This article was published in a slightly different format in the March 2008 issue of *Trusts and Estates.*

Knight's Decided. Now What?

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The US Supreme Court's unanimous decision in Knight v. Commissioner [1] on Jan 16, 2008, appears to resolve a controversy that has been raging since the early 1990s, concerning whether a trust's investment advisory fees (IAFs) are subject to the two percent of adjusted gross income floor (the two percent floor.) But Knight leaves open a good many questions, not the least of which is how the Internal Revenue Service will finalize its proposed regulations under Internal Revenue Code Section 67(e) concerning the applicability of the two percent floor to costs that are paid or incurred by trusts and estates.

The narrow question presented in Knight involved the standard for determining whether a trust's IAFs are subject to the two percent floor under IRC Section 67(e). That section provides that the two percent floor won't apply to "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." [2]

The meaning of this language had long vexed the federal courts. In the initial salvo, the US Court of Appeals for the Sixth Circuit in 1993 took the position that IAFs paid from trusts are fully deductible without regard to the two percent floor because they are incurred in connection with a trustee's fiduciary duties.[3] In contrast, the Federal Circuit and the Fourth Circuit held that IAFs are subject to the two percent floor because such costs are commonly incurred by individuals.[4] More recently, the Second Circuit, in Rudkin Testamentary Trust v. Comm'r,[5] held that such costs are subject to the two percent floor, but for a different reason: because an individual taxpayer "could" have incurred such costs.[6] In its proposed regulations—issued while Knight was pending before the Supreme Court—the IRS adopted the "could have incurred" approach taken by the Second Circuit.[7]

Although finding for the IRS commissioner by concluding that the IAFs at issue were subject to the two percent floor, the Supreme Court in Knight rejected the Second Circuit's—and therefore the proposed regulations'—"could have incurred" approach as improperly conflating the word "could" with "would" (only "would" appears in Section 67(e)(1).) Instead, the Supreme Court agreed with the approach taken by the Federal and the Fourth Circuits. According to the Supreme Court, Section 67(e)(1) excepts from the two percent floor "only those costs that . . . would be uncommon (or unusual or unlikely) for . . . a hypothetical individual to incur."[8] The question of whether a trust-related expense is fully deductible turns on a prediction about what would happen if the property were held by an individual rather than a trust. Thus, the critical question is whether costs, such as IAFs, are customarily incurred outside of trusts.[9]

But the Supreme Court left the door ajar for the two percent floor not to apply where special circumstances can be shown that generate incremental costs that an individual would not customarily incur. As the court explained: "As the Solicitor General concedes, some trust-related investment advisory fees may be fully deductible 'if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts.' There is nothing in the record, however, to suggest that [the investment advisor] charged the Trustee any differently than it would have treated an individual with similar objectives, because of the Trustee's fiduciary obligations. It is conceivable, moreover, that a trust may have an unusual investment objective may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the two percent floor. Here, however, the Trust has not asserted that its investment objective or its requisite balancing of competing interests was distinctive. Accordingly, we conclude that the investment advisory fees incurred by the Trust are subject to the two percent floor. [10]"

So what does this all mean to the practitioner? What happens next? Here are some observations:

■ **Unbundling** — First, notwithstanding the Supreme Court's rejection of the Second Circuit's "could have incurred" analysis for determining whether costs are subject to the two percent floor, the IRS is likely chomping at the bit to finalize its proposed regulations, albeit with the adjustments indicated in Knight. Still, many questions remain. So practitioners are hoping that the Service will allow a reasonable comment period to permit professional organizations and bar associations to present their views in light of the Supreme Court's recent decision. Among other things, there is the question whether unbundling should be required for trustees' fees, as well as other costs, such as legal fees. The proposed regulations require that trustees' fees, as well as "legal, accounting, investment advisory, appraisal or other fee[s], commission[s] or expense[s],[11]" be unbundled between those that are unique to trusts and estates (which would not be subject to the two percent floor) and those that are not unique to trusts and estates (which would be subject to the two percent floor.) Significantly, the proposed regulations' unbundling requirement appears inconsistent with the analysis set forth in each of the four federal courts of appeals decisions that have construed Section 67(e).[12] It certainly is directly contrary to the views expressed by both the Second Circuit and the Fourth Circuit. For, as the Second Circuit succinctly put it: "'[F]ees paid to trustees'. . . are fully deductible.[13]"

Thus, if the Service's mandatory unbundling requirement is maintained in the final regulations, there could be a round two for litigation under Section 67(e).

■ **Exceptions** — Secondly, The proposed regulations should be expanded to incorporate the special circumstances and incremental cost concerns that are expressed at the end of the Supreme Court's decision in Knight. The case sets forth a framework for this analysis that the IRS can follow.

■ **"Event codes"** — Even if the IRS were to relent in its insistence upon a mandatory unbundling requirement, it may be helpful to trusts if service providers, including investment advisors and other professionals, such as lawyers and accountants, were to separately allocate the portion of their fees and other costs that pertain specifically to the incremental cost of expert advice that would not be commonly incurred by individuals. Take, for example, a real estate transaction entered into by a trust for which a law firm represents the trustee. To support the trustee's position that some of the legal fees pertain to costs that are not commonly incurred by individuals, it may be helpful if a separate "event code" were established in the law firm's billing system to track the fees allocable to advice relating to such matters as:

- Whether the trustee, under the governing instrument and applicable state law, is authorized to enter into the transaction
- Fiduciary liability concerns, including the availability of indemnification
- The effect of the transaction upon diversification and asset allocation concerns
- The allocation of sale proceeds, as well as any subsequent payments, between income and principal
- Liquidity concerns relating to the subsequent ability to fund distributions to beneficiaries n Income tax implications to both the trust and its beneficiaries, taking into account the distributable net income carry-out rules
- Whether, as a result of the transaction, the trustee should consider whether to exercise its power to adjust or to make a unitrust election.

■ **This April 15** — What is the Knight effect upon 2007 tax returns? The case, by its terms, applies only to IAFs. It doesn't purport to apply to other fees a trust may incur, such as legal fees. In this regard, the proposed regulations expressly say: "These regulations are proposed to be effective for payments made after the date final regulations are published in the Federal Register."[14]

■ **Wrong guesses** — What are the penalty consequences to both the taxpayer and the adviser of guessing incorrectly on the nebulous question of whether a hypothetical individual would commonly incur the particular expense that has been incurred by a trust? It would be helpful if the IRS could provide safe harbors when it finalizes the proposed regulations, in addition to providing comprehensive lists to help guide practitioners concerning whether an expense paid or incurred by a fiduciary is subject to the two percent floor.

■ **Preferred investments** — Will certain investments become more attractive to trusts because the two percent floor doesn't apply to them? For example, Section 67(c) specifically excepts "publicly offered regulated investment companies" — such as mutual funds — from the two percent floor.

▪ **Trust companies and investment advisers** — Finally, what measures can trust companies and investment advisers take to underscore that a significant portion of their commissions or fees are directly attributable to costs that are not commonly incurred by individuals, and therefore are not subject to the two percent floor? Following the language at the end of Knight (where circumstances so warrant), it may be helpful to maintain a separate division or subsidiary that can accentuate services unique to trusts and estates — and which, conversely, are generally of little relevance to individuals. This division or subsidiary could emphasize such matters as time horizons relating to mandatory or discretionary principal distributions to beneficiaries, allocations between principal and income (including whether to exercise the trustee's power to adjust), and whether to make a unitrust election. As Knight instructs, the "incremental cost" attributable to these special services should be separately tracked to facilitate their deduction by trusts and estates without regard to the two percent floor. [15]

Endnotes

1. *Knight v. Commissioner,* No. 06-1286 (S.Ct. Jan. 16, 2008).
2. Internal Revenue Code Section 67(e). The stakes involved can be magnified because costs that are subject to the two percent floor also are subject to the alternative minimum tax, which could render such costs effectively nondeductible.
3. *See O'Neill v. Comm'r,* 994 F. 2d 302 (6th Cir. 1993).
4. *See Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001); *Scott v. United States,* 328 F.3d 132 (4th Cir. 2003).
5. *Rudkin Testamentary Trust v. Comm'r,* 467 F.3d 149 (2d Cir. 2006).
6. *Ibid.,* at pp. 155-56.
7. *See* 72 Federal Register 41243, 41245 (2007) (notice of proposed rulemaking) (a trust-related cost is exempted from the two percent floor only if "an individual could not have incurred that cost in connection with property not held in an estate or trust.")
8. *Knight, supra* note 1, slip opinion, at p. 10.
9. *See ibid.*
10. *Ibid.,* at pp. 12-13.
11. Proposed Treasury Regulations Section 1.67-4(c).
12. *See Rudkin, supra* note 5; *Scott, supra* note 4; *Mellon Bank, supra* note 4*; O'Neill, supra* note 3.
13. *Rudkin, supra* note 5 at p. 156 (quoting *Scott, supra* note 4, at p. 140).
14. Prop. Treas. Regulations. Section 1.67-4(d).
15. *Knight, supra* note 1, slip opinion, at p. 13.

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