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New IRS regs would limit fee deductions

By Lisa Shidler
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CHICAGO — Proposed IRS regulations that affect trusts and estates would carry with them a host of ills — including more trust fees for beneficiaries, additional work for financial advisers and increased client exposure to the alternative minimum tax — advisers and industry experts say.

At issue is whether investment management and advisory fees paid by trusts and estates should be fully deductible. The Internal Revenue Service is proposing that those costs should be deductible only when they exceed 2% of the trust's adjusted gross income.

Advisers, attorneys and accountants have differing opinions on how the current law works, and describe it as murky. The U.S. Supreme Court has agreed to review the matter in Rudkin Testamentary Trust v. Commissioner when it reconvenes in October.

If taxpayers can't fully deduct advisory fees, more of them will likely end up in the AMT bracket, because under that tax, advisory fees aren't counted as a deduction, said Earlaine Klinger, a certified financial planner with McQueen Ball & Associates Inc. of Bethlehem, Pa.

If investors can deduct only those fees that exceed the 2% floor, they will have more taxable income, she said.

Clients would also have to pay more advisory fees because they wouldn't be able to deduct all of them as they have done in the past.

As for advisers, many charge one standard fee and fear that their workloads would increase because they would have to break out specific fees to determine which were subject to the 2% rule and which weren't.

"This is going to create a big burden on corporate fiduciaries to figure out what's subject to 2%, and what's not," said Randy Thomas, a certified public accountant and CFP who is senior vice president at The Bryn Mawr (Pa.) Trust Co. and manager of its tax division.

The company is a wholly owned subsidiary of Bryn Mawr Bank Corp.

Under the new regulations, advisers would spend more time documenting fees and working more closely with investors to try to help them escape the AMT.

“There will be fewer assets available for the beneficiaries, because it’ll be more expensive to administer the trust,” said Robert Willens, a tax analyst at Lehman Brothers Inc. in New York.

J.J. Burns, principal with Melville, N.Y.-based J.J. Burns & Co. LLC, also is concerned about clients who would face the AMT.

“We have to look at the impact of the AMT for the client,” he said. “Any clients who are already in the AMT will be deeper into it.”

If the proposal becomes a law, Mr. Burns said, he will be limited to certain investments.

“I don’t like it. I have to be careful about the kinds of bonds I invest in. You have to make sure you have an AMT-tax-friendly bond portfolio,” Mr. Burns said.

While trust fees may be a headache, it’s the performance of the trust that ultimately means the most to beneficiaries, said Robert Burkarth, a regional vice president in the Stamford, Conn., office of The Householder Group Inc. in Scottsdale, Ariz.

“I think the performance is more important to most investors than any kind of fee structure,” he said.

Householder Group, which manages $4 billion in assets, charges a basic 1% fee and has already unbundled the fees.

“I don’t think it makes that big of a difference,” Mr. Burkarth said. “If the trustee’s doing a better job, investors are happy to pay and don’t care about deductibility. The difference in decent performance far outweighs the tax fee.”

But the issue may be moot, depending on how the Supreme Court decides in Rudkin.

If the IRS is defeated, presumably, the regulations would not be implemented.

Mr. Willens expressed surprise that the IRS proposed the regulations in advance of the Supreme Court’s hearing of the case and speculated that the justices may not like the IRS’ trying to enforce them before a ruling on the matter.

“It’s unusual for them to do something like this while a case is pending —especially before the Supreme Court — and it may backfire on them,” he said.

In Rudkin, the 2nd U.S. Circuit Court of Appeals in New York held that the only expenses not subject to the 2% rule are those which are “peculiar” to an estate or trust, meaning that the expenses could not have been incurred by an individual.

Using that interpretation, Mr. Willens pointed out, any investment advisory expenses that can be incurred by individuals would have to use the 2% rule.

In its proposed regulations, the IRS used the same explanation and stated that the only trust and estate fees that can be fully deductible are those that are unique to a trust.