IRS Rules For Paying Investment Management Fees From Taxable And Retirement Accounts

November 14, 2012

Executive Summary

Given the costs associated with investment advice, clients often want to maximize any available tax benefits to help mitigate the cost. Fortunately, the IRS does allow a tax deduction for certain investment-related expenses, and while the treatment isn't ideal – a miscellaneous itemized deduction subject to the 2%-of-AGI floor, and an AMT adjustment – something is better than nothing. In fact, the IRS even allows investment advisory fees to be deducted when paid on behalf of retirement accounts like IRAs and 401(k) plans. Alternatively, the IRS also allows investment advisory fees to be paid directly from a retirement account – which effectively allows the fee to be paid with 100% pre-tax dollars.

However, an important caveat is that while retirement accounts can cover their own fees, paying any other fees from such accounts can trigger highly adverse results, including taxable distributions, early withdrawal fees, and even a prohibited transaction disqualification of the entire retirement accounts! In the end, the power of tax deferral means that most clients will probably simply pay fees from taxable accounts and claim whatever tax deduction they can, but clients with shorter time horizons – including and especially retirees – should consider paying fees directly from their IRAs and other retirement accounts… but be certain those fees are only for the associated retirement accounts!

(Michael's Note: The Tax Cuts and Jobs Act of 2017 altered the rules for deducting investment management fees from taxable accounts. See here for more recent information on the tax treatment of advisory fees after TCJA.)

Deducting Section 212 Expenses

Section 212 of the Internal Revenue Code – entitled "Expenses for the Production of Income" – details the deductibility of expenses associated with an individual's money and financial issues. Under Section 212, there are three categories of deductible costs, including: "all the ordinary and necessary expenses paid or incurred during the taxable year:

- for the production or collection of income;
- for the management, conservation, or maintenance of property held for the production of income; or
- in connection with the determination, collection, or refund of any tax."

Notably, there is a requirement for the fee to be deductible to be attributable to income, which the IRS has interpreted to mean taxable income; as a result, investment management fees for tax-exempt investments like municipal bonds are not deductible. Traditional investment advisory fees, though, including ongoing AUM and wrap fees, generally *are* deductible as long as they're not directly attributable to the management of tax-exempt assets.

Unfortunately, though, the fees must be claimed as a miscellaneous itemized deduction, which means the fees are limited to a 2%-of-AGI floor, and also are an AMT adjustment and consequently non-deductible for AMT taxpayers. Although some taxpayers in the past have tried to avoid this adverse result by capitalizing the fees instead (i.e., adding them to the cost basis of the security, similar to a transaction fee), the IRS has ruled that this is not permissible treatment; for better or for worse, clients have to claim the fee as best they can and enjoy whatever deduction they do, or don't, receive in the end.

Investment Management Fees And IRA Accounts

While the treatment of investment advisory fees is relatively straightforward when paid for/from a taxable account – the fee is deductible in the year paid as a Section 212 expense, and the client will or will not get some tax benefit from that after claiming it as a miscellaneous itemized deduction subject to the 2%-of-AGI floor – the matter is somewhat more complicated when retirement accounts are involved.

The first question that arises is simply whether an investment management fee can be deducted when paid on behalf of IRA assets, given that IRAs are tax-deferred and do not create ongoing income in the first place. Fortunately, this issue has been addressed, most recently in PLR 201104061 (discussed previously on this blog), which affirmed that "wrap fee"-style arrangements like ongoing AUM and investment advisory fees can be paid with outside taxable dollars are still deducted as a Section 212 expense (a position the IRS continues to support since PLR 8830061). In previous rulings (PLRs 9005010 and 200507021), the IRS also confirmed that paying fees on behalf of an IRA will not be treated as a constructive contribution to the account (which might have otherwise exceeded annual contribution limits).

Because investment advisory fees are Section 212 expenses, this also means that a retirement account's ongoing investment advisory fee can be paid directly from the account without being treated as a taxable distribution, under Treasury Regulation 1.404(a)-3(d). However, since the fee is being paid directly with retirement account dollars and not the taxpayer's own money, it will not be personally deductible to the account owner (of course, if the retirement account is pre-tax, then by definition the entire fee would have been paid with pre-tax dollars already, so there would be no need for a tax deduction!).

Thus, in essence, the retirement account owner has a choice to pay investment advisory fees with the money in a retirement account – which is subtracted directly from the account without tax consequences – or to pay the fee with outside dollars instead, and claim the itemized deduction.

Criss-Crossing Brokerage Fees And Retirement Accounts

Notably, while the rules do allow taxable accounts to pay retirement account fees, or for retirement accounts to pay their own fees, it is *not* permissible to have a retirement account pay for fees attributable to a taxable account (or other investments), because such expenses would not be "ordinary and necessary expenses *of* the retirement account" in the first place. Instead, a payment from a retirement account for the fees of other accounts would be treated as a taxable distribution (with potential early withdrawal penalties due as well), in the same manner that using a retirement account to pay any other personal bills and expenses would be treated as a distribution.

Unfortunately, though, the potential treatment from retirement accounts is even more severe, because of the so-called "prohibited transaction" rules under Section 4975, which stipulate that when a retirement account conducts a transaction between an account and a "disqualified person" (which includes the account owner and his/her family), the transaction can be subject to a penalty tax of up to 100%(!) of the amount and the entire account can be *disqualified* (i.e., treated as though the *entire* account has been fully distributed for tax purposes).

As a result of the prohibited transaction treatment in particular, it's absolutely crucial not to have a retirement account pay someone's personal bills or engage in inappropriate transactions – which includes *not* allowing your retirement accounts to pay investment advisory fees for your personal, non-retirement accounts!

Notably, these restrictions on payments from retirement accounts also mean the retirement account should not pay *other* personal financial fees and expenses as well, including financial planning fees. Thus far, however, the IRS has been somewhat lenient in allowing a bundled fee that includes investment advisory fees and some other 'minimal' expenses (like financial planning services) to still qualify; nonetheless, advisors should be cautious about trying to bundle too many other fees and expenses into a single comprehensive "investment advisory" fee, if the fee is going to be paid from retirement accounts.

Is It A Good Deal To Pay Investment Fees From An IRA When Permissible?

Given that investment advisory fees *can* be paid from retirement accounts – as long as the fee is attributable *only* to the retirement account – the question remains whether a client *should* pay from retirement accounts when it is possible to do so.

The real answer is that "it depends" – specifically, on whether or how much of the fee would have been deductible if it was simply paid with outside dollars instead. After all, the primary benefit to paying a fee from a retirement account is the ability to pay it with pre-tax dollars – since by definition the retirement account is pre-tax. If the fee would have been fully deductible if paid with outside dollars anyway, then it's best to simply pay with outside dollars, and allow the IRA to maximize its ongoing tax-deferred growth.

However, in practice an investment advisory fee is often not fully deductible for clients, in part due to the 2%-of-AGI floor on miscellaneous itemized deductions, but more commonly because it is an AMT adjustment and consequently most or all of the deduction is lost as clients cross into AMT exposure. In such scenarios, the decision represents a trade-off – the upside to paying with outside dollars is allowing the retirement account to compound, and the upside to paying with retirement dollars is making the entire payment on a pre-tax basis. Mathematically, the power of tax-deferred compounding can eventually beat the benefit of the tax deduction (even if none of the payment is tax deductible when paid with outside dollars), but it can take anywhere from 20-40 years, depending on tax rate and growth rate assumptions.

In the end, this means that for clients with very long time horizons – or where the fee actually will be partially or fully deductible – it's best to pay with outside dollars. However, for clients where the fee is not deductible, and the time horizon is shorter – e.g., for current retirees – the best deal may be to simply deduct the fee directly from the retirement account and get the full pre-tax value. In such scenarios, though, it's still important to ensure that the retirement account is *only* paying the fees attributable to itself, to avoid the highly adverse taxable distribution and prohibited transaction consequences!

And either way, though, it will always be preferable to use "outside" dollars to pay the investment management fee for a Roth IRA, as even if the fee isn't deductible, it's better to pay with after-tax dollars from a taxable account than using future-tax-free-growth dollars from the Roth IRA itself!

(This article was featured in the Carnival of Personal Finance #388 on Sweating the Big Stuff, the Carnival of Retirement 47th edition, Nerdy Finance #17 on NerdWallet, and also Carnival of Money Pros on Vane$$a's Money.)