



Investment Advisory Fees and the Supreme Court's Decision in Knight

By: William Conway, Esq. and Randy Gardner, J.D., LL.M., M.B.A., C.P.A., C.F.P.



The Supreme Court recently resolved a conflict among the Second, Fourth, Federal, and Sixth Circuit Courts of Appeals in the Knight (formerly known as Rudkin Testamentary Trust) case. The Court, following the language of Section 67(e), held that investment advisory fees incurred by a trust were subject to the 2% of AGI floor because the expenses would have been incurred by a hypothetical individual. Consequently, similar to an individual's miscellaneous deductions, a trust's deductions may be partially disallowed.

In Proposed Regulations issued shortly after the Second Circuit's opinion in Rudkin, the Treasury Department took the position that trustee's fees which include both trust administration services and investment management services must be unbundled and allocated between the two services. In IRS Notice 2008-32, the IRS allowed fiduciaries to disregard the unbundling requirement for returns for tax years beginning before January 1, 2008. The IRS also offered that safe harbors would be included in forthcoming, revised final Regulations.

Potentially the expenses affected by the Knight decision could include accountant's fees, appraisal fees, consulting fees, and numerous other fees. The trusts most likely to be affected by the Knight decision are accumulation trusts. Also simple trusts with significant capital gain income at the trust level are likely to have high AGIs. Simple trusts with no capital gains are not affected at the trust level, although beneficiaries may pay a slightly higher tax.

The methods mentioned to circumvent the 2% floor have their flaws. Using brokers who charge commissions rather than investment advisers who charge fees makes the costs deductible against the trade but may affect the implementation of an overall investment strategy.

Using mutual funds buries the investment expenses but may limit the trustee's investment alternatives and their overall return. Shifting the deduction of the investment fees from the Form 1041 income tax return for the estate to the Form 706 filed for the estate only helps those taxpayers who owe estate tax. Shifting the management of the trust to a financial institution from a family member likely leads to a larger expense than the tax the grantor is trying to avoid.

Advisers may want to revise their trustee selection checklists to consider the impact of the 2% floor on trust expenses, but changing investment strategies and trustee choices because of the nominal additional tax that would be owed by some trusts and beneficiaries is an overreaction.

Randy Gardner is the Director of Education for WealthCounsel, LLC. He is also a Professor of Tax and Financial Planning and Director of the Certificate in Financial Planning Program at the University of Missouri, Kansas City.

William Conway is a founding member and principal of WealthCounsel whose practice in tax law, investment, and legal education is in the McLean, Virginia area.