasis in original).

[15] *Ibid*, at 309.

[16] *Ibid*, at 309-310.

[17] *Ibid*, at 310 (citing *Scott II*, at 140)(emphasis in original).

The Second Circuit affirmed the Tax Court, but established a highly restrictive interpretation of Section 67(a)(1)'s second requirement,[18] one that could rarely be met.[19] Specifically, the court stated that "the plain text of [Section] 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. Therefore, we 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."[20]

All Relevant Section 67 Cases Summarized

In summary, the case holdings establish the following propositions of law as they related to IAFs:

Case	Court	Proposition of Law
O'Neill	Tax Court	Only costs unique to the administration of a trust are fully deductible. IAFs are not unique to a trust.
	Sixth Circuit	Costs, including IAFS, attributable to the trustee's fiduciary duty, not required outside the administration of the trust, are fully deductible.
Mellon Bank	Court of Federal Claims	Only costs unique to the administration of a trust and not customarily incurred outside of trusts are fully deductible. IAFs are not unique and are commonly incurred by individuals.
	Federal Circuit	
Scott	U.S. District Court for the Eastern District of Virginia	IAFs are not necessary to fulfill fiduciary duties and, thus, are not fully deductible because under relevant state law a trustee investing in a statutory list is given absolute immunity under the prudent investor rule.
	Fourth Circuit	Only costs unique to the administration of a trust and not commonly incurred outside of trusts are fully deductible. IAFs are not unique and are commonly incurred by individuals.
Rudkin	Tax Court	Same as in *O'Neill*.
	Second Circuit	Only costs that cannot be incurred by an individual are fully deductible. IAFs are incurred by individuals.

[18] *Rudkin II*, at 2.

[19] Previously, we argued that "it is difficult to come up with any trust administration cost that meets the Second Circuit's definition of the second [requirement]. Applied strictly, this definition would not allow for full deductibility of trust administration costs that the court itself conceded would be fully deductible. The definition is so restrictive that it has the potential to make Section 67(e) superfluous, certainly a result that no canon of statutory construction can support." Janiga & Harrison, *supra* note 3, at 47.

[20] *Ibid*, at 12. In January 2007, the Second Circuit refused to reconsider its ruling.

The Tax Court's holdings in *O'Neill* and in *Rudkin* that certain administration costs, such as trustee's fees and trust accounting fees, are unique to a trust appears to contradict its holding in *Bay v. Commissioner.*[21] That case dealt with the deductibility of various administration costs, including IAFs, trustee's fees, and accounting fees - in the context of a grantor trust.[22] There, relying on *O'Neill*, the taxpayer grantor fully deducted the portion of the trust's administration costs that flowed through to her individual federal income tax return pursuant to § 671.[23] Because such deductions are treated as paid by the individual and such administration costs for individuals are MIDs, the Court denied fully deductibility.[24] In doing so, the court recognized that trustee's fees and trust accounting fees can be incurred by individuals, in conflict with its statements in *O'Neill* and *Rudkin* that such expenses are fully deductible by a trust because they are unique to a trust.

The holdings espoused by the Court of Federal Claims and the Federal Circuit in *Mellon Bank*, and the Fourth Circuit in *Scott* can be criticized on various grounds. First, the courts held that § 67(e)(1) establishes two prerequisites for full deductibility: Prong 1, which is satisfied by any trust administration cost, and Prong 2 which is satisfied by any cost that is "unique to the administration of a trust … and not customarily incurred outside a trust." The courts rejected the taxpayer's arguments that Prong 2 was satisfied if the IAFs were incurred by the trustee to meet state law fiduciary duties because, according to the courts, such an interpretation would render Prong 2 superfluous given that Prong 1 is satisfied by any trust administration expense. In doing so, the court fails to recognize that its interpretation of Prong 2 makes Prong 1 superfluous because any cost that meets Prong 2 necessarily meets Prong 1.

Second, the definition of Prong 2, as an expense that is "unique to the administration of a trust … and not customarily incurred outside a trust" seems internally inconsistent. To say that a cost is unique to a trust, suggests that it cannot be incurred outside a trust. Thus, the "unique" language is at odds with the "not customarily incurred" language.

Third, the courts frequently rebuked taxpayers for arguing that state law fiduciary standards should be considered in assessing whether Prong 2 is met by stating that the statute does not expressly refer to state law or fiduciary duties. Yet, the court's definition of Prong 2 uses terms such as "unique" and "not customarily incurred" that are not contained in the statute either.

The Second Circuit's holding in *Rudkin* also can be criticized on various grounds. First, while recognizing the internal inconsistency in the *Mellon Bank* and *Scott* interpretations of Prong 2, the court fails to recognize that its interpretation of Prong 2 - that it is only met if the costs could not have been incurred by an individual - is internally inconsistent with other parts of its opinion. Earlier, the court states that "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' are fully deductible." Yet, as noted earlier, such costs can be incurred by an individual. As such, it seems nonsensical that the court permits full deductibility for these administration expenses while denying such treatment for IAFs.

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[21] T.C. Memo 1998-411, Dec. ¶ 52,960(M).

[22] Id., Dec. ¶ 52,960(M) at 867. Because a grantor trust was involved, the court never addressed the issue of whether a trust's IAFs in a nongrantor trust context are fully deductible or are MIDs.

[23] *Id.*, Dec. ¶ 52,960(M) at 867.

[24] Id., Dec. ¶ 52,960(M) at 868.

Second, it is difficult to come up with any trust administration cost that meets the Second Circuit's definition of Prong 2. Applied strictly, it would not allow for fully deductibility of trust administration costs that the court itself conceded would be fully deductible. The definition is so restrictive that it has the potential to make § 67(e) superfluous, certainly a result that no canon of statutory construction can support.

Several of courts stated that their holdings were supported by the legislative history of § 67. However, none of the courts accurately assesses the legislative history. For example, in *Mellon Bank*, the Federal Circuit referred to the legislative history underlying the Tax Reform Act of 1986 ("TRA '86), which enacted § 67. It stated that "Congress sought to eliminate or reduce the tax benefit of placing assets in a trust." It then concluded that "[t]his result was achieved not through a significant change in the taxation of trusts, but through the application of the [2%-of-AGI] floor … to deductions from trust income." However, the Senate Report underlying the TRA '86 indicates that that problem was attacked not through use of the 2%-of-AGI floor but rather through compression of the tax brackets for trusts. The Federal Circuit also stated that another of Congress' goals in the TRA '86 was to "equate the taxation of trusts and individuals." However, there is nothing in the legislative history to the TRA '86 that supports this statement.

Back to the Supreme Court. In the contexts of the arguments set forth above, we believe that the holdings in *Mellon Bank*, *Scott*, and *Rudkin II* will be cut back and that the court will most likely come down with a rule that is similar, but not as favorable, as in *O'Neill II*. One possibility is a "but for/reasonable person standard." Specifically, would a reasonable individual investor incur the IAFS at the same level as incurred by the trust (with the burden on the taxpayer to show that such fees would not have been so incurred)? We look forward to the decision even if such a bright line test may be buried in footnote 42 of an 85 page opinion.

In the interim, as taxpayers await the Supreme Court decision, the appropriate advice for taxpayers regarding the deductibility for IAFs will depend, in part, on a trust's jurisdiction. But only in three federal appellate court jurisdictions— the Second, Fourth and Sixth—is the answer is clear.

For trusts in the Second and Fourth Circuits, taxpayers have no basis for fully deducting IAFs. For trusts in the Sixth Circuit, taxpayers may be able to fully deduct IAFs—if they can establish that the IAFs were incurred to meet the trustee's fiduciary duties. For trust in other circuits, the situation is not clear-cut. IAFs may be fully deductible, but taking that position may expose the taxpayer to audit risk and accuracy-related penalties.