In Knight we Trust

By Reg P. Wydeven
February 1, 2008

In the fall of 1982, one of my favorite all-time TV shows premiered – 'Knight Rider.' The show was about Michael Long, a young police officer who was shot in the face in the line of duty. Dying millionaire Wilton Knight rescued Long and paid for his reconstructive surgery and recuperation. In exchange, Michael agreed to fight crime.

Now known as Michael Knight, he was equipped with a souped-up, turbo-thrusting, talking Pontiac Trans-Am, the Knight Industries Two Thousand, or KITT for short. Michael lived at Knight's palatial estate called the Foundation for Law and Government. After passing, Wilton left his millions in trust to finance his dream of crime fighting, including KITT's expensive repairs and upgrades and Michael's many leather jackets.

As a result of a recent U.S. Supreme Court decision, Michael may have to scale back his wardrobe. The Court held that investment advisory fees paid by a trust, like Wilton's, can't be deducted in full for income-tax purposes. Instead, the deductibility of those fees is limited by what's known as the "2% floor" on miscellaneous itemized deductions. In other words, investment advisory fees are deductible only to the extent that their total, along with certain other miscellaneous deductions, exceeds 2% of the trust's adjusted gross income.

The case centers around a trust established in 1967 in Connecticut under the will of Henry A. Rudkin, who, with his wife, founded the food company Pepperidge Farm. In 2000, the trustee, whose name is coincidentally Michael J. Knight, hired an outside firm to provide advice on investing the trust's assets. The trust paid the firm $22,241 that year to manage about $2.9 million in marketable securities. The trust then deducted all those fees on its tax return. The IRS, however, claimed that the fees must be limited by the 2% floor, and therefore, the trust owed an additional $4,448 in taxes.

The case got to the Supreme Court after federal appeals courts across the country were divided on the issue, as they either ruled the fees were fully deductible or were subject to the 2% floor. Therefore, the rules were different depending upon the circuit in which the trust was located. The Supreme Court's decision, which trumps any lower court's rulings, means higher taxes for trusts.

According to the American Institute of Certified Public Accountants in Washington, there are nearly four million estates and trusts that outsource $10.2 billion a year for legal, accounting, tax reporting and asset management fees. These trusts and estates also pay trustees an additional $4 billion for their asset-management services. These trusts are typically created to minimize taxes, provide money for potential spendthrifts or protect assets from creditors.

Not all hope is lost though. The Court held that some fees may be deductible under certain circumstances, such as if a trust "may have an unusual investment objective, or may require a specialized balancing of the interests of various parties." Therefore, the extra cost of expert advice beyond what would normally be required for an ordinary taxpayer wouldn't be subject to the 2% floor.

But for most trusts, the ruling means less deductions, so more taxes. The heirs to the Pepperidge Farm fortune responded by saying that's the way the cookie crumbles.

This article originally appeared in the Appleton Post-Crescent newspaper and is reprinted with the permission of Gannett Co., Inc. © 2008 McCarty Law LLP. All rights reserved.