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Special needs require special lawyers.

INSIDE THIS ISSUE

- Trusts and Taxes
- Announcement
- Speakers
- Oast & Hook
- Distribution of this
Newsletter

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TRUSTS AND TAXES

On January 16, 2008, the U.S. Supreme Court settled a long-running conflict among federal appeals courts regarding fiduciary income taxes for trusts. In *Knight v. Commissioner*, (No. 06-1286), the Court ruled in a unanimous opinion that investment advisory fees paid by a trust cannot be deducted in full for income tax purposes. The Court held that the deductibility of such fees is limited by the 2% floor on miscellaneous itemized deductions.

The Knight case is also known as “Rudkin” because it involves a trust established under the will of Henry A. Rudkin, who, with his wife, founded the Pepperidge Farm Company. In 2000, the trustee, Henry Knight, hired an outside firm to advise him on investing the trust’s assets. The trust had approximately \$2.9 million in marketable securities, and it paid \$22,241 in investment advisory fees. The trust deducted all of the fees, but the IRS said that the fees had to be limited by the 2% floor. The IRS allowed the trust to deduct the investment advisory fees only to the extent that they exceeded 2% of the trust’s adjusted gross income. The result was that the IRS said the trust owed an additional \$4,448 in taxes. The trust said that the trustee had a fiduciary duty to act as a “prudent investor” under Connecticut law and therefore was required to hire an investment professional and pay investment advisory fees. The trust said that the fees should be fully deductible because they were unique to trusts.

The Court first reviewed the language of the statute governing deductions from gross income, 26 U.S.C. 67(e). The general rule of the statute is that “[T]he adjusted gross income of [a] ... trust shall be computed in the same manner as in the case of an individual.” This means that trusts can deduct costs subject to the same 2% floor that applies to individual taxpayers. The statute provides an exception to the 2% floor when two conditions are met. First, the cost must be “paid or incurred in connection with the administration of the ... trust.” Second, the cost must be one “which would not have been incurred if the property were not held in such trust.” The Court said that “[t]he statute does not ask whether a cost was incurred because the property is held by a trust; it

asks whether a particular cost ‘would not have been incurred if the property were not held in such trust.’” The Court quoted the IRS Commissioner’s brief: “Far from examining the nature of the cost at issue from the perspective of whether it was caused by the trustee’s duties, the statute instead looks to the counterfactual question of whether individuals would have incurred such costs in the absence of a trust.” The Court agreed with this view and the view of the Fourth and Federal Circuits that “[c]osts that escape the 2% floor are those that would not ‘commonly’ or ‘customarily’ be incurred by individuals.” The Court said that “whether a trust-related expense is fully deductible turns on a prediction about what would happen is a fact were changed – specifically, if a property were held by an individual rather than by a trust.”

Applying this reading of the statute to the case at issue, the Court said that it is not uncommon for individuals to hire an investment adviser, and that the “prudent investor” standard does not only apply to trustees. The standard “looks to what a prudent investor with the same investment objectives handling the investor’s own affairs would do, i.e., a prudent individual investor.” The Court said that it would be difficult to say that it would be uncommon or unusual for investment advisory fees to be incurred if the same property were held by an individual investor. The Court did say that it was conceivable “that a trust may have an unusual investment objective, or may require a specialized rebalancing of the interests of the various parties, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.” The trustee in the case before the Court did not make such an assertion, and, therefore, the Court held that the investment advisory fees were subject to the 2% floor.

This decision is particularly significant for large trusts that routinely spend substantial amounts on investment advisory fees. Many trusts, and beneficiaries will be paying higher taxes.

The attorneys at Oast & Hook can assist trustees, executors and administrators with their fiduciary duties so that laws and court rulings can be properly followed.

Announcement

Oast & Hook invites you to attend our upcoming seminar. To be held on March 13th, this seminar will focus on estate and financial, and it is entitled: “Estate and Financial Planning for Retirement.” You will find this to be an informative seminar that will discuss the many issues facing the elderly when they plan for retirement. The seminar will cover estate planning, disability planning, insurance, and public benefits planning. The seminar speakers will be Oast & Hook attorneys Andrew Hook, William Oast III and Sandra Smith. If you are interested in attending this breakfast meeting, then please complete and fax the attached registration form to 757-397-1267. For more information about this breakfast meeting, please phone Jennifer Lantz at 757-967-9724.

Oast & Hook

Oast & Hook is an elder law firm. We represent older persons, disabled persons, their families, and their advocates. The practice of elder law includes estate planning, investment and insurance advice, estate and trust administration, powers of attorney, advance medical directives, titling of assets and designations of beneficiaries, guardianships, conservatorships, and public entitlements such as Medicaid, Medicare, Social Security, and SSI, disability planning, income tax planning and preparation, bill paying, account management and reporting, care management, and fiduciary services. We also handle litigation involving these issues, such as will contests and estate administration disputes. For more information about Oast & Hook, please visit our website at www.oasthook.com.

Oast & Hook is a Virginia member of the Special Needs Alliance, a nationwide network of disability attorneys. As members of this alliance, we assist personal injury attorneys in resolving their cases to enhance the judgments and awards of their disabled clients and to maintain the eligibility of these clients for SSI and Medicaid. We are experienced in protecting the public benefits of persons with special needs and in assisting with the management of their assets. For more information about the Special Needs Alliance, visit its website at www.specialneedsalliance.com. The Special Needs Alliance has begun publication of an informative e-newsletter called *The Voice*. The purpose of this newsletter is to provide information and answers about special needs planning for family members and professionals. To subscribe to *The Voice* go to www.specialneedsalliance.com/subscribe.aspx.

Distribution of This Newsletter

Oast & Hook encourages you to share this newsletter with anyone who is interested in issues pertaining to the elderly, the disabled and their advocates. The information in this newsletter may be copied and distributed, without charge and without permission, but with appropriate citation to Oast & Hook, P.C. If you are interested in a free subscription to the *Oast & Hook News*, then please e-mail us at mail@oasthook.com, telephone us at 757-399-7506, or fax us at 757-397-1267.

Please visit us on the world wide web at:

www.oasthook.com

Our website contains information about Oast & Hook and an archive of our newsletters and other estate planning, estate administration, and elder law articles in searchable form at.

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OAST & HOOK

Presents:

Estate and Financial Planning for Retirement

Date: Thursday, March 13, 2008

Location: Hilton Norfolk Airport
1566 North Military Highway
Norfolk, Virginia

Schedule: Registration: 8:30 a.m. to 9:00 a.m.
Workshop: 9:00 a.m. to 11:30 a.m.

Presenters: Andrew H. Hook, William H. Oast III, and Sandra L. Smith

Tuition: Register on or before February 25, 2008, for an early registration fee of \$15.
After February 25, 2008, the registration fee will be \$30.

Space is limited, so please register as soon as possible. Walk-in registrations will not be accepted.
No refunds after March 1, 2008.

Registration Form

Please complete this form and either fax it to Oast & Hook at 757-397-1267 or mail it to Linda Gerber at Oast & Hook, P.C., at 295 Bendix Road, Suite 170, Virginia Beach, Virginia 23452-1294.

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For more information, please phone Jennifer Lantz or Linda Gerber at 757-399-7506.