PREDICTING HOW THE FINAL REGULATIONS WILL APPLY THE *KNIGHT* DECISION

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I. Introduction and Background

It has been 22 years since Congress added the phrase "which would not have been incurred if the property were not held in such trust or estate" to the Code (Sec. 67(e)) in the final hours of a heated closed-door Joint Conference Committee session on the Tax Reform Act of 1986.[1] Since then its meaning has been a mystery, spawning eight costly court battles, resulting in a three-way circuit split, and culminating in the U.S. Supreme Court's *Knight* decision on January 16, 2008.[2]

All this energy has been spent trying to determine the boundaries set by a 17-word phrase that aims to exempt certain administrative costs of an estate or trust from the Sec. 67(a) 2% floor on miscellaneous itemized deductions. Although the announced purpose of the 2-percent floor in Sec. 67(a) was to simplify recordkeeping and prevent individuals from deducting personal expenses, the exact purpose of Sec. 67(e) is not so clear. Sec. 67(e) allows an estate or trust a full deduction for administrative costs "which would not have been incurred if the property were not held in such trust or estate." But what does that mean?

The only explanation of Sec. 67(e) in the legislative history appears in the Conference Committee Report in a four-sentence paragraph describing when costs of passthrough entities owned by individuals, estates, and trusts are subject to the 2% floor.[3] Read in context, it appears that Congress intended the phrase to subject only administrative costs flowing from passthrough entities owned by the estate or trust. The various courts that have been confronted with the issue have offered differing explanations of the section. The Sixth Circuit in *O'Neill* held that it allows a full deduction for costs that are necessary to fulfill the trustee's duties.[4] The Federal and Fourth Circuits in *Mellon Bank* and *Scott* held that it allows a full deduction only for costs not commonly incurred by individuals.[5] And most recently, in 2006 in *Rudkin Testamentary Trust*, the Second Circuit held that it allows a full deduction only for costs that individuals are incapable of incurring.[6]

Given the multiple interpretations of Sec. 67(e), Chief Justice Roberts chose the middle road in interpreting the provision's meaning in order to achieve his confessed goal of unanimity among the justices.[7] Indeed, the Roberts Court has achieved unanimity in nearly 50 percent of their cases compared to about 30 percent over the last 50 years. Knight holds that "costs incurred by trusts that escape the 2% floor are those that would not ‘commonly’ or ‘customarily’ be incurred by individuals.”[8] It essentially adopts the *Mellon/Scott* approach:

> “Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers”, See *Scott*, 328 F.3d at 140;
>
> ***
>
> 67(e) “treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts” *Mellon Bank*, 265 F. 3d at 1281…. We agree with this approach. [9]

After endorsing the *Mellon/Scott* approach, Chief Justice Roberts added his own explanation, which he framed as a prediction: “[T]he 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 by a trust.” The “direct import of the language in context” is to ask “whether expenses are ‘customarily’ incurred outside of trusts.” This, he said, “necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. Thus, in asking whether a particular type of cost ‘would not have been incurred’ if the property were held by an individual, Sec. 67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur.”[10]

Taxpayers must now live with that narrowly constructed compromise, despite the fact that both the taxpayer and the government described the test as “inadministrable” in briefs and oral argument before the Court.

II. Administrative Guidance

As soon as the Court issued its opinion, it became clear that Prop. Regs. Sec. 1.67-4 had to be withdrawn or amended. The proposed regulations (REG-128224-06) adopted the Second Circuit’s view (expressed in *Rudkin*) that a full deduction is allowed only for costs an individual cannot incur. The Court described this interpretation of Sec. 67(e) as “fly[ing] in the face of the statutory language.”[11] The issuance of the Court’s decision at the beginning of the 2008 tax filing season required quick action on everyone’s part.

A. AICPA Tax Section E-Alert

The AICPA led the way by issuing guidance to its members on February 4, 2008, in a Tax Section e-alert addressing how to treat outside investment advisory fees, trustee fees, fiduciary income tax preparation fees, and other costs in preparing 2007 Forms 1041, U.S. Income Tax Return for Estates and Trusts.[12] The AICPA offered the following advice on these subjects:

Investment advisory fees: Based on the Supreme Court's reading of Sec. 67(e)(1), investment advisory fees paid by the trust to an investment adviser are subject to the 2% floor unless the trustee can show that there is an "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer" or that the investment adviser "impos[ed] a special, additional charge applicable only to its fiduciary accounts" or that trust has "an unusual investment objective, or . . . require[s] 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 2 percent floor."[13]

To exempt any part of the investment advisory fee from the 2% floor, the trustee must substantiate that it would be unusual for an individual who owned the same property to have incurred the same cost. Such substantiation could include, for example, the trust agreement investment directives, the special needs of the trust beneficiaries, fee schedules, descriptions of the services provided, or surveys and statistics about common investor traits to the extent they are obtainable.

Trustee fees and unbundling: Because the Supreme Court did not specifically address trustee fees and agreed with the Mellon/Scott approach, which allowed a full deduction for them, trustee fees should be exempt from the 2% floor. Moreover, it "would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur" trustee fees. Thus, unbundling is not required until and unless the final regulations require such treatment.

Fiduciary tax return preparation fees: Based on the Supreme Court's agreement with *Mellon/Scott* and the Service's long-standing position, fiduciary income tax return preparation and judicial accounting fees should be exempt from the 2% floor. Moreover, it would be uncommon (or unusual or unlikely) for a hypothetical individual to incur these costs.

Other costs: Tax return preparers should inquire about the nature of other costs and determine on a case-by-case basis whether it would be unusual or uncommon for an individual with the same property to incur the cost. In some cases it will be easy to decide whether a cost is uncommon to individuals, such as disputes over income and principal. However, most types of fees, such as consulting fees, appraisal fees, and family office expenses, will require a high level of judgment and adequate substantiation to claim a full deduction.

B. AICPA Comments to Treasury

Four days after sending its e-alert to members, the AICPA also sent comments to Treasury and the IRS asking them to withdraw Prop. Regs. Sec. 1.67-4 and to open a new comment period so the public can explain the complex issues that trustees face when comparing their costs with those of an ordinary individual with the same property.[14] The AICPA comments include 15 examples of unique situations that trustees face in managing property under the Prudent Investor Act for the benefit of others. It also proposed solutions to the examples, hoping to learn where the IRS will draw the "commonly" line, whether in terms of percentages, portfolio size, unique circumstances involved, or some combination.

> **Example 1:** A trust owns $2 million of U.S. Treasury bonds, which the decedent, D, owned and managed during his lifetime. D's spouse is trustee and current income beneficiary of the trust. The trust pays her no fee for serving as trustee. Upon her death, the trust divides into a separate trust for each of the couple's five children and grandchildren and terminates at the death of the youngest beneficiary living at the time of D's death. D's will, which created the trust, requires the trustee to provide adequate income for the current beneficiaries based on their accustomed standard of living and to preserve and protect the principal against inflation. The trust should last approximately 100 years based on normal life expectancies of the beneficiaries.
>
> The spouse/trustee has no experience in managing money. A financial adviser recommends that she sell the bonds and invest in mutual funds because it is safer and more economical based on her portfolio size. Instead, the spouse/trustee hires ABC

Advisers to design and manage a portfolio of individual stocks and bonds that will satisfy the specific purposes of the trust. ABC charges the trust 1% of the portfolio value for its services every year.

Recommended solution: The fees are not subject to the 2% floor because the investment advice is unique to the purposes of the trust. The investment adviser is required to balance the needs of the income beneficiary versus the needs of the remainder beneficiaries as opposed to the investment advice for an ordinary person with $2 million of securities, who would benefit from the income and any growth in the underlying assets.

Example 2: Assume the same facts as in Example 1, except that the U.S. Treasury bonds are worth $5 million. Recent reliable surveys and statistics show that 25% of people in the area with a $5 million portfolio use the services of an investment adviser.

Recommended solution: The fees are not subject to the 2% floor because they would not be commonly incurred, since only 25% of individuals in a similar situation would have incurred such fees.

Example 3: Assume the same facts as in Example 1, except that the U.S. Treasury bonds are worth $10 million. Recent reliable surveys and statistics show that 55% of people in the area with a $10 million portfolio use the services of an investment adviser.

Recommended solution: The fees are subject to the 2% floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, or other circumstances of the trust or that they are incremental to or different than what an ordinary person with $10 million of securities would commonly incur.

Example 4: Assume the same facts as in Example 1, except that the trust is not multigenerational. It terminates on the spouse’s death and divides equally among the five children. The spouse is 80 years old and does not need the trust money to live comfortably. Thus, her main motive in hiring the adviser is to increase the trust assets for her children.

Recommended solution: The fees are subject to the 2% floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, and other circumstances of the trust or that they are incremental to or different than what an ordinary person with $2 million of securities would commonly incur.

Example 5: Assume the same facts as in Example 3, except that the spouse/trustee properly delegates her investment function to ABC Advisers under the Prudent Investor Act, which confers fiduciary liability upon ABC for its investment advisory services.

Recommended solution: The fees are not subject to the 2% floor because the investment adviser is a trustee under the state's Prudent Investor Act, and it is unusual for an individual to incur trustee fees.

Example 6: D creates a separate trust during his lifetime for each of his five children, placing $2 million in each trust. Each child is the trustee of his or her own trust, which pays them a trustee fee of 1% of the corpus value each year and terminates when the child reaches age 50. Child V hires an investment adviser to design a portfolio so that he can retire at age 50 when the trust terminates. Child W invests in blue chip stocks that he picks himself. Child X invests in oil and gas wells. Child Y invests in hedge funds and limited partnerships. Child Z invests in indexed mutual funds.

Recommended solution: The fees incurred by the trust of child V are not subject to the 2% floor as long as the trustee can meet his burden to show that people with his portfolio (such as his siblings) would not normally hire a professional adviser.

Example 7: A nongrantor trust incurs $50,000 of legal fees during the year. One-fourth of the fees relate to a lawsuit by one of the beneficiaries against the trustee for imprudently investing in tobacco stocks. Another fourth relates to a lawsuit against the trustee for withdrawing capital gains as part of income. Another fourth relates to whether the trust should change its situs to a state that allows the trust to convert to a unitrust. The last fourth relates to a shareholder derivative action involving one of the securities.

Recommended solution: The legal fees related to the derivative lawsuit are subject to the 2% floor unless the trustee can establish that all or part of them are unique to the purposes, terms, distribution requirements, and other circumstances of the trust or that it would be uncommon for an ordinary person to hire counsel for this purpose. The rest of the legal fees are not subject to the 2% floor because they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust.

Example 8: A nongrantor trust incurs significant legal fees during the year to defend a lawsuit against the trustee for breach of fiduciary duty for improper investing under the state's Prudent Investor Act. As part of the settlement agreement, the trustee agrees to hire a professional investment adviser who will invest strictly according to the purposes, terms, distribution requirements, and other circumstances of the trust.

Recommended solution: The investment adviser's fees are not subject to the 2% floor because they are uniquely tailored to the litigation settlement terms and the trust agreement.

Example 9: A nongrantor trust incurs $10,000 of accounting fees during the year in addition to the normal fees for tax return preparation. The purpose of the fees is to prepare an accounting of the trust's activities for the beneficiaries.

Recommended solution: These accounting fees are not subject to the 2% floor since producing such an accounting is unique to a trust and would not be common for an individual to incur.

Example 10: A nongrantor trust incurs $30,000 of accounting fees during the year in addition to the normal fees for tax return preparation. One-third of the fees is for special tax advice on whether the trust should make a Sec. 643(e)(3) election to recognize the gain upon distribution of property. Another third relates to special tax advice on whether the trust could achieve a higher after-tax rate of return by investing in rental real estate. The last third relates to advice on whether the trust should transfer its assets to an LLC to reduce state income taxes.

Recommended solution: One-third of the accounting fees related to the special trust tax election is not subject to the 2% floor because the election can be made only by a trust or an estate and not by an individual. The remaining two-thirds of the accounting fees are subject to the 2% floor unless the trustee can show that they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust or that it would be uncommon for an individual to incur these services.

Example 11: A trust is a multigenerational trust similar to the one in Example 1, except that its assets consist of $50 million of securities and income-producing real estate. The trustee is an unrelated individual who is paid an annual fee of 1% of the portfolio value. The trustee determines that the most economical means of managing the trust assets is to open a family office and staff it with a full-time clerk, office manager, and money manager. In doing so, the trust incurs rent of $30,000, salaries and payroll taxes of $250,000, employee benefits of $30,000, office supplies of $15,000, telephone expenses of $5,000, legal and accounting fees of $30,000, and other miscellaneous administrative costs of $10,000 in addition to the trustee's fee.

Recommended solution: The family office expenses are not subject to the 2% floor as long as the trustee can show that they are unique to the purposes, terms, distribution requirements, and other circumstances of the trust and that it would be uncommon for an individual to incur these services.

Example 12: D worked for M Oil Co. throughout his career. When he died, his estate consisted entirely of M stock. D's will created a bypass trust, naming T Trust Co. as trustee. D's will directed the trustee to retain the M stock, overriding the duty to diversify under the Uniform Prudent Investor Act. T charges a fee of 1% of the trust portfolio, regardless of whether it actively manages a diversified portfolio or retains the M stock.

Recommended solution: No part of the trustee fees are subject to the 2% floor because trustee fees are unique to a trust and the trustee is providing little or no investment advisory service.

Example 13: Assume the same facts as in Example 12, except that in addition to the 1% fee charged, T charges an additional fee of 0.75% of the trust portfolio specifically related to managing a portfolio when its duty to diversify a portfolio under the Uniform Prudent Investor Act is being overridden.

Recommended solution: No part of the trustee fees are subject to the 2% floor because trustee fees are unique to a trust and the trustee is providing little or no investment advisory service.

Example 14: D owned an art collection during his lifetime. His will directs that the collection, along with other assets, be transferred to a trust for his children. The trustee pays an appraiser $15,000 to value the collection so that he can determine the suitability of the investment (in light of the terms and purpose of the trust) and to reflect the proper fair market value of assets on the trust records for trust accounting purposes.

Recommended solution: The appraisal fees are not subject to the 2% floor because an individual would not have a trust accounting and would not commonly face the same needs that caused the trustee to obtain the appraisal.

Example 15: ABC Trust Co. offers its services to be the trustee of trusts. The annual fee for these services is a percentage of the value of the assets held in the trust, so the fee varies only based on the size of the assets. ABC does not charge separate investment advisory fees for internal investment advice. If a particular trust wants to seek investment advice from outside persons or organizations, the trust will be required to pay for those services, but the fee to the corporate trustee will not be reduced.

Recommended solution: No part of the trustee fees are subject to the 2% floor because trustee fees are unique to a trust and are incurred regardless of any investment advisory services performed by the trustee.

The AICPA will supplement these comments with its views on safe harbors.

C. Treasury's Interim Guidance in Notice 2008-32

Nineteen days after receiving the AICPA comments, on February 27, 2008, the IRS issued Notice 2008-32, agreeing to extend the comment period on the proposed regulations through May 27, 2008.[15] It also announced that trustees need not unbundle their fees for 2007 and prior years—a welcome bit of news, because bankers and trustees had already unofficially agreed among themselves that they would not unbundle for 2007 tax returns.

The IRS interim guidance stated that Prop. Regs. Sec. 1.67-4 would be modified and may include safe harbors for unbundling trustee fees. It requested comments on whether safe harbors would be helpful, how they might be formulated, and what might be reasonable percentage(s) of administrative costs subject to the 2% floor. It also requested input on whether safe harbors should reflect the nature or value of the trust assets and/or the number of beneficiaries. This indicates that the IRS may be considering a safe harbor to exempt small trusts or those with multiple beneficiaries. Notice 2008-32 did not, however, ask for input on the meaning of "commonly." This may indicate that the final regulations will leave the question open to a facts and circumstances test rather than attempt to draw a bright line.

III. Parsing the Supreme Court's Opinion

The Supreme Court found little or no ambiguity in the statute, beginning and ending its analysis with conventional statutory construction. This also allowed it to avoid any discussion of legislative history or how much agency deference is warranted under *Chevron*.[16] It found that the "proper reading" and the "direct import of the language in context" is to "ask whether expenses are 'customarily' incurred outside of trusts."

A. The Statute Requires Making a Prediction

The text, it found, requires determining what would happen if the property were held by an individual rather than a trust.

> In the context of making such a prediction . . . the word "would" is best read as "express[ing] concepts such as custom, habit, natural disposition, or probability." . . . [S]uch an exercise necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. Thus, in asking whether a particular type of cost "would not have been incurred" if the property were held by an individual, §67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur.[17]

The only good news about the Court's "proper reading" is that it requires practitioners to make a prediction. Because people predict what they believe to be the most likely outcome, any good-faith prediction should meet the "more likely than not" standard under the preparer penalty rules.[18] However, substantiating this prediction is quite another matter.

B. Costs Must Not Be "Commonly" Incurred

The Court's explanation of its "commonly" test in Knight is confusing. The opinion first states that the test "ask[s] whether expenses are 'customarily' incurred outside of trusts."[19] If they are, then they are subject to the floor when incurred by a trust. This inquiry tolerates a fairly high rate of occurrence outside a trust—maybe 20, 30, or even 40%—before a cost is subject to the floor. But in the same paragraph, the Court rephrases the explanation in a slightly different manner: "except[ing] from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."[20] The latter view would exempt only costs that would be unlikely outside a trust. This inquiry tolerates very little occurrence outside a trust before a cost is subject to the floor.

Which is the proper inquiry—whether something "customarily or commonly occurs" outside a trust or whether it is "uncommon, unusual, or unlikely" outside a trust? There is a wide range of frequencies with which costs can occur in between these two meanings of "commonly." Put simply, what percentage is "commonly"? Chief Justice Roberts also seemed to struggle with this question during the oral argument:

> *C. J. Roberts:* Let's say it's $3 million in the trust, and we think maybe 60 percent of people would hire an investment advisor; 40 percent would think they can do just as well on their own. Is that customarily incurred by individuals?
>
> *Mr. Miller* [for the government]: I think it might well be enough . . .
>
> *C. J. Roberts:* Your answer . . . is "might well be," and that's a fairly vague line when it comes to taxes.[21]

Where Treasury draws the line will make a significant difference in how many types of costs are subject to the 2% floor.

C. Compare to a Hypothetical Person

In order to predict what a hypothetical person would do, we must know something about him or her. We know that he or she has the same property as the trustee. The Court also suggests that this hypothetical person might have "similar objectives" as the trustee.[22] But it would be highly unlikely for individuals investing for themselves to have the same investment objectives as a trustee investing to balance income and principal for multiple beneficiaries. We also need to know the hypothetical person's age, educational background, investment experience, health, family size and circumstances, other available resources, standard of living, risk tolerance, and many other characteristics that most investment advisers are ethically bound to inquire about.[23] Without this information it is impossible to predict what investment costs, if any, a hypothetical person would incur.

D. The Trustee Has the Burden of Proof

The Court found that the trustee has the burden to show that it is uncommon or unusual for individuals with the same property to hire an investment adviser.[24] It found that Knight failed to do so because he did not "assert that its investment objective or its requisite balancing of competing interests was distinctive,"[25] despite his testimony in Tax Court that his fiduciary duties extended to 22 beneficiaries of a multigenerational trust and that he did not possess the requisite skills to fulfill those duties under the Connecticut Uniform Principal and Income Act[26] without expert advice tailored to the trust. According to the court, Knight failed to show that he is in any different position than an individual investor. Based on this, it is unclear just what it would take to show that a trustee is in a different investment position than an individual.

In *Mellon,* the government asked the court "to take judicial notice of facts manifested on the financial pages of any newspaper: individuals often pay investment-advisory fees for property not held in trust."[27] But the court noted that "the fact that individuals 'often' pay investment advisory fees for property not held in trust suggests that 'on many occasions' they do not."[28] And because the government offered no evidence as to why the court should conclude that the case falls within the first group, the court denied the government's motion for summary judgment.

So how does a trustee prove whether it is common or uncommon for individuals with the same property to hire an investment adviser or that his or her costs are distinctive? Chief Justice Roberts hinted during oral argument that this could be based on common practices and may vary according to the size of the trust:

> *C. J. Roberts:* So how does your customarily or commonly incurred test work? Let's say you have two trusts, one $10 million, the other $10,000. I think an individual with $10 million might well seek investment advice, but an individual with only 10,000 might decide it's not worth it. Would you have a different application of the two percent rule for those two trusts?
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> *Mr. Miller* [for the government]: . . . I think one might well look at that because the comparison would be individuals with similar assets, and as your Honor knows, there might be a difference depending on the size.[29]

IV. Putting the Opinion into Practice

Because the statute requires a prediction and places the burden of proof squarely on the trustee, how should trustees support their predictions? There are very few statistics on the relative frequency with which individuals incur many of the costs a trustee incurs. But trustees must consider how to gather that information if they hope to claim a full deduction. It is not enough to provide the details of the trustees' own costs; they must also compare it to what others "commonly" incur.

A. Substantiating What People "Commonly" Do

Perhaps trustees could obtain a statement from the investment adviser describing how the services they provide the trust differ from those they would typically provide to an individual with the same property. The investment adviser probably also has access to data from financial institutions and regulatory agencies that show what percentage of accounts in each size range are typically managed by professionals and which ones are not. An accounting firm might use its client base as a typical sample to determine what percentage of people with certain portfolio sizes hire investment advisers.

Surveys: Trustees might also consider hiring a professional to conduct a survey for them. But how large a sample will suffice? Should it be local, regional, or national? What constitutes a reliable sample? Will people volunteer to share such confidential information? Surely the cost of the survey will be fully deductible because individuals do not need to conduct surveys to determine if their costs are deductible. Perhaps more people will offer surveying services after the Knight decision. Or perhaps the large financial institutions will assume that burden for their customers.

Bill descriptions: All service providers should provide more detailed billing statements to their trust clients describing the unique services they perform for them and indicating whether they commonly provide those same services to other similarly situated individuals.

Affidavits: In addition to providing more detailed bill descriptions, service providers might also consider submitting affidavits describing how their services to trusts differ from those provided to individuals. For example, a landlord could testify that it is uncommon to rent space for a family office to an individual with similar property. A roofing contractor could testify that it would be unusual for someone who owned that rented house to replace the roof unless they had an extraordinary trust-related reason not common to those outside a trust. Or an insurance agent could testify about whether most people would typically insure that property without some compelling and distinctive trust-related reason.

Such extraordinary efforts to document whether the trustee's costs are commonly incurred by others can be costly and complex.

B. Defining Investment Advisory Fees

The *Knight* decision made it clear that investment advisory fees are generally subject to the 2% floor unless the trustee can show that his or her costs are somehow extra, special, incremental, or different from those of an ordinary individual. A natural question, therefore, is what are investment advisory fees? The Investment Advisers Act of 1940 defines them as fees charged by investment advisers who, for compensation (hourly, fixed, commission, or combination), engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, [issue] or [promulgate] analyses or reports concerning securities.[30] Investment advisers are required to register with the SEC and/or the states in which they do business.[31]

Specifically excluded from the definition of investment adviser are (1) banks, (2) lawyers, accountants, engineers, or teachers whose performance of such services is solely incidental to the practice of their own profession, (3) commission-based brokers or dealers who receive no special compensation for the advice portion, and publishers of financial news, (4) persons who advise only on obligations of the United States (i.e., treasury bonds, etc.), and (5) any other person or class of persons that the SEC exempts under its rulemaking authority. As discussed below, the SEC has also exempted individual trustees from the definition of investment advisers where they are not compensated or engaged in the business of advising others.

C. Identifying "Extra, Special, Different, or Incremental" Costs

Recognizing that a trust may incur certain extra, special, distinctive, incremental, or additional fees that individuals would not commonly incur, the Court noted that:

> 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 Warfield charged the Trustee anything extra, or treated the Trust 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, or 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 2% 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 2% floor.[32]

Thus, to the extent that the trustee can document that all or part of the investment advisory fees paid are extra, special, distinctive, incremental, or additional, they are allowed in full. The key, therefore, is demonstrating and documenting that either the charges or the services provided by the investment adviser are different. There are as many ways to do this as there are trustees and advisers. But the burden of proof is on the trustee.

D. Unbundling Trustee Fees

The Supreme Court did not directly address how Sec. 67(e)(1) affects the deduction for trustee fees. But it can be reasonably inferred from the decision that they are fully deductible because Knight agreed with *Mellon* and *Scott*, which allowed a full deduction for trustee fees on the basis that individuals do not commonly incur them.

Moreover, it does not automatically follow that because investment advisory fees are generally subject to the 2% floor, the investment portion of trustee fees must also be subject to the floor. Nothing in the Court's opinion required or even implied that result. Indeed, trustees are not "investment advisers" because they are not engaged in the business of advising others. Rather, they are managing and investing their own trust corpus.[33] Moreover, banks are specifically excluded from the definition of investment adviser under the Investment Advisers Act.[34]

E. Using Delegation Agreements

Whether or not the final regulations require unbundling of trustee fees, a trustee who pays an outside investment adviser should consider formalizing the arrangement with a delegation agreement. [See EXHIBIT A]. Section 9 of the Uniform Prudent Investor Act encourages, and may mandate, trustees to delegate all or part of their fiduciary investment functions if necessary to enable them to comply with the prudent investor standard.[35] Most state versions of the 1994 Prudent Investor Act subject an agent to fiduciary liability when a trustee delegates all or part of his or her fiduciary investment function to the agent adviser. A delegation agreement simply formalizes the arrangement that many trustees already have informally.

A delegation agreement acknowledges that the trustee is conferring a trust power on the agent and that the agent becomes liable to the trust for his or her actions.[36] If the trustee properly delegates, the trustee is no longer liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.[37] To properly delegate, the trustee must (1) exercise reasonable care, skill, and caution in selecting the agent; (2) establish the scope and terms of the delegation consistent with the terms of the trust; and (3) periodically review the agent's actions in order to monitor his or her performance and compliance with the terms of the delegation.[38] Some states, such as Texas, may have additional requirements in order to shift liability to the agent.[39] Thus, where the trustee properly delegates, the agent essentially steps into the shoes of the trustee. And if trustee fees are fully deductible, so should the agent's fees be when he or she steps into the shoes of the trustee.

Regardless of whether there is a delegation agreement, investment advisers should provide more detailed descriptions of their services in order to distinguish them from services performed for ordinary individuals. Such descriptions could include, for example, "specialized balancing of the interests of trust beneficiaries" or "compliance with the terms of the [X] Trust Agreement." The Court held that in these cases, the "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor."[40] The cost of routine investment advice, if there is such a thing, would still be subject to the floor.

Indeed, a new cottage industry of special trust advisers may spring up to provide investment advice only to trustees. If their services are tailored to trustees and are unavailable to individuals, they should pass the Court's test of "not commonly incurred outside of a trust."

F. Unbundling Legal and Accounting Fees

Lawyers and accountants should also provide their trust clients with more detailed statements, itemizing which costs are "commonly incurred" by individuals and which are not.

But even this does not solve all the problems. Suppose a trust asks an attorney for advice on whether to engage in a tax-free exchange under Sec. 1031. Such advice may be uncommon both inside and outside a trust because tax-free exchanges occur infrequently. Does this fact alone make the advice fully deductible by the trust, despite there being nothing unique to trusts about it? However, if the trustee asks an accountant whether to make a 65-day election under Sec. 663(b), that may be another matter because only a trust can make that election. Should accountants distinguish on the basis of which Code section they advise on or how often they provide the same advice to their other clients? This degree of hairsplitting flies in the face of Congress's intent to simplify recordkeeping when it enacted Sec. 67(a) in 1986.[41] It will be helpful if Treasury keeps this in mind when it issues final regulations.

G. Other Costs Potentially Affected

While the Court's decision applied only to the investment advisory fees incurred by the Rudkin Testamentary Trust, its interpretation of the statute applies broadly to every conceivable type of cost incurred in connection with the administration of an estate or trust, except those specifically exempted under Sec. 67(b) (taxes, interest, casualty losses, charitable, medical, etc.). Although there is not room here for a complete list of the possible costs affected, a few of them are:

[] Bank charges;

[] Safe deposit boxes;

[] Insurance;

[] Appraisal fees;

[] Family office expenses (rent, salaries, supplies, telephones);

[] Tax advice and preparation; and

[] Property maintenance.

Based on the Supreme Court's holding that costs are subject to the 2% rule unless the trustee can show that they are not commonly incurred by ordinary individuals with the same property, each category will need to be analyzed and supported separately. It will be interesting to see how the final regulations deal with these other types of costs.

H. Avoiding the Modifier "Trust"

The court sent a clear signal that adding the modifier "trust" to distinguish a cost from one commonly incurred by individuals is not enough to escape the floor. The Court explained that:

> trust investment advice fees are only aptly described as such because the property is held in trust; the statute asks whether such costs would be incurred by an individual if the property were not. Even when there is a clearly analogous category of costs that would be incurred by individuals, the Trustee's reading would exempt most or all trust costs as fully deductible merely because they derive from a trustee's fiduciary duty. Adding the modifier "trust" to costs that otherwise would be incurred by an individual surely cannot be enough to escape the 2% floor.[42]

However, following the Court's logic and removing the modifier "trust" from every cost could subject nearly everything to the 2% floor.

V. How Safe Harbors Might Apply

In both Prop. Regs. Sec. 1.67-4 and Notice 2008-32, the IRS requested input on whether and to what extent safe harbors might be useful in determining reasonable percentages of costs subject to the 2% floor. In October 2007, members of the Individual and Fiduciary Income Tax Committee of the RPTE Section of the American Bar Association sent their comments to Treasury on safe harbors and suggested that Treasury adopt differing safe-harbor percentages for various types of cost categories.[43]

Aside from the complexity of this type of safe harbor, it does little but perhaps save some alternative minimum tax (AMT) in isolated instances. The floor is a fixed amount based on 2% of adjusted gross income (AGI). Everything above that is fully deductible anyway. In order to benefit from an incremental cost, the trustee must show that his or her ordinary, routine, or nonspecial costs are less than the floor. In other words, a trustee needs to classify nearly all of his or her costs as "special" in order to benefit from a safe harbor. Otherwise, whatever portion is classified as ordinary applies toward the floor just as it would without the safe harbor, leaving the trustee in no better shape, as the Example below shows.

Example: A Trust and B Trust each have $5 million in assets and pay a 1% investment advisory fee, or $50,000. In 2007 they each had AGI consisting of $500,000. A can show that 80% of its investment advisory fees are “extra” or “special,” leaving only $10,000 subject to the floor. But B cannot show that any of its fees are extra or special. Both trusts must reduce their deduction for investment advisory fees by $10,000 (2% of AGI), deducting only $40,000. Thus, A is no better off than B, despite the fact that 80% of its fees were “extra special.”

Nonetheless, to the extent that the safe harbor excludes an amount from the 2% floor, it also excludes it from classification as an AMT adjustment. This will make a difference in only a handful of cases in which nearly all of the trust’s AGI consists of capital gains. In those cases, avoiding an AMT addback will save the trust a 15% alternative minimum capital gain tax because the regular and AMT capital gain rates are the same.

A simpler and more reasonable approach to safe harbors would be to include deminimis rules or exempt small trusts and estates—say, those with assets under $5 or $10 million—or those with multiple beneficiaries or successive generations. In such cases it is more likely that the fiduciary will be compelled to seek professional advice uniquely tailored to the trust, unlike an individual owner of the same property who invests based on his or her own whims. Larger estates and trusts and those that do not meet this type of safe harbor will simply need to document how their costs differ from those commonly incurred by individuals.

VI. Conclusion

Did the Supreme Court really solve anything? Or did it simply substitute one uncertainty for another—battling over what percentage is “commonly incurred” instead of the statutory meaning? Worse yet, the final regulations may be so onerous as to discourage a small trustee from even trying to fully deduct administrative costs, given the small dollars at stake, the substantiation required, and the penalties for failure to do so.

Moreover, as the Supreme Court noted, 44 states and the District of Columbia have adopted the heightened investment standard of the Prudent Investor Act.[44] A trustee’s duties are much more onerous than they were in 1986 when the statute was enacted. Trustees should be entitled to fully deduct costs compelled by their fiduciary duties. It may be time to update the tax law to reflect modern fiduciary standards.

The only way to bring the needed relief is through legislative action. Because of the obvious problems caused by Sec. 67(e) as it is currently formulated, it should be possible to convince Congress that revising Sec. 67(e) would clarify the law and make it easier for taxpayers to comply with it, and for the IRS to administer it. However, given the general antipathy of the public to trusts (which are often seen as devices used by ‘rich” people to avoid taxes) and the perceived loss of revenue that such a change might cause, actually getting Congress to act may be a challenge.

SMITH TRUST INVESTMENT DELEGATION AGREEMENT

This Investment Delegation Agreement is made and entered into this _______ day of _________________, 2008, by and between **JOE SMITH**, Trustee (the "Trustee") of the **SMITH TRUST** created under that certain Trust Agreement dated October 27, 2007 (the "Trust"), and **ABC ADVISERS, INC**., a Texas limited partnership (the "Agent") for the purposes and upon the terms hereinafter set forth.

WHEREAS, the Trust is an irrevocable trust created under the laws of the State of Texas by and between **MARY SMITH** as Grantor, and the Trustee; and

WHEREAS, the underlying Trust Agreement provides:

WHEREAS, Section 117.011 of the Texas Trust Code [Uniform Prudent Investor Act § 9] authorizes a trustee to employ and delegate investment and management functions to an investment agent and provides that a trustee shall not be responsible for investment decisions made by such agent under certain circumstances; and

WHEREAS, the Trustee desires to employ the Agent and to delegate the investment management responsibilities to the Agent with respect to certain Trust assets as permitted by the terms of the Trust Agreement and Section 117.011 of the Texas Trust Code; and

WHEREAS, the Agent, in consideration of the receipt of a reasonable fee for providing such investment management services, is willing to accept investment management responsibilities with respect to the Trust assets transferred to its control.

NOW, THEREFORE, it is agreed as follows:

1. Retention of Agent: The Trustee hereby retains the Agent to provide investment management services with respect to the Trust assets described in Schedule A attached hereto and those assets which may from time to time be transferred to the Agent's control upon the terms and conditions of that certain Investment Management Agreement, attached hereto as Schedule B and made a part hereof for all purposes (the "Account"), and the Agent hereby accepts the retention and agrees to provide such investment management services.

2. Acknowledgement of Duty: The Agent acknowledges that, with respect to the investment management of the Account, it owes a duty to the Trust to exercise reasonable care to comply with the terms of the delegation. Agent agrees to submit periodic investment performance reports to the Trustee and consult with the Trustee from time to time as needed to carry out its delegated duties.

EXHIBIT A

The author gratefully acknowledges the contributions of Kent H. McMahan, Partner, Fulbright & Jaworski, L.L.P., 1301 McKinney, Suite 5100, Houston, TX 77010-3095 to this Delegation Agreement.

3. Scope of the Delegation: The Agent shall carry out its investment management responsibilities in accordance with the purposes and terms of the Trust Agreement and in accordance with such written guidelines and policy directives as shall be furnished to it, in writing, by the Trustee. Agent agrees to evaluate investment and management decisions respecting individual assets not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the Trust. Agent further agrees to make a reasonable effort to verify facts relevant to the investment and management of trust assets and may invest in any kind of property or type of investment consistent with the standards of the Uniform Prudent Investor Act.

The Agent agrees to invest and manage Trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the Trust. In satisfying this standard, Agent agrees to exercise reasonable care, skill, and caution. The Agent agrees to consider such of the following as are relevant to the Trust in investing its assets:

(a) general economic conditions;

(b) the possible effect of inflation or deflation;

(c) the expected tax consequences of investment decisions or strategies;

(d) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(e) the expected total return from income and the appreciation of capital;

(f) other resources of the beneficiaries;

(g) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(h) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(i) [OTHER TO BE INSERTED DEPENDING ON THE CIRCUMSTANCES]

4. Assets Transferred to the Account: The Trustee will determine what portion of the Trust assets will be transferred to or from the Account from time to time. The Trustee shall notify the Agent, in writing, of any proposed transfers to or from the Account.

5. Governing Law: The provisions and terms of this Agreement shall be governed and construed in accordance with the laws of the State of Texas. The parties agree to be subject

to the jurisdiction of the courts of the State of Texas solely with respect to the determination of any issues relating to the interpretation or enforcement of the terms of this Agreement.

6. No Arbitration or Limitation: Nothing in this Agreement shall require the Trustee or any beneficiary of this Trust to arbitrate disputes with Agent or shorten the time period in which claims may be brought against the Agent by the Trustee or any beneficiary.

EXECUTED and AGREED TO this _______ day of __________________, 2008.

____
JOE SMITH-Trustee of the Smith Trust
"Trustee"

ABC Advisers, Inc.

____

By: ____________________
Title: ____________________
"Agent"

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[1] Summary of Conf. Agreement on H.R. 3838, JCS-16-86 (8/29/86).
[2] *Knight*, 128 S. Ct. 782 (2008).
[3] H.R. Conf. Rep. 99-841, pt. 2, p. 34, reprinted at 1986 U.S.C.C.A.N. 4075.
[4] *O'Neill*, 994 F2d 302 (6th Cir. 1993).
[5] *Mellon Bank, N.A.*, 265 F3d 1275 (Fed. Cir. 2001); Scott, 328 F3d 132 (4th Cir. 2003).
[6] *Rudkin Testamentary Trust*, 467 F3d 149 (2d Cir. 2006).
[7] Rosen, "Robert's Rules," 299 Atlantic Monthly, no. 5 (January/February 2007).
[8] *Knight*, slip op. at 9.
[9] *Id.* at 9–10.
[10] *Id.* at 10.
[11] *Id.* at 5–6.

[12] "Important AICPA Guidance for Filing 2007 Form 1041s—Deducting Trust Administrative Costs After Knight," AICPA Tax e-Alert (February 4, 2008); "AICPA Offers Guidance to CPAs on Preparing Fiduciary Returns," 2008 TNT 27-39, Doc. 2008-2661 (February 7, 2008).
[13] *Knight*, slip op. at 13.
[14] "AICPA Asks Treasury to Withdraw Proposed 2 Percent Floor Regs in Light of Recent Supreme Court Decision," 2008 TNT 29-17, Doc 2008-2943 (February 8, 2008).
[15] Notice 2008-32, 2008-11 IRB.
[16] *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 US 837 (1984).
[17] *Knight*, slip op. at 10.
[18] Sec. 6694(a)(2); Notice 2008-13, 2008-3 IRB 282.
[19] *Knight*, slip op. at 10.
[20] *Id.*
[21] *Knight*, transcript of oral argument at 39–40.
[22] *Knight*, slip op. at 13.
[23] Certified financial planners (CFPs) that offer investment advice for compensation must be registered investment advisers. They must also abide by CFP Board Code of Ethics and Professional Responsibility, Principle 7, Rule 703, Practice Standard 500-2 ("The financial planning practitioner shall investigate products or services that reasonably address the client's needs. The products or services selected to implement the recommendation(s) must be suitable to the client's financial situation and consistent with the client's goals, needs and priorities").
[24] *Knight*, slip op. at 10.
[25] *Id.* at 13.
[26] Conn. Gen. Stat. §45a–541a(a) (2007).
[27] *Mellon Bank, N.A.*, 47 Fed. Cl. 186 (2000), aff'd, 265 F3d 1275 (Fed. Cir. 2001).
[28] *Id.*
[29] *Knight*, transcript of oral argument at 39.
[30] Investment Advisers Act of 1940 §202(a)(11), 15 USC Section 80b-2(a)(20).
[31] *Id.*
[32] *Knight*, slip op. at 12–13 (citations omitted).
[33] See *Selzer v. Bank of Bermuda Ltd.*, 385 F.Supp 415, 420 (S.D.N.Y. 1974) (finding the Advisers Act inapplicable because "the trustee does not advise the trust corpus, which then takes action pursuant to its advice, rather the trustee acts himself as principal"); but see Joseph J. Nameth, SEC No Action Letter, 1983 WL 30256 (January 31, 1983) ("We believe that a person who, for compensation, engages in the business of investment management with discretionary power to buy and sell securities is an investment adviser even if such business is operated through the medium of trusts").
[34] Investment Advisers Act of 1940 §202(a)(11)(A), 15 USC Section 80b-2(a)(20).
[35] Uniform Prudent Investor Act §9.
[36] *Id.* at §9(b).
[37] *Id.* at §9(c).
[38] *Id.* at §9(a).
[39] Tex. Prop. Code §117.011(c).
[40] *Knight*, slip op. at 13.
[41] H.R. Rep. 99-426 at 109–110 (1985); S. Rep. 99-313 at 78–79.
[42] *Knight*, slip op. at 8.
[43] "ABA Members Provide Detailed Comments, Recommendations on Proposed Regs. on Limitations on Estates or Trusts," 2007 TNT 217-19, Doc. 2007-24815 (October 25, 2007).
[44] The other six states have adopted their own versions of the prudent investor standard (*Knight*, slip op. at 4, n. 2).