

## Trustee Fees Subject to the 2% AGI Floor for Deductibility

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The United States Supreme Court in *Knight*<sup>1</sup> has resolved in favor of IRS the split among Circuit Courts of Appeal on the issue of deductibility of trustee investment advisory fees. The Court held in overly simplified summary that trust investment advisory fees are generally subject to the 2% of adjusted gross income (AGI) floor for them to be deducted. However, the court noted that investment advisory fees for special trust objectives are exempt from the 2% floor. While IRS has taken the position that determinations under Section 67(e) (1) of what investment advisory fees are affected by this decision is dependent on the “could not” standard, the Court in *Knight* did adopt a more taxpayer favorable standard of “commonly or customarily” in making this interpretation. This decision is effective for tax years after 2007.

The Court made clear in *Knight* that the labeling of the payments will not assist the taxpayer in getting out of the 2% floor. Thus, care must be taken to document the expense as one which is “commonly or customarily” of the nature that would permit full deductibility. Since this rule is based on a Supreme Court decision, no particular jurisdiction is going to be able to provide a better result. Furthermore, experts are advising that the prudent person rule (the need for trustees to obtain outside investment advice to be prudent) will be tested against what an individual *would* do “commonly or customarily”, rather than what a trustee *should* do. This means that the fees incurred for investment advice need to be separately stated and that it is not possible to bring them into full deductibility just by mandating the trustee to incur them in the instrument. However, it is possible to capitalize the investment advisory fees, which may be long term beneficial to the taxpayer, since there would be recovery in the event of sale of the instruments in which they are capitalized. Finally, where there are unusual investment objectives or specialized balancing of interests among beneficiaries, the trust investment advisory fees may be fully deductible where the taxpayer can show that the investment goals cannot be reasonably compared with individual investors. This may only provide deductibility to the incremental costs of the specialize advice and again require detailed proof to establish. The service may provide some safe harbors, such as to cover the costs related to the division or distribution of income or corpus among beneficiaries where those services are unique, as was set out in Prop. Reg. 1.67-4(b). This proposed regulation will now have to be amended to conform to the *Knight* decision.

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<sup>1</sup> *Knight*, 101 AFTR 2d 2008-544, 169 L Ed 2d 652, 2008-1 USTC ¶150132 (2008), *aff'g* William J. Rudkin Testamentary Trust, 98 AFTR 2d 2006-7368, 467 F3d 149, 2006-2 USTC ¶150569 (CA-2, 2006)