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IRS To Investors: Fees For "Wrap Accounts" Not Capital Costs (CCA 200721015)

Reversing what had been assumed to be its previous position, IRS Chief Counsel, through an advice memorandum, has ruled that the annual fee paid by a growing number of investors on their brokerage accounts in lieu of commissions paid on each trade should not be considered a "carrying charge" for the account. As a result, and contrary to what has been the practice of many investors, taxpayers may not elect to capitalize the fees under Reg §1.266-1(b) and add the amount to the basis of their investments pro rata. Instead, the fee can only be treated as a Schedule A miscellaneous itemized deduction, which is subject to an overall two percent adjusted gross income (AGI) floor.

- ***CCH Take Away.*** Due to the significant impact of the position taken in this Chief Counsel's Advice on a large number of investors and due to the lack of guidance with more precedential value, many practitioners and financial investment firms are up in arms. Adding fees to basis in the case of stocks helps lower the capital gain eventually due on their sale. While a miscellaneous itemized deduction may offset ordinary income, getting past the two-percent AGI floor is usually difficult for those wealthy enough to find themselves in flat fee arrangements.

- ***Comment.*** Maxine Aaronson, a tax attorney in Dallas, told CCH "the real impact of this CCA is that many taxpayers will never see any tax benefit from the payment of a wrap fee because either they don't itemize or they lose the benefit through the two percent floor, the phase-out of itemized deductions, or the application of the AMT."

"Wrap accounts"

In the "wrap account" under consideration, the taxpayer entered into a contract with a brokerage firm to pay an annual fee equal to a percentage of the market value of all assets in taxpayer's investment account. In return, the brokerage firm agreed to act as an investment advisor and custodian for those assets, review and evaluate taxpayer's investment objectives, and hire an unaffiliated manager to invest the assets. No separate commissions were paid for trades. A portion of the fee was withdrawn from taxpayer's account every quarter.

Definition of carrying charge

The IRS Chief Counsel took the position that the wrap fee could not be treated as a carrying charge (a capital expenditure) and must be deducted. While Code Sec. 266 allows taxpayers to elect to treat carrying charges as capital charges, Reg §1.266-1(b)(1) limits the categories of expenses qualifying for that treatment. These categories include:

(1) Taxes, mortgage interest, and other carrying costs for unimproved or unproductive real property;
(2) Loan interest, taxes, and necessary expenditures for any real property;
(3) Taxes and loan interest related to personal property; and
(4) "Any other taxes and carrying charges with respect to property,…which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account." Since the wrap fee clearly does not fall into the first three categories,

the Chief Counsel focused the advice memorandum on examining the propriety of allowing capitalization based on the fourth category.

Since the term "carrying charge" is not defined in Code Sec. 266 or its regs, the IRS looked to the definition of similar terms in Code Sections 166(b) and 263(g). This comparison led the agency to decide that carrying charges are "expenses incurred when acquiring, financing, and holding property." Examples include expenses for insurance, storage, and transportation. The wrap fee charged to the brokerage account did not fall within this definition, according to the IRS, because it was incurred independent of taxpayer's acquiring property and was not a necessary expense of holding property. Instead, the agency stated that the fee was better viewed as a "currently deductible investment expense." *Reference: TRC BUSEXP: 9,302.* ■