

Investment Advice is Not Fully Tax Deductible

On January 16, 2008 the U.S. Supreme Court decided unanimously that investment advisory fees cannot be deducted in full. In doing so, they settled the differences between two lower courts. However, they also made things harder for administrators of trusts and estates.

Generally, investment advisory fees would be considered a miscellaneous expense deduction. Miscellaneous expenses are deductible only to the extent the total for the year exceeds 2 percent of a person's adjusted gross income (AGI). This is commonly called the "2 percent floor."

For trusts and estates, the AGI is generally computed the same way as it is for individuals. One important exception to that rule, however, is that costs paid for the administration of a trust or estate, which could have been avoided if the assets were not held in a trust or estate, are fully deductible. In other words, they are not subject to the 2% floor.

The IRS and the Tax Court have generally found that deductions for investment advice provided to a trust ARE subject to the 2% floor. They reason that investment advisory fees are investment advisory fees, whether that advice is being given to an individual, or to the trustee of a trust.

The uncertainty began when the Sixth Circuit Court overruled the Tax Court and declared that investment advisory fees paid by the trust to the trustees in discharging their fiduciary duties qualified under the tax law exception – and were thus fully deductible.

A couple of years later, by contrast, the Second Circuit Court sided with the IRS and against the trustees. The case involved a trust established by the founder of Pepperidge Farms bread (later sold to Campbell Soups). The Court said that the tax code exception only applies to costs that *could not* have been incurred by an individual. Because investment advisory fees can be incurred by an individual, the deduction should be subject to the 2 percent floor.

This year the U.S. Supreme Court settled the issue, but it didn't side completely with either the Second or Sixth Circuit Court. Instead, the Court held that costs incurred by trusts that escape the 2 percent floor are limited to those that *would not* commonly or customarily be incurred by individuals.

There is a subtle difference between fees that "could not" be incurred and those that "would not." This ruling seems to allow for a full deduction of fees that are out of the ordinary – perhaps charged only to trusts. The Court said, "...some trust-related investment advisory fees may be fully deductible if an investment adviser were to impose a special, additional charge applicable only to its fiduciary accounts..."

Now that the deductibility rules have been settled for the nation, the IRS is scrambling to revise its regulations to match. If trustees have been taking a full deduction for advisory fees, the result of this Court ruling may be reduced income to beneficiaries.



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KETRA A. MYTICH, LTD.
6809 N. KNOXVILLE AVE., SUITE B.
PEORIA, IL 61614-2866