



# **Pioneer Bank & Trust**

## **Trust & Investments**

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## Unbundled fees

Henry Rudkin's family was involved in the founding of the food products company Pepperidge Farm. The business was sold to Campbell's Soup Company in the 1960s, and the proceeds found their way into a trust established under Henry's will when he died in 1967. During tax year 2000, when the trust was worth \$2.9 million, the trustee paid an investment advisor \$22,241 for advice that led to reported trust income for that year of \$624,816. The trust deducted the entire fee, but the IRS demanded a haircut of 2% of AGI, reducing the deduction to \$9,780 and increasing the trust's income tax due by \$4,448. The Service argued that because investment advisory fees are not unique to trust management, they are subject to the 2% floor for miscellaneous expenses.

Although that may seem like a small sum to litigate over, it also has implications for the Alternative Minimum Tax, so the trustee took the IRS to Court. The trustee maintained that because investment of trust assets is essential to the discharge of fiduciary duties, all of the expenses of trust management must be fully deductible.

A unanimous Supreme Court held for the IRS. Said the Court: "The text requires determining what would happen if a fact were changed; such 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." Individuals with \$3 million investment portfolios routinely seek out investment advice, so the 2% floor does apply to such expenses.

Last year the IRS finalized Regulations on deductibility of trustee's fees, in accord with this Supreme Court decision. The new rules took effect on January 1. Whenever a trustee pays a third party for investment advice, those fees will be subject to the 2% floor. What about trustees that provide both fiduciary services and investment management for a single fee? The Regulations are complicated, but boiled down, the new rules generally require trustees to "unbundle" their fees, identifying the portion that goes to investment management services. That portion will not be fully deductible, but the rest will. The IRS permits trustees to use any reasonable method to allocate their fees among the services they provide.

(January 2015)

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