

Tax Deductibility of Investment & Financial Planning Expenses

All miscellaneous itemized deductions are eliminated. This includes investment advisory fees. Ultimately, the Tax Cuts and Jobs Act (TCJA) went with the Senate proposal, repealing all miscellaneous itemized deductions that were otherwise subject to the 2%-of-AGI floor under IRC §67.

Tax Planning for Investment Advisory Fees

The loss of the deduction for investment advisory fees will make it substantially more appealing to have IRAs and other retirement accounts pay their own advisory fees, as fees paid by an IRA are still permissible IRC §212 expenses of the IRA, and fees paid from a pre-tax IRA are by definition 100% pre-tax (the equivalent of making those fees a deductible expense). However, it's important to bear in mind the limitations of paying advisory fees from IRAs – in particular, that only investment advisory fees can be paid from an IRA (not financial planning fees), and that an IRA should only pay its own advisory fees (and not the fees for any other accounts, which can be treated as a taxable distribution or even a prohibited transaction). And of course, it will still be preferable to use outside dollars to pay the advisory fees for a Roth IRA (given that it's not pre-tax money, which means there's no tax benefit to using Roth dollars to pay fees).

Custodial Fees for Retirement Plans

Many traditional retirement plans and account custodians charge some sort of annual maintenance fee. If the fee is paid for with funds inside the account or plan, then they cannot be deducted on Schedule A. However, even with the elimination of the tax benefit for the fees paid, clients can still obtain the equivalent of a tax deduction for some expenses. The key is to pay traditional IRA fees directly from the traditional IRA, effectively gaining a deduction since the investment fees will be paid from pretax funds. The IRS has held consistently that retirement accounts can pay their own investment expenses, both commissions and fees, with no adverse tax effect to account owners.

Caution should be taken before deducting fees for a taxable account from an IRA. Although some advisors may be doing this, it is not permitted by the tax code. Deducting investment management fees for a taxable account from an IRA may violate the prohibited transaction rule. In this case, the IRA owner could be subject to a penalty tax of up to 100% of the distribution. The entire IRA could also be disqualified. In short, this would create a potentially large tax bill since the IRA would be taxed as though the entire balance was distributed.

Deducting Financial Planning Fees

There is no section of the Internal Revenue Code (IRC) that authorizes tax deductions for financial planning fees. Consequently, advice regarding retirement planning, insurance, and cash flow planning would not be tax deductible but instead treated as a personal expense.

Deductibility of Trust Investment Advisory Fees

Similar to provisions for individuals, The Tax Cuts and Jobs Act of 2017 (TCJA) also eliminated miscellaneous itemized deductions subject to the 2% AGI floor, including investment advisory fees, for trusts and estates. However, the IRC, provides an exception to this limitation for deductions that meet the following requirements:

1. The deductions are for costs that were paid or incurred in connection with the administration of the estate or trust, and
2. Such costs would not have been incurred if the property were not held in the estate or trust.

General Rule – Investment Fees are Subject to Two-Percent Floor on Itemized Deductions.

The U.S. Supreme Court has ruled that only estate or trust expenses that would be uncommon, unusual, or unlikely for a hypothetical individual to incur are not classified as miscellaneous itemized deductions subject to the two-percent floor. IRS Regulations are consistent with the Supreme Court decision. Consequently, investment advisory fees incurred by an estate or trust are generally no longer deductible under TCJA.

Exception to the General Rule:

However, certain incremental costs of investment advice beyond the amount normally charged to an individual investor are not subject to the two-percent floor on itemized deductions and therefore not eliminated under TCJA. If the fee would be unusual, the trust could take a deduction. Many factors must be considered, such as the trust instrument and the trust's investment directives. Other factors to consider include what services were provided and the special needs, if any, of the trust beneficiaries. Regional differences may also come into play. It may be uncommon for individuals to incur some types of investment advisory fees in certain areas of the country. The excess of fee may be "attributable to an unusual investment objective" of the trust or estate or to the need for a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. The facts and circumstances of every trust are different, requiring a case-by-case review.

Allocation of Bundled Fees

Per IRS regulations, a single fee or commission (a "bundled fee") paid by an estate or non-grantor trust must be allocated between the costs that were previously treated as miscellaneous itemized deductions subject to the 2% floor that are now eliminated and those trust-specific deductions that remain. The allocation can be made using any reasonable method.

Deducting Business-Related Investment Fees

The general rule is that if you own a business that has "investments" in its name, then all investment-related fees pertaining to managing those holdings can be deducted as a business expense. Businesses are entitled to a deduction for ordinary and necessary expenses paid or incurred during the taxable year for the production of income and the management, conservation or maintenance of property held for the production of income.

Limitation on Deduction of Investment Expenses for Upper Tier Partnerships and their Investors.

A common structure for hedge funds and certain other investments is a tiered partnership structure due to the flexibility it provides. In a typical hedge fund set up, one partnership (the fund itself) known as the lower tier partnership (LTP) is often owned by another partnership (the manager) known as the upper tier partnership (UTP). The IRS ruled that the management fee paid or incurred by a LTP is an ordinary and necessary business expense in carrying on its trade or business, but the management fee paid by a UTP, which engages in the passive activity of holding limited partnership interests for the production of income, constitutes a miscellaneous expense.

The ruling states that for tax purposes, each LTP is a "trader", engaged in the business of trading in securities. On the other hand, the UTP's activities consist solely of acquiring, holding and disposing of interests in the LTPs, and does not rise to the level of a trade or business for tax purposes. That is, the UTP (often referred to as a "fund of funds,") is considered an investor, not a trader, for tax purposes. In general, whether a partnership is considered a trader or an investor will largely depend on the partnership's level of portfolio turnover and types of portfolio transactions.

For an individual, the distinction between being invested in a pass-through entity that is a trader and one that is an investor is critical since individuals are no longer able to benefit from miscellaneous itemized deductions.

The ruling, however, gives no guidance as to what constitutes a "trader" partnership, but merely assumes that conclusion in reaching its result.

Conclusion

All miscellaneous itemized deductions are eliminated. This includes investment advisory fees. Taxpayers should work with their tax professionals to determine what expenses are subject to the limitations and to develop strategies to minimize the impact of such limitations. Taxpayers need to understand the tax issues that can arise as they pay for investment management and financial planning services. They need to be cognizant of which accounts those expenses are paid from, particularly in the case of IRAs and bundled financial advisory fees.

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