Was the Supreme Court Really Wearing Shining Armor? A Hard Day's *Knight* for Trusts and Estates

By Marc S. Bekerman

Andrew O. Alcala

It is rare for the Supreme Court of the United States to review cases under Subchapter J of the Internal Revenue Code concerning the income taxation of trusts and estates. The reasons for this lack of review are many, including the Court's limited docket, the relatively few audits of fiduciary income tax returns (which result in few contested matters in the area), and the increased use of grantor trusts, which remove the taxation of the trust from Subchapter J by requiring the income and deductions to be reported by grantors on their personal income tax returns.

Occasionally a case will be important enough for the Supreme Court to review, such as when there is a conflict between the circuit courts of appeal or there is insufficient guidance in an area. In *Knight v. Commissioner,* 128 S. Ct. 782 (2008), the Supreme Court resolved the conflict between various circuit courts and addressed questions that were over 20 years old. This article will review the history of the question of law presented by *Knight* and some of the effects of the Supreme Court's decision in *Knight*.

History of Code § 67 Limitation on Itemized Deductions

Before 1986, there was no limitation on a taxpayer's ability to deduct "miscellaneous itemized deductions." As part of the Tax Reform Act of 1986, Code § 67 was enacted to permit a deduction for miscellaneous expenses only to the extent that such expenses exceed 2% of the taxpayer's adjusted gross income. A miscellaneous itemized deduction is defined as any deduction not specifically exempted from such treatment in Code § 67(b). Ostensibly, this provision had the dual purpose of minimizing fraud and simplifying record keeping for taxpayers so they would not have to maintain sufficient records for relatively small

Marc S. Bekerman is the associate director and adjunct professor of law of the Graduate Tax Program at New York Law School and maintains his trusts and estates practice in New York. Marc serves as vice-chair of the Section's Standing Committees on CLE and Community Outreach, as a member of the Standing Committee for Planning, and as a member of the Section's Council.

amounts. The reduction of otherwise valid deductions, however, can also be viewed as a tax increase for taxpayers who itemize deductions.

Code § 67(e) provides that a trust or estate is subject to the provisions of Code § 67 except that the section will not apply to deductions for costs that

- are paid or incurred in connection with the administration of the estate or trust and
- would not have been incurred if the property were not held in such trust or estate.

It has been long thought that many expenses incurred in estate and trust administration fall within the exception provided by Code § 67(e) and are thus not subject to the 2% limitation on miscellaneous administration expenses. Some examples of these expenses include fiduciary commissions, most legal fees, and appraisal expenses. For some expenses, however, the applicability of Code § 67(e) is not as clear. The best example are the fees paid by fiduciaries to professional investment managers for services rendered in connection with the investment of assets held by trusts and estates.

Investment Management Expenses

An individual who incurs investment management expenses may be able to deduct those expenses under Code § 212. Code § 67(b) does not indicate that such a deduction is not a miscellaneous itemized deduction, resulting in such expenses being subject to the provisions of Code § 67. Therefore, an individual taxpayer can only deduct personal investment management expenses to the extent that his or her miscellaneous itemized deductions exceed 2% of the taxpayer's adjusted gross income.

Unlike an individual investing on his or her own account, an executor or trustee must invest in accordance with the local law of the jurisdiction. These are often "prudent man" or "prudent investor" rules, depending on the jurisdiction and time frame in question. The penalties for a fiduciary who fails to satisfy its duty of care can be severe, including surcharge, denial of commissions, and removal.

Under the modern trend of the prudent investor rule, it is frequently expected that an individual executor or trustee will obtain expert investment advice to meet its fiduciary obligations. This can be compared to the use of a corporate fiduciary that already possesses the expected investment expertise. It is these fiduciary duties regarding investments, which are present in a trust or estate but not present for individual taxpayers, that formed the basis of the argument that investment management expenses incurred by a trust or estate should fall within Code § 67(e) and be fully deductible.

It is interesting to note the value of the deduction involved. For a trust with a value of $1 million, a 5% rate of income return, and no capital gains, the trust will have adjusted gross income of $50,000. As such, any miscellaneous itemized deductions (that is, expenses that do not fall within the exceptions set forth in Code § 67(b) or 67(e)) must be reduced by 2% of $50,000, or $1,000. Assuming the highest federal income tax bracket of 35%, and ignoring any potential alternative minimum tax consequences, the cost to the taxpayer of the applicability of Code § 67 to the investment management expenses is $350 on a $1 million trust using these assumed returns. In the *Knight* case, for example, the difference between the deduction claimed on the return and the deduction allowed was approximately $13,000 on over $600,000 in income.

The Early Cases

In what appears to have been a case of first impression, the Tax Court rejected the taxpayer's contention that investment management fees should fall within the provisions of Code § 67(e) and agreed with the IRS that such expenses were subject to the 2% floor on miscellaneous itemized deductions under Code § 67. On appeal, however, the Sixth Circuit Court of Appeals reversed this holding and agreed with the taxpayer's argument that the fiduciary's investment obligations and need for expert investment advice caused the related expenses to fall within the purview of Code § 67(e) and therefore were fully deductible. *O'Neill v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993).

The IRS published its non-acquiescence in *O'Neill* and indicated its intent to continue to pursue this issue. See IRS action on decision, 1994-06 (Sept. 12, 1994). Indeed, taxpayers have lost all of the published cases decided after *O'Neill* despite the holding of the Sixth Circuit. For example, the Court of Appeals for the Federal Circuit affirmed the Court of Federal Claims in holding that these expenses fall outside of Code § 67(e) in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001). Similarly, the Fourth Circuit Court of Appeals affirmed a U.S. district court holding for the IRS in *Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003).

As a result, not only was there a conflict in the circuits but also a question about the viability of the *O'Neill* decision, which continued to be rejected by courts that subsequently considered the issue of deductibility of investment management expenses. A further complication was that the IRS had continually promised to issue regulations to address the issue, but no regulations were forthcoming.

William L. Rudkin Testamentary Trust

The William L. Rudkin Testamentary Trust was established under the will of Henry A. Rudkin on April 14, 1967. The situs of the trust was Connecticut and the trust was funded primarily with the proceeds of sale of a family business, Pepperidge Farm (a food products company), to Campbell Soup Company.

The 2000 fiduciary income tax return was timely filed on behalf of the trust and reported total income of $624,816 along with a deduction of $22,241 for "other deductions not subject to the 2% floor," which were listed as investment management fees paid to Warfield Associates, Inc. No deductions were claimed for "Allowable miscellaneous itemized deductions subject to the 2% floor."

On December 5, 2003, a statutory notice of deficiency was issued by the IRS determining a deficiency of $4,448 for the 2000 tax year that resulted from disallowing the full deduction of the $22,241 in investment management fees and, instead, permitting a deduction of $9,780 (the amount by which the expense of $22,241 exceeded 2% of the adjusted gross income of $623,050). The trustee petitioned the Tax Court disputing the determination on the ground that the investment advisory fees should not be subject to the 2% limitation. (The parties subsequently became aware that the notice of deficiency contained an error in its computation of adjusted gross income. The parties, however, agreed not to change the resulting deficiency of $4,448 at issue because of the alternative minimum tax.)

The Tax Court Decision

In *William L. Rudkin Testamentary Trust v. Commissioner,* 124 T.C. 304 (2005), the Tax Court reviewed its decision in *O'Neill*, which had been reversed by the Sixth Circuit as discussed previously, along with the decisions of the Fourth and Federal Circuits, which were consistent with its own prior decision in *O'Neill*. In a decision by Judge Wherry, which was reviewed by the entire Tax Court and agreed to by 17 of the other judges, the Tax Court rejected the Sixth Circuit's decision in *O'Neill* and followed its own precedent. Given the scope of the Tax Court judges in agreement with the decision in *Rudkin*, it is clearly unlikely that a taxpayer would prevail on this issue in the Tax Court (unless appeal would be made to the Sixth Circuit where *O'Neill* would still control).

The court also noted that appeal in *Rudkin* would be to the Second Circuit Court of Appeals, which had not previously ruled on this issue. This is an important consideration as the Second Circuit encompasses New York, Connecticut, and Vermont, and a Second Circuit holding would affect a significant amount of wealth and numerous sizeable trusts and estates with a situs in one of these jurisdictions. As such, a decision by the Second Circuit on this issue, either for the taxpayer or for the IRS, would be considered extremely influential.

The Second Circuit Decision

The IRS was far more successful in the Second Circuit than it had likely thought possible. In *William L. Rudkin Testamentary Trust v. Commissioner,* 467 F.3d 149 (2d Cir. 2006), not only did the Second Circuit agree that investment management expenses incurred by a trust or estate fell outside of Code § 67(e), the court set forth a new interpretation of Code § 67(e) that would greatly narrow its applicability. The Second Circuit proposed that an expense would qualify under Code § 67(e) only if it could not have been incurred by an individual property owner. Therefore, not only would investment management expenses be subject to the 2% limitation, but items such as preparation of certain tax returns also would be subject to the limitation.

Post–Second Circuit Decision

The Second Circuit's decision clearly raised concerns among taxpayers and their advisors. Not only had the Second Circuit sided with the IRS that investment management fees did not qualify under Code § 67(e), but the Second Circuit had also raised the bar for other expenses that might qualify under Code § 67(e). Further, the number and value of trusts that would now be subject to these interpretations of Code § 67(e) were significant. As such, the taxpayer petitioned the U.S. Supreme Court for a writ of certiorari seeking review of the Second Circuit's decision.

As an aside, the author thought that the IRS, having won convincingly at the Tax Court level and in the Second Circuit, would have settled the matter with this particular taxpayer given the relatively small amount involved for the year in issue. First, this would have allowed the Second Circuit decision to remain the law, at least in the three states falling within its jurisdiction (and therefore in the Tax Court where appeal would be made to the Second Circuit). Second, it was clear that, outside of cases appealable to the Sixth Circuit, taxpayers would be unable to litigate this issue successfully in the Tax Court given the decision of the Tax Court in *Rudkin* and the number of Tax Court judges who agreed with the opinion. Finally, it would appear likely that future courts that consider this issue, whether trial courts or circuit courts of appeal, would follow the trend set by every court to determine this issue (with the exception of the Sixth Circuit). No such agreement, however, was made between the IRS and the taxpayer and, in the author's opinion, this was an opportunity lost by the IRS.

In addition to the Second Circuit's decision, and perhaps in response to the taxpayer's petition for a writ of certiorari in which the taxpayer discussed the failure of the IRS to issue promised guidance in this area, the IRS finally issued Proposed Regulations adopting the reasoning of the Second Circuit on the interpretation of Code § 67(e). Under the Proposed Regulations, only expenses unique to trusts and estates would qualify under Code § 67(e) and not be subject to the 2% floor. The Regulations gave examples of unique expenses such as fiduciary accountings, required court filings, preparation of fiduciary income tax and estate tax returns, distributions to beneficiaries, trust or will contests, fiduciary bond premiums, and communications with beneficiaries. The Regulations also gave examples of expenses that are not unique such as custody and management of property, investment advice, preparation of gift tax returns, defense of claims by creditors of the decedent or the grantor, and the purchase, sale, maintenance, repair, insurance, or management of nontrade or business property. Further, the Proposed Regulations advised that a fiduciary that charges one fee for several services must unbundle its fees into those subject to the 2% limitation (that is, costs that are not unique to trusts and estates such as the investment management portion) and those that are not subject to the 2% limitation (that is, costs that are unique such as the traditional executor or trustee commission).

After the Supreme Court granted certiorari, certain people (including the author) questioned whether the Court intended to review the income tax aspects of the matter or whether it would view this as an administrative law issue based on the newly issued Regulations. After oral argument, however, it was fairly clear that the Supreme Court was interested in reviewing the effect of this matter on the income taxation of trusts and estates.

Supreme Court Decision

The Supreme Court heard the matter under the name of *Knight*, the trustee of the Rudkin trust. In its decision, the Supreme Court agreed with the analysis of the Federal Circuit in *Mellon Bank, N.A.* and the Fourth Circuit in *Scott* that was endorsed by the Tax Court in its decision in *Rudkin* that investment management expenses incurred by an estate or trust are usually not covered by Code § 67(e) and as such are subject to the 2% limitation on miscellaneous itemized deductions. In doing so, the Court rejected the taxpayer's contentions that the fiduciary obligations of a trustee or executor to follow local law regarding investments allow investment management expenses to fall within the purview of Code § 67(e). Clearly this was a loss for the taxpayer. It was not a total victory for the IRS, however, in that the Court also rejected the more stringent test to qualify under Code § 67(e) as set forth in the Second Circuit's decision. Further, the Supreme Court did allow that investment advisory fees paid by an individual trustee would not be subject to the 2% floor if the trustee can show an incremental cost or special additional charge or unusual investment objective, other than what would normally be required for an ordinary taxpayer.

The Days After *Knight*

Knight has certainly resolved the question of the deductibility of investment management fees in most circumstances. As a result of *Knight*, some considerations for practitioners include the following.

Computations

The Supreme Court has made the computations associated with determining the income tax liability of an estate or trust more complicated given the interrelated nature between the amount allowable as a deduction when subject to the 2% limitation and computing the adjusted gross income of the trust or estate.

Proposed Regulations

Despite the Supreme Court's decision in *Knight*, it appears that the IRS will proceed with its Proposed Regulations. It is worth monitoring this situation to determine whether the IRS retreats at all in the finalization of these Regulations given the decision of the Supreme Court. This is especially true with application to corporate fiduciaries.

Effect on Corporate Fiduciaries

A typical fiduciary's commission continues to qualify under Code § 67(e) as an expense not subject to the 2% limitation, even after the Supreme Court's decision in *Knight*. Certain fiduciaries, however, often include investment management and other services as part of their fees and commissions. The Proposed Regulations opine that such a fiduciary must unbundle its fees into those subject to the 2% limitation (for example, the investment management portion) and those that are not subject to the 2% limitation (for example, the traditional executor or trustee commission). A number of corporate fiduciaries have taken the position that there is no need to unbundle their fees. This analysis argues that the Supreme Court rejected much of the Second Circuit decision that formed the basis of the Proposed Regulations and that the Regulations will need to be revised to conform to the Supreme Court's decision in *Knight*. Although this argument has merit, practitioners should be careful when explaining the potential costs of using a corporate fiduciary to their clients. It should be noted that the IRS has issued guidance that a bundled fee need not be broken out for 2007 tax years or earlier.

Conclusion

The *Knight* decision has certainly had a significant effect for trusts and estates and their advisors. The full implication of the decision has not yet been ascertained, but it raises questions in both the planning and administration contexts. ■