



**Agricultural Law Press**

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# Agricultural Law Digest

Volume 19, No. 3

February 8, 2008

ISSN 1051-2780

## U.S. Supreme Court in *Rudkin* Says Investment Advisory Fees Are Subject to the 2% Floor

-by Neil E. Harl\*

In a rare unanimous opinion, the United States Supreme Court on January 16, 2008 settled, for now, the question of whether investment advisory fees are fully deductible.<sup>1</sup> The high court held that investment advisory fees incurred by trusts are generally subject to the two-percent floor for miscellaneous itemized deductions.<sup>2</sup> The decision means that such fees are deductible only to the extent that their total, along with certain other miscellaneous itemized deductions, exceeds two-percent of the trust's adjusted gross income, which translates into smaller deductions and more taxable income for many trusts.

### History of the controversy

Under the statute,<sup>3</sup> the adjusted gross income of estates and trusts is addressed as follows—

“For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that —

“(1) the deductions for 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, and

“(2) the deductions allowable under sections 642(b), 651, and 661,

shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provision of this section.”

The controversy materialized in the form of a split among the circuit courts of appeal over the deductibility of fees paid by nongrantor trusts and estates for investment advice. The Sixth Circuit Court of Appeal, in 1993, interpreted the statute as permitting trusts and estates to deduct fully investment advisory fees.<sup>4</sup> On the other hand, the Federal Circuit in 2001<sup>5</sup> and the Fourth Circuit in 2003<sup>6</sup> held that the language of the statute did not allow the full deduction of fees for investment advice on the grounds that those fees are commonly incurred outside of the trust context. In addition, the Second Circuit Court of Appeal held that a full deduction was permitted only for those costs that could not have been incurred by an individual.<sup>7</sup> Inasmuch as investment advisory fees are costs that could be incurred by individuals, the deduction was subject to the two-percent floor. The trustee in the Second Circuit case asked the Supreme Court to resolve the split among the circuits. The petition for certiorari was granted on June 28, 2007.<sup>8</sup>

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### The Supreme Court Decision

The Supreme Court disagreed with the Second Circuit approach of asking if the cost could have been incurred by an individual on the grounds that is not reflective of the statutory language and also rejected the trustee's argument that the test should be whether a particular expense of a trust was caused by the fact that the property was held in trust. The Supreme Court embraced the reasoning in the Federal Circuit case<sup>9</sup> that only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of the trust context are fully deductible.

In the last paragraph of the opinion, the Court observed that the Solicitor General believes that "[s]ome trust-related advisory fees may be fully deductible if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts. To that, the court pointed out "[i]t is conceivable, moreover, that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of the various parties such that a reasonable comparison with individual investors would be improper."<sup>10</sup> In such instances, the Court noted, the extra cost of expert advice beyond what would normally be required for an ordinary taxpayer would appear not to be subject to the two-percent floor. Those factors were not present in the case before the Court, however.

### Standing of Proposed Regulations

The Department of the Treasury had issued proposed regulations that would exclude certain estate and trust expenses (those unique to an estate or trust) from the two-percent floor for itemized deductions.<sup>11</sup> Under those regulations, which followed the Second Circuit approach, non-unique expenses would be subject to the two-percent floor,<sup>12</sup> a cost would be considered unique to an estate or nongrantor trust if an individual could not have incurred the cost in connection with property not held in an estate or trust<sup>13</sup> and if a fee were paid on a "bundled" basis, it would have to be unbundled to show unique and nonunique costs.<sup>14</sup> It should be noted that the Supreme Court did not address the issue of unbundling of fees as suggested in the proposed regulations.

In light of the U.S. Supreme Court decision on January 16, 2008, the proposed regulations are likely to be repropoed.

### FOOTNOTES

<sup>1</sup> I.R.C. § 67(e). See Knight, Trustee of the William L. Rudkin Testamentary Trust v. Comm'r, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,132 (S. Ct. 2008), 128 S. Ct. 782 (2008). See also Harl, *Agricultural Law Manual* § 8.02[2] (2008).

<sup>2</sup> Knight, *supra* note 1; I.R.C. § 67(e).

<sup>3</sup> I.R.C. § 67(e), enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 132(a), 100 Stat. 2085 (1986). Before the passage of the Tax Reform Act of 1986, below-the-line deductions were deductible in full. This resulted in extensive

recordkeeping and "significant administrative and enforcement problems for the Internal Revenue Service." H.R. Rep. No. 99-426, p. 109 (1985).

<sup>4</sup> William J. O'Neill, Jr. Irrevocable Trust v. Comm'r, 98 T.C. 227 (1992), *rev'd*, 994 F.2d 302 (6th Cir. 1993), *non-acq.*, 1994-2 C.B. 1.

<sup>5</sup> Mellon Bank, N.A. v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,642 (Fed. Cl. 2000), *aff'd*, 265 F.3d 1275 (Fed. Cir. 2001).

<sup>6</sup> Scott v. United States, 186 F. Supp. 2d 664 (E.D. Va. 2002), *aff'd*, 328 F.3d 132 (4th Cir. 2003).

<sup>7</sup> William L. Rudkin Testamentary Trust v. Comm'r, 124 T.C. 304 (2005), *aff'd*, 467 F.3d 149 (2d Cir. 2006).

<sup>8</sup> 551 U.S. \_\_\_\_ (2007), 127 S. Ct. 3005 (2007).

<sup>9</sup> Mellon Bank, N.A. v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,642 (Fed. Cl. 2000), *aff'd*, 265 F.3d 1275 (Fed. Cir. 2001).

<sup>10</sup> Knight, Trustee of the William L. Rudkin Testamentary Trust v. Comm'r, 2008-1 U.S. Tax Cas. ¶ 50,132 (S. Ct. 2008), 128 S. Ct. 782 (2008).

<sup>11</sup> Prop. Treas. Reg. § 1.67-4.

<sup>12</sup> Prop. Treas. Reg. § 1.67-4(a).

<sup>13</sup> Prop. Treas. Reg. § 1.67-4(b).

<sup>14</sup> Prop. Treas. Reg. § 1.67-4(c).

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