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Deductibility of Investment Advisory Expenses by Individuals, Estates and Non-Grantor Trusts

by Domingo P. Such, III, *Chicago, Illinois, and*
Thomas P. Ward, *Chicago, Illinois*[1]

Editor's Synopsis: This article, along with its accompanying examples, explains and illustrates how investment advisory expenses are deducted by estates and non-grantor trusts. The authors show how IRC Section 212 defines what is deductible and how the 2% floor on miscellaneous itemized deductions applies under IRC Section 67.

Introduction[2]

This article addresses the federal income tax rules that govern the deductibility of investment advisory expenses incurred outside of a trade or business by individuals (including grantor trusts), estates and non-grantor trusts.[3] Having spoken on the subject at various bar association meetings and other professional educational gatherings, it is clear that the topic generates significant confusion given its complex evolution and the growing complexity of our tax system.[4] This article will (1) briefly set forth the historical position of Congress and the Internal Revenue Service (the "IRS") on the deductibility of investment management expenses; (2) clarify the multifaceted current classification of investment advisory expenses; (3) outline the limitations on the deductibility of investment advisory expenses incurred by individuals (including grantor trusts), estates and non-grantor trusts under current law; and (4) by example illustrate the significant impact that these limitations have on those taxpayers that have high adjusted gross income ("AGI") or are subject to the alternative minimum tax regime.

Background

Overview of the Calculation of Taxable Income

The Code imposes tax on the "taxable income" of both individuals and trusts.[5] The calculation of taxable income begins with a determination of gross income which includes "all income from whatever source derived."[6] Deductions for individuals fall into two general categories: (1) those deductions taken from AGI if the taxpayer is eligible for and elects to itemize deductions (sometimes referred to as "below-the-line" deductions),[7] such as investment advisory expenses incurred by an investor, and (2) deductions taken directly against gross income regardless of whether the taxpayer elects to itemize deductions (sometimes referred to as "above-the-line" deductions), such as trade or business expenses.[8] As this article explains, below-the-line deductions are subject to certain limitations that do not apply to above-the-line deductions.[9]

Evolution of the Position of the IRS and Congress with Respect to the Deductibility of Investment Advisory Expenses

For a number of years following the inception of the U.S. federal income tax system, the only statutory

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[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations promulgated thereunder.

[3] A "grantor trust" refers to a trust the tax attributes of which the grantor, due to the facts or provisions in the trust, is taxed on all the items of trust income, deduction and credit for income tax purposes under I.R.C. §§ 671-679. A "non-grantor trust" is a trust that is a separate taxpayer from the grantor for income tax purposes.

[4] The Code originally with 11,400 words now has 7,000,000. The IRS now has 480 different tax forms, plus 280 more forms to explain how to fill out the first 480 forms and the number is growing. The website to help you is http://www.irs.gov/individuals/index.html.

[5] I.R.C. §§ 1(a), 1(e). A trust generally calculates taxable income in the same manner as an individual taxpayer, with some exceptions. I.R.C. § 641(b).

[6] I.R.C. § 61(a).

[7] Alternatively, a taxpayer can deduct the standard amount under I.R.C. § 63(c). The amount of the standard deduction varies according to the filing status of the taxpayer. This article assumes the taxpayer will choose to itemize his, her or its deductions.

[8] I.R.C. § 62(a).

[9] For example, the so-called "2% floor" applicable to certain miscellaneous itemized deductions under I.R.C. § 67.

authority under which a taxpayer could arguably claim a deduction for profit-oriented expenses was the predecessor to Section 162, which on its face provided deductions only for expenses incurred in "carrying on a trade or business."[10] However, in those early and less complex years, the IRS treated expenses arising from both a taxpayer's trade or business and other profit-oriented expenses as essentially the same, grouping them together under the predecessor to Section 162, and allowing deductions for both types of expenses.[11]

The simple grouping of expenses would not last. A clear distinction between profit-oriented expenses and those incurred as part of a trade or business would be drawn. In 1941, the United States Supreme Court in *Higgins v. Commissioner* ruled definitively in favor of the IRS on the issue, holding that a taxpayer was not entitled to a deduction for expenses incurred in a profit-oriented activity, unless such an activity was part of a trade or business.[12] In *Higgins*, the taxpayer spent a significant amount of time, money and energy managing a sizeable portfolio of investments which included real estate and securities.[13] The portfolio was so sizeable that the taxpayer maintained an office and hired assistants to help him manage the assets.[14] Nevertheless, the Supreme Court held that the taxpayer was not entitled to deductions with respect to any of the expenses incurred in the course of managing his portfolio.[15] In so holding, the Supreme Court noted that despite the size of his portfolio and the level of activity required to maintain it, the taxpayer did not have a trade or business—he was only managing his own wealth.[16] In the eyes of the Court, without a trade or business, deductions for such expenses were simply impermissible under the tax law at that time.[17] The IRS responded to the Court's decision in *Higgins* by revoking all of its prior guidance and authority permitting deductions for non-business, profit-oriented expenses.[18]

In 1942, Congress responded to both the Supreme Court's decision in *Higgins v. Commissioner* and the shift in the IRS's position by enacting the predecessor to Section 212.[19] In enacting the predecessor to Section 212, Congress's goal was to create some level of equity between taxpayers engaged in a profit-oriented activity, on one hand, and taxpayers engaged in a trade

[10] *See* section 23(a) of the INTERNAL REVENUE ACT OF 1928 which provided as follows:

> [In computing net income there shall be allowed as deductions:]
>
> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken title and in which he has no equity.

[11] *See* O.D. 537, 2 C.B. 175 (1920) (permitting a deduction for certain expenses incurred by an estate in the collection of income, such as rent and payments to a business agent, but noting that certain expenses such as executors fees and attorneys fees were not proximately related to the collection of income and therefore not deductible); O.D. 877, 4 C.B. 123 (1921) (noting that a deduction for rent and the cost of clerical expenses would be granted a taxpayer who primarily held stocks and bonds if he could show that such costs were ordinary and necessary within the meaning of section 214(a)(1) of the REVENUE ACT OF 1918 (the predecessor to section 23(a) of the REVENUE ACT OF 1928)); IT 2751 XIII-1 C.B. 43 (1934) (assessing authorities permitting deductions for expenses incurred in the production or collection of income and finding a clear intent to permit deductions for such expenses, based upon the principle that business expenses represent the cost of producing income and, therefore, stating that all ordinary and necessary expenses incurred in the production of income should give rise to deductions).

[12] Higgins v. Commissioner, 312 U.S. 212 (1941). Shortly after deciding *Higgins*, the Supreme Court reiterated and applied the standard set forth in *Higgins*. *See* City Bank Farmers Trust Co. v. Helvering, 61 S. Ct. 896 (1941) (finding that a trust holding stock and bonds was not engaged in a trade or business and, therefore, not entitled to deductions for trustee fees paid), and United States v. Pyne, 61 S. Ct. 893 (1941) (holding that executors were not entitled to deductions with respect to estate administration expenses, including attorney fees, for the estate of a decedent who was a financier and investor, despite arguments by the executors that they were entitled to such deductions by virtue of the fact that they were trying to continue to manage the estate in the same way that the decedent managed it, or that they were in the trade or business of conserving and protecting the estate).

[13] Higgins, 312 U.S. at 213.

[14] *Id*.

[15] *Id*. at 218.

[16] *Id*.

[17] *Id*.

[18] *See* I.T. 3452 1941-1 C.B. 205 (1941) and I.T. 1941-2 C.B. 187 (1941) (citing *Higgins*, revoking prior guidance allowing non-business deductions as inconsistent with the Court's decision, and noting profit-oriented expenses not connected with a trade or business will not give rise to a deduction).

[19] *See* section 23(a)(2) of the INTERNAL REVENUE CODE (1942), which provided as follows:

> [In computing net income, there shall be allowed as deductions:]
>
> In the case of an individual, all the ordinary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

S. Rept. 1631, 77th Cong., 2d Sess., reprinted in 1942-2 C.B. 504, 570.

or business, on the other hand.[20] However, today, taxpayers engaged in a profit-oriented activity are not on a level playing field with taxpayers engaged in a trade or business. As discussed in this article, there are several significant differences between a deduction allowable under Section 162 for a trade or business expense and a deduction allowable under Section 212 for an investment advisory expense.

Overview of Section 212

The current version of Section 212 provides as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.[21]

The Treasury Regulations provide further guidance on the deductibility of expenses under Section 212. In order to be considered "ordinary and necessary," expenses must be "reasonable in amount and must bear a reasonable or proximate relation to the production or collection of taxable income or to the management, conservation or maintenance of property held for the production of income."[22] Section 212 expenses, while not related to a trade or business, must still be distinguished from expenses arising from sport, hobby or recreation.[23] The question of whether a transaction is carried out for the production or collection of taxable income, as opposed to carried out for sport, hobby or recreation, is to be determined based on all of the facts and circumstances.[24] Taxpayer intent alone is not sufficient to make a determination.[25]

Section 212 expenses can include the following: (1) investment advisory fees; (2) subscriptions to investment advisory publications; (3) qualifying attorneys' fees; (4) expenses of clerical help and office rent in managing investments; (5) fees to collect interest and dividends; (6) losses on deposits in insolvent or bankrupt financial institutions; (7) service charges on dividend reinvestment plans; and (8) trustee's fees for an individual retirement account if separately billed and paid.[26]

Limitations Imposed on Section 212 Deductions

Section 67 defines "miscellaneous itemized deductions" as all itemized deductions other than those listed under Section 67(b). Since Section 212 expenses are not listed under Section 67(b), they by default are characterized as miscellaneous itemized deductions.[27] Miscellaneous itemized deductions are below-the-line deductions and are subject to a variety of limitations which are described in greater detail below.

Section 67: The 2% Floor

Under Section 67(a), a taxpayer can only deduct miscellaneous itemized deductions to the extent that all of his or her itemized deductions collectively exceed 2% of his or her AGI.[28] This limitation is frequently referred to as the "2% floor." In addition to investment advisory expenses, expenses such as unreimbursed employee expenses and state income taxes

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[20] *See* S. Rept. 1631, 77th Cong., 2d Sess., reprinted in 1942-2 C.B. 504, 570 (stating that amendment allows a deduction for "the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production or collection of income, or for the management, conservation or maintenance of property held by the taxpayer for the production of income, *whether or not such expenses are paid or incurred in carrying on a trade or business*.") (emphasis added).

[21] I.R.C. § 212.

[22] Treas. Reg. § 1.212-1(d).

[23] Expenses arising from sport, hobby or recreation are covered by I.R.C. § 183 rather than I.R.C. § 212.

[24] Treas. Reg. § 1.183-2(b).

[25] *Id*.

[26] *See* Treas. Reg. § 1.67-1T(a)(1)(i); IRS Pub. 529, "Miscellaneous Deductions" (2009).

[27] I.R.C. § 67(b). The deductions listed under I.R.C. § 67(b) are interest, taxes, personal casualty losses, charitable contributions, medical and dental expenses, impairment-related work expenses, estate tax in the case of income in respect of the decedent, deductions allowable in connection with personal property used in a short sale, deductions relating to computation of tax when the taxpayer restores an amount in excess of $3,000 held under claim of right, deductions where annuity payments cease before investment recovered, amortizable bond premiums, and deductions in connection with cooperative housing corporations. These deductions are not subject to the 2% floor on miscellaneous itemized deductions.

[28] I.R.C. § 67(a).

paid are included as miscellaneous itemized deductions when calculating the 2% floor. Miscellaneous itemized deductions that cannot be taken because they do not exceed 2% of a taxpayer's AGI in a given taxable year cannot be carried forward. Such deductions are permanently lost.

Section 68: Overall Limit on Itemized Deductions

Any amount deductible under Section 67(a) is subject to further reduction by Section 68. Section 68 reduces a taxpayer's itemized deductions by an amount equal to the lesser of (1) 3% multiplied by the excess, if any, (a) the itemized deductions over (b) the "applicable amount"[29] and (2) 80% of the total itemized deductions of the taxpayer.[30] For taxable years beginning after December 31, 2005 and before January 1, 2010, the amount of reduction under Section 68 is limited to a fraction of the amount calculated under Section 68(a).[31] For taxable years beginning in calendar years 2006 and 2007, the applicable fraction is 2/3.[32] For taxable years beginning in 2008 and 2009, the applicable fraction is 1/3.[33] Section 68 does not provide a similar limitation of the reduction for taxable years beginning in subsequent calendar years.[34]

Section 56: Exclusion from Alternative Minimum Tax Calculation

Unlike deductions for trade or business expenses, no deduction is allowed for Section 212 expenses for purposes of the alternative minimum tax.[35] As a result, any amount deducted from AGI for miscellaneous itemized deductions will be added back into the taxpayer's AGI to compute the alternative minimum taxable income, thereby increasing any alternative minimum tax expense.

Application of Limitations to Estates and Non-Grantor Trusts

The 2% floor applies to individual taxpayers (and grantor trusts) as well as to estates and non-grantor trusts.[36] The rules for applying the limitations to an estate or non-grantor trust, however, introduce an additional level of complexity on top of the prior analysis. In order to apply Section 67 to an estate or non-grantor trust, Proposed Treasury Regulations issued on June 27, 2007 direct the taxpayer to divide the expenses of an estate or a non-grantor trust into two categories.[37] To the extent that a cost incurred by

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[29] I.R.C. § 68(b) defines the "applicable amount" as $100,000 (or $50,000 in the case of separate returns filed by married taxpayers) multiplied by the cost of living adjustment under I.R.C. § 1(f)(3). The applicable amount for 2009 was $166,800 ($83,400 for married filing separately). *See* Rev. Proc. 2008-66. Rev. Proc. 2009-50, which sets forth inflation-adjusted items for 2010, does not specify the applicable amount for 2010 because I.R.C. § 68(b) does not apply in 2010.

[30] I.R.C. § 68(a). Note that I.R.C. § 68 does *not* apply to estates.

[31] I.R.C. § 68(f).

[32] *Id.*

[33] *Id.*

[34] I.R.C. § 68(g), which was added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), provides that, for tax years beginning after 2009, the I.R.C. § 68(a) limitation on the deductibility of itemized deductions will no longer apply. However, the Economic Growth and Tax Relief Reconciliation Act also provides that the full I.R.C. § 68(a) limitation will apply again for tax years beginning after 2010. The Federal Budget for Fiscal Year 2011 (the "2011 Budget") confirms the approach of the Economic Growth and Tax Relief Reconciliation Act and includes a proposal to permanently reinstate the I.R.C. § 68(a) limit on itemized deductions. Under the 2011 Budget proposal, for 2011 the "applicable amount" would be $250,000 for married taxpayers filing jointly and $200,000 for single taxpayers in 2009 dollars, determined as adjusted for inflation between 2009 and 2011. After 2011, the "applicable amount" would be indexed annually for inflation. *See* Dept. of Treasury, General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals (Feb. 2010).

[35] I.R.C. § 56(b)(1)(A)(i).

[36] The taxation of estates and non-grantor trusts require the use of distributable net income ("DNI") as a taxing concept. DNI is accounting income from an estate or trust, whether taxable or tax-exempt, that is distributable to beneficiaries, net of estate and trust expenses and deductions. DNI may be modified, depending on whether DNI is being used to determine if a distribution is (1) deductible to the estate or trust, (2) taxable to the beneficiary, or (3) tax-exempt interest. In general, DNI is calculated in the same manner as in the case of an individual under I.R.C. § 643 with various modifications. The 2% floor limitation is reflected in the calculation of an estate's or trust's tentative taxable income, DNI, the distribution deduction, and the final taxable income. Thus, the reduced deduction pursuant to the 2% floor limitation increases the trust's tentative taxable income, DNI, and possibly, the trust's final taxable income. Commentators Carol Cantrell and Steve R. Akers have noted that calculating the 2% floor may result in a circular calculation that occurs when a trust pays a beneficiary more than its DNI. This occurs because adjusted gross income depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions which depends on its adjusted gross income. The IRS has provided an algebraic formula found in the instructions to Form 1041, pp. 17-18 to solve the interrelated calculation. DNI passes through to the beneficiaries with the same tax character of income received by an estate or trust and the benefit of some of the estate's or trust's deductions pursuant to I.R.C. §§ 652 and 662.

[37] Prop. Treas. Reg. § 1.67-4(a).

an estate or non-grantor trust is unique to such an entity, that cost is not subject to the 2% floor.[38] To the extent that a cost included in the definition of miscellaneous itemized deductions and incurred by an estate or non-grantor trust is not unique to such an entity, that cost is subject to the 2% floor.[39]

Under the Proposed Treasury Regulations, a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property that is not held in an estate or trust.[40] In assessing a particular cost, the IRS will consider the type of product or service rendered to the estate or trust, rather than the characterization of the cost charged for that product or service.[41] The Proposed Regulations contain a non-exclusive list of products or services that will be considered unique to an estate or trust, including services rendered in connection with: (1) fiduciary accountings; (2) judicial or quasi-judicial filings required as part of the administration of the estate or trust; (3) fiduciary income tax and estate tax returns; (4) the division or distribution of income or corpus to or among beneficiaries; (5) trust or will contests or constructions; (6) fiduciary bond premiums; and (7) communications with beneficiaries regarding estate or trust matters.[42] Similarly, the Proposed Regulations contain a non-exclusive list of products or services that will not be considered unique to an estate or trust, and therefore will be subject to the 2% floor, including those rendered in connection with: (1) custody or management of property; (2) advice on investing for total return; (3) preparation of gift tax returns; (4) the defense of claims by creditors of the decedent or grantor; and (5) the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.[43]

In 2008, the United States Supreme Court in *Knight v. Commissioner* confronted the issue of whether investment advisory fees paid by a trustee were expenses unique to a non-grantor trust or estate and, therefore, exempt from the 2% floor under Section 67(e).[44] The trustee argued that he had sought and obtained investment advice because his fiduciary duties under state law required him to invest and manage trust assets as a prudent investor would.[45] Because an individual acting on his or her own behalf is not subject to the same fiduciary duties, the trustee argued that an individual *could not* incur trust investment advisory fees.[46] While the trustee's argument was accepted by the Second Circuit Court of Appeals on review below and was adopted by the IRS in the Proposed Regulations, the Supreme Court ultimately disagreed with the trustee's argument, overruling the Second Circuit and noting that applying an analysis of whether an individual *could* incur trust investment advisory fees "flies in the face of statutory language".[47] The Supreme Court strongly asserted that had Congress intended to use the word "could," they would have. Instead, they used the word "would." Thus, the Supreme Court held that the proper analysis is not whether an individual *could* incur trust investment advisory fees, but whether it is uncommon or unusual for individuals to hire investment advisors.[48] The Court noted that the fiduciary standard referred to a "prudent investor" rather than a "prudent trustee" and made clear that a hypothetical individual prudent investor would reasonably seek investment advice.[49] Further the Court noted that there was nothing in the record to suggest that the investment advisor charged the trustee any additional fee or treated the trustee any differently than the advisor would have treated an individual investor.[50] As a result, the Court could not find that the fees *would not* have been incurred if the property were held by an individual, and therefore, held that the investment advisory fees were subject to the 2% floor.[51]

The Proposed Treasury Regulations expressly provide that if an estate or non-grantor trust pays a single "bundled" fee, commission or expense for both costs

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[38] Prop. Treas. Reg. § 1.67-4(a), interpreting I.R.C. § 67(e)(1), which provides that the AGI of an estate or trust shall be computed in the same manner as in the case of an individual, except that 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 in the property were not held in such trust or estate shall be treated as allowable in determining AGI.

[39] *Id*.

[40] Prop. Treas. Reg. § 1.67-4(b).

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] Knight v. Commissioner, 128 S. Ct. 782 (2008). Prior to the Court's decision in *Knight*, the circuits had been split on the issue. *See* Scott v. United States, 328 F.3d 132 (4th Cir. 2003) (holding that investment fees are common expenses of individual investors and, therefore, are subject to the 2% floor); Mellon Bank v. United States, 265 F.3d 1275 (Fed. Cir. 2001) (holding that investment fees are not unique to trust administration and, therefore, are subject to the 2% floor); and O'Neill v. Commissioner, 994 F.2d 304 (6th Cir. 1993) (holding that investment fees are incurred solely because property is held in trust and, therefore, are excepted from the 2% floor and are fully deductible).

[45] Knight, 128 S. Ct. at 787.

[46] *Id.*

[47] *Id.*

[48] *Id.* at 789-90.

[49] *Id.* at 790.

[50] *Id.* at 791.

[51] *Id.*

that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must use "any reasonable method" to identify the portion of the fee, commission or expense that is not unique to trusts and estates and, therefore, is subject to the 2% floor.[52]

In light of the *Knight* case, the IRS issued additional guidance regarding "bundled fiduciary fees" in Notice 2008-32.[53] In Notice 2008-32, the IRS indicated that final regulations under Section 67(a) would be consistent with the Court's holding in *Knight*. However, because the IRS did not expect such regulations to be issued before the due date for 2007 tax returns, Notice 2008-32 granted taxpayers permission to deduct the full bundled fiduciary fee without regard to the 2% floor for tax years beginning before 2008. In Notice 2008-116, the IRS extended the reprieve from unbundling fiduciary fees to tax years beginning before 2009 as regulations on the subject had not yet been issued.[54] In Notice 2010-32, the IRS again extended the interim guidance provided in Notices 2008-32 and 2008-116 to tax years beginning before January 1, 2010.

Application of Limitations to Pass-Through Entities

While the limitations of Section 67 apply only to individuals and trusts, Section 67(c) and Temporary Treasury Regulation Section 1.67-2T explicitly prevent the use of pass-through entities to avoid the 2% floor.[55] Temporary Treasury Regulation 1.67-2T provides that while the 2% floor does not apply to partnerships or S corporations, when the deductions flow through to the partner or shareholder, such deductions are then subject to the 2% floor applicable to that partner or shareholder.[56]

Illustration of the Impact of Limitations Imposed on Section 212 Deductions

The value of investment expense tax deductions could be as low as zero after considering all the applicable limitations. Taken together, Sections 67 and 68 (except in 2010 when Section 68 does not apply) work to limit the deductions to which taxpayers are entitled for investment advisory expenses and thereby raise the effective tax rate of the individuals and trusts subject to their limitations. While the limitations set forth in these Sections impact all taxpayers with investment advisory expenses, the impact increases in magnitude as the taxpayer's AGI rises. Additionally, Section 56 operates to prevent taxpayers subject to the alternative minimum tax from taking any deduction with respect to Section 212 expenses. The following examples illustrate these limitations and restrictions. These examples focus on individual taxpayers; however, the same result follows for non-grantor trusts once it is determined that the expenses at issue are not unique to a non-grantor trust and are therefore subject to the 2% floor. The same result should also follow for estates under Section 67 but not under Section 68, as Section 68 does not apply to estates. Accordingly, the deductibility of investment advisory expenses of an estate would not be subject to the second level of limitation on deductibility imposed by Section 68.

Impact of Section 67 as AGI Increases

Examples 1-3 illustrate the impact of Section 67 as a taxpayer's 2010 AGI increases. In each of these examples, the individual is not engaged in a trade or business, but simply holds a variety of investments and engages an investment advisor to manage the investments. In each example, the taxpayer pays the investment advisor a total of $500,000 in investment advisory expenses during 2010. Because the taxpayer in each example is not engaged in a trade or business, the investment advisory expenses will be characterized as miscellaneous itemized deductions. Finally, in each example, the investment advisory expenses are assumed to be the taxpayer's only miscellaneous itemized deductions. Because each of the following examples reflect the 2010 income tax consequences to the taxpayer, no further reduction under Section 68 is reflected.

> *Example 1:* Individual A has $1,000,000 of AGI in 2010. Section 67(a) will apply the 2% floor to disallow $20,000 (2% of Individual A's AGI) of the miscellaneous itemized deductions. As a result of the operation of Section 67, $20,000 of the potential deductions stemming from Individual A's $500,000 of investment advisory expenses will be disallowed in 2010, leaving Individual A with a total deduction of $480,000.

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[52] PROP. TREAS. REG. § 1.67-4(c).

[53] Notice 2008-32, 2008-11 I.R.B. 593 (Feb. 27, 2008).

[54] Notice 2008-116, 2008-52 I.R.B. 1372 (Dec. 11, 2008).

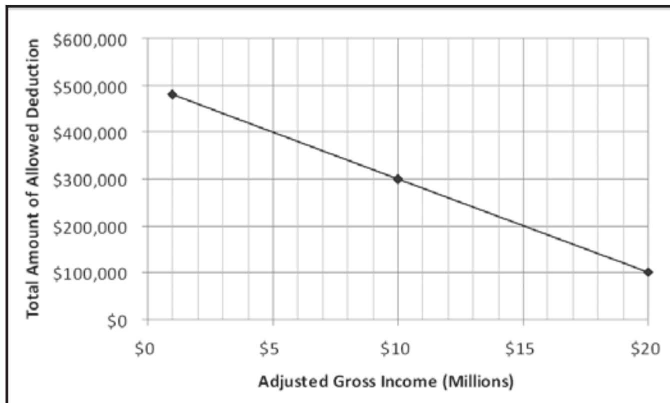
[55] I.R.C. § 67(c); TEMP. TREAS. REG. § 1.67-2T(b).

[56] *See also* TREAS. REG. § 1.702-1(a)(8)(i) (each partner shall take into account separately his distributive share of non business expenses as described in I.R.C. § 212).

Example 2: Individual B has an AGI of $10,000,000 in 2010. Section 67(a) will apply the 2% floor to disallow $200,000 of the miscellaneous itemized deductions. As a result of the operation of Section 67, $200,000 of the potential deductions stemming from Individual B's $500,000 of investment advisory expenses will be disallowed in 2010, leaving Individual B with a total deduction of only $300,000.

Example 3: Individual C has an AGI of $20,000,000 in 2010. Section 67(a) will apply the 2% floor to disallow $400,000 of the miscellaneous itemized deductions. As a result of the operation of Section 67, deductions for $400,000 of Individual C's $500,000 of investment advisory expenses will be disallowed in 2010, leaving Individual C with a total deduction of only $100,000.

The following graph illustrates the increasing impact of Section 67 to the taxpayers in Examples 1, 2 and 3 as their AGI increases. On this graph, the Y-axis reflects the total amount of deduction allowed after factoring in the Section 67 limitations. In the examples above, while Individual A, a taxpayer with an AGI of $1,000,000 only loses 4% of his or her deductions for investment advisory expenses, Individual C, a taxpayer with an AGI of $20,000,000 loses 80% of his deductions under Section 67 stemming from the same expense.



Impact of Section 67 as Section 212 Expenses Increase

Examples 4-6 illustrate the impact of Section 67 when a taxpayer's AGI remains the same, but investment advisory expenses increase. Again, in each of these examples, the taxpayer is not engaged in a trade or business and does not have any miscellaneous itemized deductions in addition to the investment advisory expenses. In each example, the taxpayer has an AGI of $10,000,000 during 2010.

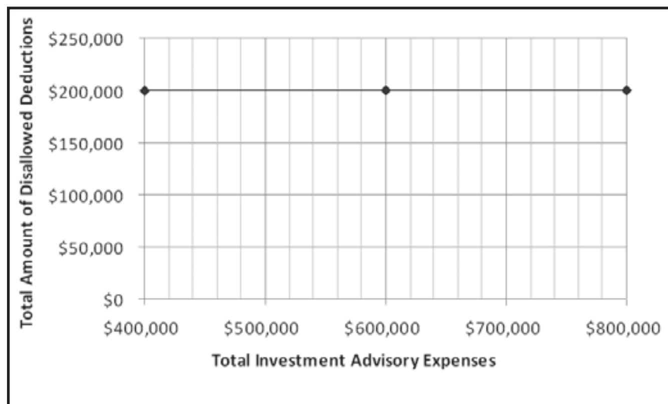
Example 4: Individual D has $400,000 in investment advisory expenses in 2010. Section 67(a) will apply the 2% floor to disallow $200,000 of the miscellaneous itemized deductions. As a result of the operation of Section 67, $200,000 of the potential deductions stemming from Individual D's $400,000 of investment advisory expenses will be disallowed in 2010, leaving Individual D with a total deduction of $200,000.

Example 5: Individual E has $600,000 in investment advisory expenses in 2010. Section 67(a) will apply the 2% floor to disallow $200,000 of the miscellaneous itemized deductions. As a result of the operation of Section 67, $200,000 of the potential deductions stemming from Individual E's $600,000 of investment advisory expenses will be disallowed in 2010, leaving Individual E with a total deduction of $400,000.

Example 6: Individual F has $800,000 in investment advisory expenses in 2009. Section 67(a) will apply the 2% floor to disallow $200,000 of the miscellaneous itemized deductions. As a result of the operation of Section 67, $200,000 of the potential deductions stemming from Individual F's $800,000 of investment advisory expenses will be disallowed, leaving Individual A with a total deduction of $600,000.

The following graph illustrates the impact of Section 67 to taxpayers as their investment advisory expenses increase but their AGI remains static. On this graph, the Y-axis reflects the total amount of the disallowed deductions. As illustrated on this graph, regardless of how much the total amount of investment advisory expenses increases, the total amount of the

deductions disallowed under Section 67 will remain static as long as the AGI remains static.



Impact of Section 68 Post-2010

As noted above, Section 68(a) does not apply to further reduce a taxpayer's allowable deduction in 2010.[57] If Section 68(a) is reinstated for 2011 and future tax years, with an applicable amount of $250,000, as currently proposed in the 2011 Budget, Section 68(a) would then apply to further reduce the deduction by the lesser of 3% of AGI above the specified base or 80% of allowable deductions.

In Example 3, if all relevant facts remained the same, Section 68(a) would apply in 2011 to further limit Individual C's deduction by $80,000 (80% of allowable deductions, which is the lesser of 3% of AGI above the specified base or 80% of allowable deductions). After application of Section 68(a), Individual C would only be entitled to deduct $20,000 of the $500,000 total investment advisory expenses incurred in 2011.

In Example 6, if all relevant facts remained the same, Section 68(a) would apply in 2011 to further limit Individual F's deduction by $292,500 (3% of AGI, which is the lesser of 3% of AGI above the specified base or 80% of allowable deductions). After application of Section 68(a), Individual F would only be entitled to deduct $307,500 of the $800,000 total investment advisory expenses incurred in 2011.

Impact of Section 56

Example 7 illustrates the restrictions on the deductibility of Section 212 expenses when a taxpayer is subject to the alternative minimum tax. Again, the individual is not engaged in a trade or business and does not have any miscellaneous itemized deductions in addition to his or her investment advisory expenses. The individual has an AGI of $10,000,000 and investment expenses of $500,000 in 2010.

> *Example 7*: As shown in Example 2, outside of the alternative minimum tax context, Individual G would be entitled to deduct $300,000 of his $500,000 investment expense against his AGI. However, because Individual G is subject to the alternative minimum tax, Section 56 will prohibit Individual G from taking any deduction with respect to the investment advisory expenses. All $500,000 of investment advisory expenses will be disallowed as a deduction for alternative minimum tax purposes.

Conclusion

The phase-out of deductibility of investment advisory expenses is an issue that impacts individuals, estates and non-grantor trusts alike. Further, it is an issue which grows in magnitude with a taxpayer's AGI. As a taxpayer's AGI increases, the taxpayer's ability to deduct investment advisory expenses diminishes significantly. If the AMT is applicable, the deduction for investment advisory expenses may be disallowed entirely. Taxpayers should work with their financial advisors and tax professionals to determine what expenses are subject to the limitations, to monitor the impact of these limitations and to develop strategies to minimize such impact.

[57] While it is possible that Congress would attempt to retroactively extend the application of I.R.C. § 68(a) to miscellaneous itemized deductions incurred in 2010, such a retroactive extension would likely be subject to challenge.

Volume 35, No. 4, Spring 2010

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The ***ACTEC Journal*** (ISSN 1544-4945) is published quarterly for the Fellows of The American College of Trust and Estate Counsel as a professional service.

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