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TAKING STOCK INTERNATIONAL PLANNING

A Tense Time For Trust Administration

Dumont casts a pall. *Rudkin* sends a chill. And this new Democratic Congress—what might it do to the capital gains tax rate?



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In 2006, courts spoke to two important issues in trust administration. The *Dumont* case was overturned,¹ providing a brief respite for trustees that own large stock concentrations. And *Rudkin* was affirmed,² seeming to confirm that, at least in the Second Circuit, investment management fees incurred by trusts cannot be fully deducted for income tax purposes. These cases involve two of the most difficult issues in trust administration: investing a trust with an undiversified asset concentration and deducting investment management fees. Even with these decisions, trustees do not have complete certainty about these key responsibilities, diversification and tax planning. And the two responsibilities will be subject to even more uncertainty as we head into a new era of a Democratic majority in Congress.

DUMONT REVERSED

Dumont followed a line of cases that began in 1995 with *Janes*.³ These cases had several facts in common. First, the trustee held a concentration of publicly traded stock that had a low cost for income tax purposes. Second, the remaindermen in these cases objected to the fact that the trustee failed to diversify that concentration. Third, the trustee's actions occurred mostly before 1995, the date New York's prudent investor rule became law. And finally, in each of these cases, the lower court held the trustee liable for damages for this conduct.

One major difference between *Dumont* and its forerunners is that the *Dumont* trust contained language that might be interpreted as requiring a large stock concentration. With respect to the Eastman Kodak stock that the testator knew would be held by the trustee, the trust stated: "It is my desire and hope that said stock will be held

by my said Executors and by my said trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock. The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so."⁴ Most practitioners and trustees would believe such language provides strong justification for retaining the stock and insulates the trustee from liability for doing so. Unfortunately, a probate court did not agree, and found the trustee liable for damages of almost \$21 million.

Fortunately for the trustee, in February 2006, the Supreme Court of the State of New York, Appellate Division, Fourth Judicial Department unanimously reversed this lower court decision and dismissed all objections. In September, the New York Court of Appeals affirmed this decision based on a technicality: The date on which the lower court determined that the trustee should have sold the stock was not contained in the objectants' pleadings, but rather was based on a "composite, unpleaded theory of imprudence."⁵ But the Appellate Division did offer some solace to trustees by stating in dicta that there was no evidence that the trustee acted imprudently in failing to sell the stock, and that the lower court's determination was improperly based on hindsight.

These cases offer little guidance to trustees on the issue of diversification, especially if the trust

If the capital gains tax rate is going up, that impacts trustees' handling of concentrations of low-cost stock.

document specifically directs that the trustee will not be liable for lack of diversification. Clearly, diversification is an important part of managing risk in a portfolio. But what if the trust's creator does not want the trustee to sell the security? Can the trustee follow those directions? Or, does a trustee follow those directions at its peril? These are questions that we will be exploring in the year ahead. But pity any trustee who becomes litigation fodder for that exploration.

RUDKIN

While *Dumont* provides us with no certainty on stock concentrations, the U.S. Court of Appeals for the Second Circuit seemed to provide certainty on another issue: Can trustees take a full income tax deduction for investment management fees? The appellate court affirmed *Rudkin*, seeming to make clear that investment management fees paid by trustees are tax-deductible only when they exceed 2 percent of the trust's adjusted gross income. In other cases, the court effectively eliminated the deduction. However, on Nov. 28, 2006, the commissioner filed a petition asking the Second Circuit to rehear *Rudkin en banc*. So for now, even that certainty is up in the air.

Under Internal Revenue Code Section 67(a), investment management fees for individuals are treated as miscellaneous itemized deductions and are deductible only to the extent that the aggregate of all miscellaneous itemized deductions exceeds 2 percent of adjusted gross income. Generally, trusts are taxed in the same manner as individuals. But there is one exception: Expenses that would not have been incurred if the property were held outside of a trust are

fully deductible and not subject to the 2 percent floor. The Sixth Circuit in *O'Neill v. Comm'r*,⁶ determined that investment management fees paid by trustees are a necessity imposed by the trustees' duty to invest assets for the income beneficiary and remainderman. This determination resulted in the fees being fully deductible for income tax purposes. The Federal Circuit and the Fourth Circuit subsequently held otherwise, and in *Rudkin*, the Second Circuit has joined them—at least for the time being. These courts reached this conclusion in spite of the fact that trustees are bound by law to invest assets prudently—and this is an increasingly difficult task, given the uncertainty that results from *Dumont* and related decisions. The rationale is that the trust expenses that are incurred simply because the trust exists and that would not otherwise be incurred are not subject to the 2 percent floor, although other expenses are. Because individuals may incur investment management expenses, they are subject to the floor. Trustee commissions, on the other hand, are not subject to the 2 percent floor.

Two inconsistencies result from this holding. First, there are a few thoughts to take away from *Rudkin*. Many professional trustees charge a trustee commission that incorporates all trustee services, including custody, investment management, tax preparation and administration. That fee should be fully deductible as "reasonable compensation" under the trustee commission statute that exists on the books in so many states. Second, the expense ratio charged by mutual funds remain fully deductible for income tax purposes

because mutual funds net out from their income the investment management fees attributable to those funds. These two inconsistencies provide an opportunity to provide added value to trust beneficiaries.

DEMOCRATS

The new Democratic Congress may bring about significant changes in the tax law that could impact a trustee's decision to diversify low cost stock.

Most Democrats did not vote for the Bush administration's dividend and capital gains tax cuts. Now that the Democrats are in power, will capital gains tax rates and taxes on dividends go up?

The capital gains tax rates are especially important for trustees whose trusts are in the Second Circuit and may own large concentrations of low-basis stock. Selling that stock to diversify will result in the realization of capital gain and payment of tax. Is now the time to sell that stock, before capital gains tax rates go up? Certainly trustees will need to keep an eye on this new Democratic regime. ■

Endnotes

1. *Testamentary Trust UW Dumont*, 2004 WL 1468746 (Surr. Ct. 2004), *aff'd*, *In re Dumont*, 2006 WL 259834 2006 N.Y. Slip Op. 00866 (N.Y. App. Div. 2006).
2. *William K. Rudkin Testamentary Trust et al. v. Commissioner*, 124 T.C. 19 (2005), 2006 WL 2972609 (2d Cir. Oct. 18, 2006).
3. *In Re Estate of Janes*, 165 Misc.2d 743, 630 N.Y.S.2d 472 (Surr. Ct. 1995).
4. *Supra* note 1.
5. *Ibid*.
6. 93-1 USTC para. 50,332, 994 F.2d 302 (6th Cir. 1993).

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