**The Different Tax Treatment of Investment Advisory Fees and Brokerage Fees;**
**The Lower the Fiduciary Duty, the Better the Tax Consequences**

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## I.
## Introduction

Investing in securities has inherent risks. The specific securities in an investor's portfolio may plummet overnight, the market could crash, or an investment professional could engage in fraudulent activity, leading to an investor loss. A 2002 poll concluded that forty percent of Americans had at least $10,000 invested in the stock market at that time.[2] Considering the large percentage of Americans investing in securities, it would seem rational to expect that tax laws would be written in a way that encourages taxpayers to seek investment professionals who are held to high standards of conduct. However, the tax laws not only fail to provide incentives for taxpayers to seek the advisors with the highest degree of fiduciary duties, but actually *favor* the use investment professionals with the *least* accountability. This article will explore the current tax laws, analyze the policy considerations and propose alternatives to the current system.

Generally speaking, investment advisory fees may be deducted under Internal Revenue Code ("IRC") § 212(2)[3] if: (1) a taxpayer elects to itemize his[4] deductions, pursuant to IRC § 67(e); and (2) only to the extent that those fees exceed two-percent of the taxpayer's

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[2] *See* J. Brent Wilkins, Comment, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. Ill. U. L. J. 339 (2005).
[3] Unless otherwise provided all citations to the IRC are to the Internal Revenue Code of 1986, as amended.
[4] Use of the masculine pronoun throughout this paper is not meant to favor one gender, but is substituted in place of "his or her" for improved readability. *See* IRC § 7701(o)(1)(3) (providing that words importing the masculine gender include the feminine as well).

adjusted gross income.[5] Brokerage fees, in contrast, are treated as capital expenditures[6] which are proper adjustments to basis.[7] Therefore, when a taxpayer sells a security with a higher basis (due to brokerage fee adjustments), he does not recognize as much gain as he would without the basis adjustment—thereby reducing his overall tax liability.

Section II of this article describes the various types of fees that taxpayers incur in investing in securities. Section III analyzes how the tax law treats investment advisory fees versus brokerage fees. Section IV examines the legislative history of particular sections of the IRC in order to understand Congress' intent in enacting them. Then section V analyzes the duties that investment advisors and brokers owe to their clients. Section VI scrutinizes the policy implications of the current tax Code. Finally section VII proposes revisions to the current tax code to better align the IRC with investors' expectations for their financial professionals.

## II.
## Fees that Taxpayers Incur in Securities Investments

A. Types of Financial Services Professionals:

Although the National Association of Securities Dealers ("NASD") [8] lists many designations[9] used to describe investment professionals, there are two main categories: (1) brokers and (2) registered investment advisors.[10] Brokers are regulated by the NASD and

[5] *See* IRC § 67(a).
[6] *See* Treasury Regulation ("Regulation") § 1.263(a)-2(e).
[7] *See* IRC § 1016(a).
[8] The NASD is a self regulated organization which serves as the primary private-sector regulator of America's securities industry. It oversees the activities of over 5,100 brokerage firms, and more than 657,690 registered securities representatives. The NASD licenses individuals and admits firms to the industry, writes rules governing their behavior, ensures regulatory compliance and sanctions those who do not comply. NASD also operates the largest securities dispute resolution forum in the world—processing over 8,000 arbitrations and 1,000 mediations per year. *See* the NASD website, *available at* www.nasd.com (last visited February 21, 2006).
[9] To view a complete list of NASD's professional designations and descriptions of each *see* http://apps.nasd.com/investor_Information/resources/designations/AllDesigByAcronym.asp (last visited February 21, 2006).
[10] *See* Dean Starkman, *ISO: An Advisor to Trust*, Washington Post (September 18, 2005).

investment advisors are governed by the Securities and Exchange Commission ("SEC"). [11]

Investment advisors are defined in the Investment Advisors Act ("IAA") as,

> …any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…[12]

The definition specifically excludes other professionals from this definition, including brokers, so long as the broker's "…performance of such service is solely incidental to the conduct of his business as a broker or dealer and receives no special compensation therefor…"[13] Brokers are defined under the Securities Exchange Act ("SEA") as "…any person engaged in the business of effecting transactions in securities for the account of others."[14] The core role of a broker is to execute transactions for customers—no other investment professional can perform this function.[15] Brokers may provide a wide range of services for their clients related to the securities transaction, such as research and advice prior to effectuating a trade, but for the most part, their function is execution of trades.[16]

B. <u>Common Fee Structures</u>:

According to the NASD, investment professionals are most commonly paid in one or more of the following ways: (1) hourly fee; (2) fee-only; (3) commissions on the investment products they sell; (4) a percentage of the value of the assets they manage; and (5) a combination

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[11] The SEC was established by Congress in 1934 to enforce the Securities Act of 1933 and the Securities Exchange Act of 1934, promote stability in the markets and to protect investors. The SEC requires publicly-traded companies to disclose meaningful financial and other information to the public. Further, the SEC oversees stock exchanges, broker-dealers, investment advisors, mutual funds, and public utility holding companies. The primary concern of the SEC is to promote the disclosure of important information, enforcing the securities laws, and protecting investors who interact with these various organizations or individuals. *See* the SEC website, *available at* www.sec.gov (last visited February 21, 2006).
[12] IAA §202(a)(11), 15 U.S.C. §80b-2(a)(11).
[13] IAA § 202(a)(11)(C), 15 U.S.C. §80b-2(a)(11)(C).
[14] SEA §3(a)(4)(A), 15 U.S.C. §78c(4)(A).
[15] *See* Barbara Black, *Brokers and Advisors – What's in a Name?*, 11 Fordham J. Corp. & Fin. L. 31, 36 (2005).
[16] *Id*.

of fees and commissions.[17] This article will examine in detail three of these: commissions; fee-only; and fee-based accounts.[18]

A. Commissions:

For investment professionals who charge commissions, they typically earn them on a transaction by transaction basis.[19] Brokers are the only investment professionals who are authorized to charge commissions.[20] To the extent that commissions depend on the volume of transactions, there is a built-in incentive for brokers to trade frequently (whether or not such trading is necessary for that particular investor).[21] Commission fees are not only incurred through the use of live brokers. Several companies primarily offer brokerage services online or via automated-service telephone for customers to effectuate transactions themselves without the assistance of a broker.[22] Even firms that primarily market live brokers, also offer online and telephonic services.

Some examples can best illustrate the actual fees that industry-leading companies charge their customers in brokerage commissions. For broker-assisted trades, Charles Schwab's commission rates range from $35 plus 1.70% of the principal trade size, for trades between $0-$2,499, and $270 plus 0.09% of the trade size for trades of $500,000 and over.[23] Commissions for executing trades online range from $9.95 per trade, to $19.95 per trade.[24] Automated phone stock trade commission rates range from $14.95 per trade to $29.95 per trade—based on the

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[17] *See* http://apps.nasd.com/investor%5FInformation/resources/designations/ (last visited February 21, 2006).
[18] Interview with Ian Yankwitt ("Yankwitt Interview"), in White Plains, N.Y. (October 27, 2005).
[19] *Id*.
[20] *Id*. (Mr. Yankwitt noted that some investment advisors may also be brokers; in which case they may charge commissions).
[21] *See* discussion *infra* Section V.A.ii.
[22] Four major companies in this category are: E*Trade, Scottrade, Fidelity and Ameritrade.
[23] *See* Charles Schwab website, *available at* www.schwab.com (last visited February 21, 2006).
[24] *Id*.

frequency of a customer's trading.[25] Vanguard offers similar services. For broker-assisted transactions, Vanguard's standard commission rate is $45 plus $0.05 per share.[26] The standard commission rate for online-transactions is the greater of $25 or $0.025 per share.[27] Similarly, Ameriprise Financial charges $75 per trade of 1,000 shares or less for broker-assisted transactions.[28] For online trades, Ameriprise charges $19.95 for trades of 1,000 shares or less.[29]

Several companies place their primary focus on services which allow investors to execute their trades online without the assistance of a broker. For example, E*Trade's commissions range from $6.99 to $9.99 per trade based on the number of trades per quarter.[30] E*Trade recently has offered one-hundred free trades to persons opening new accounts.[31] Ameritrade customers can trade unlimited shares at a rate of $10.99 per transaction online.[32] Scottrade boasts of $7 per transaction commissions on its online trading.[33] Fidelity Investments charges a standard commission rate of $19.95 per trade and as low as $8.00 per trade for persons with $1,000,000 in household assets or who perform 120 trades per year and have $25,000 in household assets.[34] Because the commission fees are notably less expensive with online transactions, it is logical to surmise that some level of advise is contemplated for the use of a live broker.

B. Fee-Only:

In a "fee-only" type arrangement the investment professional charges a either a flat annual fee or a flat percentage based on the size of the account and is indifferent to the number

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25 *Id*.
26 *See* Vanguard website, *available at* www.vanguard.com (last visited February 21, 2006).
27 *Id*.
28 *See* Ameriprise Financial website, *available at* www.ameriprise.com (last visited February 21, 2006).
29 *Id*.
30 *See* E*Trade Financial website, *available at* www.etrade.com (last visited December 1, 2005).
31 *Id*.
32 *See* Ameritrade website, *available at* www.ameritrade.com (last visited February 21, 2006).
33 *See* Scottrade website, *available at* www.scottrade.com (last visited February 21, 2006).
34 *See* Fidelity Investments website, *available at* www.fidelity.com (last visited February 21, 2006).

of transactions that occur.[35] Investment advisers normally charge their clients fees in this manner.[36] Ameriprise describes this type of an account as one in which "[y]our Ameriprise financial advisor may charge a flat, fixed fee for your planning services based on your financial goals and advice needs."[37] Charles Schwab offers two fee accounts: (1) "Schwab Portfolios™ with Advised Investing," and (2) "Schwab Advisor Network®."[38] "Schwab Portfolios™" charges 1.25% of the eligible assets in the account and "Schwab Advisor Network®" charges an average of 1% of the assets under management.[39] Thus the fee-only arrangement, unlike a commission arrangement, is indifferent to the quantity of transactions made on an account.

C. Fee-based accounts:

In the case of fee-based accounts, companies either charge both fees and commissions or charge fees and receive other revenue streams that are commission-like.[40] For these account, as in fee-only accounts, the fees are generated based on the amount of assets under management.[41] In fee-based accounts, however, the investment professional receives additional revenue, either from commissions, 12(b)(1) fees or from other revenue sharing arrangements, depending on the products purchased or sold by the client.[42] When major brokerage firms began offering fee-based accounts in 1999, there was some debate as to whether brokers would be regulated under the IAA when servicing such accounts because the charges were based both on commissions and advice-related fees.[43] On April 12, 2005, however, the SEC adopted Rule 202(a)(11)-1, which

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[35] *Id*.
[36] *Id*.
[37] *See* Ameriprise website, *supra* note 28.
[38] *See* Charles Schwab website, *supra* note 23, at http://www.schwab.com/public/schwab/home/advice/advised_investing?cmsid=P-993478&lvl1=home&lvl2=advice&refid=P-1056397&refpid=P-998828 (last visited February 21, 2006).
[39] *Id*.
[40] *See* Yankwitt Interview, *supra* note 18.
[41] *Id*.
[42] *Id*.
[43] *See* Black, *supra* note 15, at 33.

eliminated "no special compensation"[44] as a requirement for exclusion from the statutory definition.[45] Rule 202(a)(11)-1 excludes brokers who use fee-based accounts from the definition of investment advisors. Therefore, brokers remain excluded from IAA provisions when using fee-based accounts.

Several companies currently offer fee-based accounts. Consider, for example, Ameriprise Financial. That company explains that its asset-based fee accounts operate as follows:

> Ameriprise Financial Services also offers other fee-based advisory services available in separate "wrap accounts." Part of the annual asset-based fee for the advice and related services on the assets in the wrap account is paid to your advisor. This fee includes transactional fees and could be ideal for clients who prefer not to pay fees for each transaction like they would in a typical brokerage account.[46]

Thus, Ameriprise and its brokers may enjoy the lower fiduciary duty standards imposed on brokers while offering an investment advisory type account. Charles Schwab also offers two types of fee-based accounts: "Advised Investing Signature," and "Schwab Private Client™."[47] In the descriptions of both accounts, some level of advice is contemplated, yet a footnote is careful to disclose that the accounts are "brokerage accounts." The footnote states:

> These are brokerage services. The Securities and Exchange Commission requires all broker-dealers who give brokerage advice for a fee to make the following disclosure. Accounts enrolled in these services are brokerage accounts and not advisory accounts. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product

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[44] *See* IAA, *supra* note 13.
[45] Rule 202(a)(11)-1, 17 C.F.R. §275.202(a)(11)-1.
[46] *See* Ameriprise Financial website, *supra* note 28.
[47] *See* Charles Schwab website, *supra* note 23, at http://www.schwab.com/public/schwab/home/advice/advised_investing?cmsid=P-993478&lvl1=home&lvl2=advice&refid=P-1056397&refpid=P-998828 (last visited February 21, 2006).

> and over time. Please call us at 888-878-3892 if you have questions about the difference between a brokerage service and an advisory service.[48]

The "Advised Investing Signature" account charges 0.50% on eligible assets, with a $250 quarterly minimum charge.[49] The first 60 equity trades per year will not incur any commission charges.[50] The minimum assets needed to maintain this account is $150,000.[51] The fees incurred in a "Schwab Private Client™" account are a maximum of 0.75% on eligible assets, with a minimum quarterly charge of $1,000.[52] The first 120 equity trades per year will not incur any commission charges.[53] The minimum amount of assets in this account is $500,000.[54]

The fee-based account is a compelling example of the danger of providing preferential tax treatment for brokerage fees. Firms have successfully classified these accounts as brokerage accounts, thereby maintaining a lower fiduciary duty standard. Fee-based accounts, however, resemble investment advisory accounts in that they do not charge fees based on a transactional basis. However, as the Schwab footnote states, brokers are paid by the customers *and* sometimes "by people who compensate us based on what you buy."[55] There is a potential danger that brokers could make recommendations based on more than what is in a customer's best interest. An investor could foreseeably make an investment decision based on preferable tax treatment without considering the potentially harmful fiduciary consequences.[56]

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[48] *Id*.
[49] *Id*.
[50] *Id*.
[51] *Id*.
[52] *Id*.
[53] *Id*.
[54] *Id*.
[55] *See* Schwab, *supra* note 48, and accompanying text.
[56] *See* discussion *infra* Section V.

## III.
## How the Internal Revenue Code Treats Investment Advisory Fees and Brokerage Fees

A. Investment Advisory Fees:

Private investors frequently seek assistance from professionals when making investment decisions. Investment advisors almost always charge their clients fees for services rendered. Generally speaking, investment advisory fees are considered personal expenses and therefore are not deductible under IRC § 262(a).[57] Yet, it will be very difficult for taxpayers to receive a tax benefit in connection with the fees paid for investment advice due to the narrow constraints of the IRC. Therefore, taxpayers must pay nearly all investment advisory fees out-of-pocket and likely are not able to deduct any of these expenses.

As a preliminary matter, a taxpayer will not be concerned about the deductibility of investment advisory fees unless he itemizes his deductions. IRC § 63(e) states in relevant part "[u]nless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year."[58] Once a taxpayer makes an election under IRC § 63(e) to itemize his/her deductions, the analysis turns to whether the fees paid to an investment advisor may be deductible. IRC § 212(2) allows for a deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year…(2) for the management, conservation, or maintenance of property held for the production of income."[59] Treasury Regulation ("Regulation") § 1.212-1(b) defines income for the purposes of § 212 as: "… not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income

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[57] *See* IRC § 262(a).
[58] *Id.*
[59] *Id.*

but applies as well to gains from the disposition of property."[60] Regulation § 1.212-1(g) sets forth an example of a qualifying expenditure:

> [f]ees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.[61]

Case law provides further guidance on what types of expenses may be deducted under § 212. The Tax Court, in *Honodel v. Commissioner*[62] set forth the basic rule that "[f]ees paid for investment counsel and advice concerning existing and future or potential investments have been held to be deductible as 'ordinary and necessary expenses paid or incurred by an individual during the taxable year for the production or collection of income.'"[63] Courts, in determining whether expenses fall under § 212, look to "whether the services were performed in the process of acquisition or for investment advice."[64] Thus fees paid to investment advisors that satisfy the requirements of § 212 may be deductible as a miscellaneous itemized deduction.

Miscellaneous itemized deductions are itemized deductions *other than* those specifically listed under IRC § 67(b).[65] Section 212 deductions are not listed under section 67(b), and thus are classified as miscellaneous itemized deductions. Further Regulation § 1.67-1T(ii) provides an example of an expense that would be classified as a miscellaneous itemized deduction: "[e]xpenses for the production or collection of income for which a deduction is otherwise

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[60] *Id.*
[61] *Id.*
[62] 76 T.C. 351, 364 (1981)
[63] *Id.*
[64] *Id.* at 365.
[65] *See* IRC § 67(b).

allowable under section 212(1) and (2), such as investment advisory fees, subscriptions to investment advisory publications…"[66]

If a taxpayer successfully classifies fees paid to an investment advisor as a miscellaneous itemized deduction under § 212, there is another step in determining whether that expense will be recognized as a deduction. A taxpayer still must comply with IRC § 67's two-percent floor on miscellaneous itemized deductions. As a general rule under IRC § 67(a), "[i]n the case of an individual, the miscellaneous itemized deduction for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2-percent of adjusted gross income."[67] Therefore, a taxpayer may only deduct investment advisory fees to the extent that those fees exceed 2-percent of that taxpayers adjusted gross income.[68]

In summary, a taxpayer may recognize a deduction for expenses that comply with § 212, if (1) those fees exceed 2-percent of the taxpayer's adjusted gross income and (2) the taxpayer makes an election under § 63(e) to itemize his deductions.

**Example I:**

*In 2004 Rhonda (an individual taxpayer) has an adjusted gross income of $100,000 and spends $2,500 on investment advisory fees. Assume Rhonda elects to itemize her deductions.*

Since Rhonda has decided to itemize her deductions[69], the next inquiry is whether the fees she paid to her investment advisor exceed 2-percent of her adjusted gross income.[70] Two-percent of $100,000 is $2,000. The amount that Rhonda spent in excess of $2,000 may be deducted.

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[66] *Id.*
[67] *Id.*
[68] *See William L. Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304 (2005) (holding that even a trust's investment advisory fees are only deductible to the extent that they exceed two-percent of the trust's adjusted gross income).
[69] *See* IRC § 67(e).
[70] *See* IRC § 67(a).

Rhonda spent a total of $2,500 on investment advisory fees. Accordingly, Rhonda is able to deduct $500 from her taxable income. The remaining $2,000 will not be deductible.

B. Brokerage Fees:

Fees that investors pay in connection with acquiring or disposing of securities (brokerage fees) are treated, for tax purposes, entirely differently than investment advisory fees. Brokerage fees will result in a basis adjustment to a taxpayer's security regardless of his adjusted gross income or whether the taxpayer elects to itemize his deductions. Brokerage fees receive a favorable tax treatment when compared to investment advisory fees.

The Tax Court in *Honodel* stated: "expenditures that are capital in nature are not deductible under § 212 because such expenditures fail to satisfy the 'ordinary and necessary' requirement of that section."[71] Regulation § 1.212-1(n) states: "[c]apital expenditures are not allowable as nontrade or nonbusiness expenses…where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212."[72] IRC § 263 ("Capital expenditures") states, "[n]o deduction shall be allowed for—(1) any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[73] Regulation § 1.263(a)-2(e) lists two examples of capital expenditures: "[c]omissions paid in purchasing securities [and] [c]omissions paid in selling securities.."[74] The Supreme Court in *Woodward v. Commissioner* further summarized the law concerning capital expenditures as follows: "[i]t has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most

[71] *See Honodel*, *supra* note 62, at 364. (*citing* Regulation § 1.212-1(n) and *Woodward v. Commissioner,* 397 U.S. 572, 575 (1970)).
[72] *Id.*
[73] *Id.*
[74] *Id*.

familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities…"[75] Thus, brokerage fees (if paid in the acquisition or disposition of securities) will be classified as capital expenditures.

Once an expense is properly classified as a capital expenditure under § 263, the basis in the capital asset (in this case the security) may be adjusted accordingly. IRC § 1016(a) provides the general rule that, "[p]roper adjustment in respect of the property shall in all cases be made…for expenditures, receipts, losses, or other items, properly chargeable to capital account…"[76] Thus, brokerage fees associated with the purchase or sale of securities may be offset against the purchase or sale price of stock to decrease a capital gain or increase a capital loss.[77]

**Example II:**

*Tom is a private investor who files his tax return as an individual taxpayer with an adjusted gross income of $80,000. Tom purchased one share of a stock ("Security X") in 1999 for $100, and paid his broker $5 to execute the purchase. Tom sells Security X in 2004 for $200, and pays his broker $5 to execute the sale.*

Tom can increase his basis in Security X to the extent of $10 ($5 brokerage fee for purchasing the stock plus $5 brokerage fee for selling the stock) , leaving him with an adjusted basis of $110 in Security X. Tom sold Security X for $200, so his total capital gain is $90 ($200 minus $110). Tom, in effect, has reduced his overall tax liability by $10, having properly adjusted his basis in Security X by the amount he paid in brokerage fees.

**Example III:**

*Same facts as "Example II," except in addition to brokerage fees, Tom also pays $20 to his investment advisor in 2004.*

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[75] *See Woodward, supra* note 71, at 575-576 (*citing* Regulation § 1.263(a)-2(e) and *Helvering v. Winmill,* 305 U.S. 79 (1938)).
[76] *Id.*
[77] *See* Regulation § 1.263(a)-2(e).

For the reasons set forth in "Example II," Tom would be permitted to increase his basis in Security X to the extent of $10. Tom's investment advisory fees, however, would not be deductible. Two-percent of Tom's adjusted gross income is $1,600 (80,000 * .02). Tom only spent $20 on investment advisory fees, which is below the 2-percent floor of $1,600. Pursuant to IRC § 67(a), Tom may only deduct investment advisory fees to the extent that they exceed 2-percent of his adjusted gross income. Thus, Tom's investment advisory fees are not deductible.

C. Summary:

When determining the tax treatment of fees associated with securities investments, a taxpayer should look to "whether the services were performed in the process of acquisition or for investment advice."[78] The taxpayer may be able to deduct investment advisory fees (if related to investment advice), but only if the taxpayer itemizes his deductions and only to the extent that the fees exceed 2-percent of the taxpayer's adjusted gross income. With regards to brokerage fees, however, a taxpayer may use those fees as an offset against the selling or purchasing price of the security, without regard to the 2-percent floor or whether the taxpayer itemizes his deductions.

## IV.
## Legislative History

It is no secret that provisions in the IRC influence taxpayers' conduct. Tax legislation may be motivated explicitly by lawmakers' desire to encourage or discourage certain behavior by taxpayers. Some times certain language inadvertently promotes or discourages conduct by taxpayers. This section will examine the congressional intent behind the enactment of the relevant IRC provisions discussed in this paper.

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[78] *See Honodel*, *supra* note 62, at 365.

IRC §212 was originally enacted as the Internal Revenue Act ("IRA") of 1939 as section 23(a)(2).[79] No substantive changes were made when the Code number was changed to §212 in the IRA of 1954.[80] In the 1954 Code, § 212, provided that an individual who has elected to itemize his deductions shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income, (2) for the management, conservation, or maintenance of property held for the production of income, or, (3) in connection with the determination, collection or refund of any tax.[81] Thus, from 1954 through 1986 a taxpayer could deduct investment advisory fees as long as he itemized his deductions, unlike current law where fees must exceed § 67's two-percent floor in order to be deductible.

Regulation 1.263(a)-2, the provision dealing with examples of capital expenditures, was promulgated on November 26, 1960. Yet, even prior to the Regulation, courts consistently had held that brokerage commissions were a proper adjustment to basis.[82] Thus, § 1.263(a)-2 was a mere codification of prior case law and practice.

The most significant legislative action came by way of the Internal Revenue Code of 1986 (the "1986 Code"). One of the apparent goals of the 1986 Code was to simplify the prior tax laws. The Committee on Ways and Means in the House of Representatives wrote: "The committee believes that, where possible, the tax system should be made more simple. The complexity of the current tax system exacts a cost of time, effort, and burdensome recordkeeping. To some extent, this complexity is necessary to assess accurately one's ability to

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[79] *See* 1 INTERNAL REVENUE ACTS OF THE UNITED STATES: THE REVENUE ACT OF 1954 WITH LEGISLATIVE HISTORIES AND CONGRESSIONAL DOCUMENTS A59 (Bernard D. Reams, Jr. ed. 1982).
[80] *Id*.
[81] *Id*.
[82] *See Helvering v. Wilmington Trust Co.*, 305 U.S. 79 (1938).

pay taxes…for the majority of taxpayers, however, the tax system need not be complex. "[83] The Committee continued by offering, what it believed to be, two major simplifications:

> Perhaps the most important steps taken by the committee bill to reduce the complexity found by many taxpayers are the significant increase in the standard deduction and the imposition of a floor under itemized deductions. Due to these changes, an estimated 13 million taxpayers who presently file itemized returns are expected to file nonitemized returns, which is a 30 percent reduction in the number of itemized returns. These taxpayers will be freed from the need for recordkeeping for many incidental expenditures.[84]

The law prior to the 1986 code was that a taxpayer could deduct investment advisory fees from his ordinary income as long as he itemized his deductions. Several proposals were presented to significantly restrict this deduction when the 1986 code was enacted. Under the House bill, the total of the taxpayer's miscellaneous itemized deductions would be allowable only to the extent exceeding *one percent* of the taxpayer's adjusted gross income.[85] The Senate Amendment suggested repealing all miscellaneous itemized deductions that were allowable under then-current law, with the exception of eight deductions (investment advisory fees did not fall within the exception).[86] Thus, the Senate proposed to completely disallow an investment advisory fee deduction. Finally, President Reagan's proposal was as follows: "[t]he miscellaneous itemized deductions would be moved 'above-the-line' (i.e., would also be deductible by nonitemizers), and allowed only to the extent that, when aggregated with the employee expenses described below, they exceeded one percent of the taxpayer's adjusted gross income (AGI)."[87] The

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[83] *See* H.R. REP. NO. 99-426, at 58 (1985).
[84] *Id*.
[85] *See* 1986 U.S.C.C. & A.N. 4118, at II-33 (1986).
[86] *Id*.
[87] *See* JCS-44-85, at 10 (1985).

final negotiated version of the bill subjected miscellaneous itemized deductions to a floor of two percent of the taxpayer's adjust gross income.[88]

Prior to the passage of the 1986 Code, the Joint Committee on Taxation wrestled with the issue of whether to impose a floor on miscellaneous itemized deductions.[89] The Committee recognized competing policy considerations in imposing such a floor.[90] The policy in favor of enacting a floor was as follows:

> In one sense, the use of a deduction floor fosters simplicity. It relieves taxpayers of the need to keep records substantiating incidental expenses unless they have reason to expect that their allowable deductions may exceed the floor. It also relieves the Internal Revenue Service of the need to audit and verify deductions claimed for numerous small items. The Administration proposal is based on the view that this problem is particularly significant in the case of miscellaneous deductions, and that taxpayers make numerous errors of law regarding allowable deductions in the miscellaneous category.[91]

Clearly an objective of the Committee was to simplify the tax laws and reduce potential errors that taxpayers would make in calculating their tax liability. The Committee also acknowledged the potential inequity of a floor on miscellaneous itemized deductions:

> On the other hand, to the extent a deduction that ought in theory to be allowable in full is restricted by the use of a floor, the floor is arguably unfair. It penalizes taxpayers who have deductions that are subject to the floor, in comparison to other taxpayers, by depriving them at least in part of a deduction that may be important to the accurate measurement of income. For example, a taxpayer who earned $1,000 in a stock transaction, but paid a broker $500 to manage his assets, would not be able to deduct the fee if his or her total miscellaneous deductions equaled less than one percent of adjusted gross income. Taxpayers with miscellaneous deductions might not object to the burden of keeping accurate records if the result were to reduce their tax liabilities.[92]

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[88] *See* 1986 U.S.C.C. & A.N. 4118, at II-33 (1986).
[89] *See generally* JCS-36-85 (1985).
[90] *Id* at 206
[91] *Id*.
[92] *Id*.

The Committee's contemplation of situations where taxpayers would be deprived of a deduction demonstrates a clear recognition that the imposition of a floor would be unfair to some taxpayers.

The Committee also considered the implications of classifying miscellaneous deductions as "above-the-line" or "below-the-line" deductions:

> First, there may be a policy decision that all taxpayers should be allowed to benefit from the deduction. However, it is not necessarily clear why this concern should be more applicable to miscellaneous deductions than, for example, to deductions for home mortgage or consumer interest, casualty losses, or medical expenses. Further, nonitemizers benefit from the allowance of deductions that can be claimed only by itemizers, since the zero bracket amount is intended to reflect such expenditures typically made by nonitemizers.
>
> Second, as a matter of tax policy there is a general distinction between above-the-line and itemized deductions, although many deductions may be allocated inconsistently with this theoretical distinction. In principle, a deduction is allowed above-the-line if, as an expense of generating income, it must be subtracted from gross income in order to arrive at an accurate measurement of the taxpayer's true net income. By contrast, itemized deductions generally are considered to reflect personal expenditures which, although not properly deductible in measuring economic income, are allowed for reasons of social policy…
>
> However, in view of the fact that the Administration proposal generally keeps other itemized deductions below-the-line, the proposal to move miscellaneous deductions above-the-line may instead be based on the view that they are properly allowable in calculating economic income—a view theoretically inconsistent with the decision to allow them only to the extent in excess of a floor, although arguably supportable for simplification purposes.[93]

Applying the principles that the Committee set forth for classifying deductions as "above-the-line" or "below-the-line" it would seem that investment advisory fees are more like expenses of generating income as opposed to personal expenditures. Once again, however, it seems as though simplicity trumped that rationale.

[93] *Id*. at 207.

Judging by the legislative debates and the differing proposals from the House of Representatives, Senate and President Reagan, it is apparent that the legislative focus was principally centered around simplifying the tax code by means of reducing the number of itemizing taxpayers. Unfortunately, Congress did not indicate any concern over the fiduciary duties of investment professionals and the fact that the 1986 Code would favor the use of brokers rather than investment advisors. The next section will examine the fiduciary duty implications applicable to investment professionals since Congress ignored this important issue in enacting the 1986 Code.

## V.
## Fiduciary Duties of Investment Advisors and Brokers

Investment advisors are regulated by the SEC and brokers are regulated by the NASD.[94] Although these terms are sometimes used synonymously, their roles with clients and fiduciary duty standards are very different.[95] As Professor Jill Gross has explained, "[o]n the spectrum of advisors, brokers are the least accountable to investors."[96] That being said, there are well-defined duties that brokers and investment advisors owe to their respective clients.

A. Duties Owed by Brokers:

The degree of duty owed by brokers depends on the relationship between the broker and his client. "It is settled law, however, that brokers are not liable for their customers losses unless they made an unsuitable recommendation, exercised control over the account, or made a material misstatement of fact. A broker can stand by even if he knows that the customer is engaged in an

[94] *See supra* note 11 and accompanying text.
[95] *See* Black *supra* note 15, at 35 (Professor Black argues that investors are often confused about the roles and responsibilities of the various financial services professionals).
[96] *See* Starkman, *supra* note 10 (quoting Professor Gross, Associate Professor of Law, Pace University School of Law; and co-director of Pace Law's Securities Arbitration Clinic).

unsuitably risky investment strategy without an understanding of the risks involved."[97] The important concept here is that a brokers relationship with his customer is not generally considered a fiduciary one, "unless the broker exercises investment discretion over the customer's account."[98] The following subsections will set forth specific duties that brokers owe to their clients.

i. Suitability:

Brokers have a duty to recommend only those securities that they reasonably believe are suitable for the customer, based on information disclosed by the customer about his other security holdings, his financial status, and his investment objectives.[99] NASD Rule 2310(a) states: "(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[100] Paragraph (b) goes on to provide that *prior to* the execution of a transaction recommended to a non-institutional customer, brokers should make reasonable efforts to obtain information concerning the customers: (1) financial status; (2) tax status; (3) investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[101]

ii. Churning:

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[97] Barbara Black and Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. Pitt. L. Rev. 483, 486.
[98] *See* Black, *supra* note 15, at 36.
[99] *See* Black and Gross, *supra* note 97, at 490.
[100] *See* NASD Conduct Rule 2310, NASD Manual (CCH) 4111 (1998) ["NASD Manual"], *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466 (last visited February 21, 2006).
[101] *Id.*

If a broker exercises control over his customer's account, excessive trading or churning may occur. The SEC describes churning on its website as, "excessive buying and selling in your account by your broker. For churning to occur, your broker must exercise control over the investment decisions in your account, either through formal written discretionary agreement or otherwise, and must engage in excessive trading in light of the financial resources and character of the account for purpose of generating commissions."[102] As can be surmised from the SEC definition, churning can occur whether a broker has actual authority to make investment decisions or de facto authority.[103]

NASD Conduct Rule 2310-2(b)(2) prohibits excessive trading or churning,[104] but recognizes that there is not a bright-line rule to determine what constitutes excessive trading: "[t]here are no specific standards to measure excessiveness of activity in customer accounts because this must be related to the objectives and financial situation of the customer involved."[105] With regards to discretionary accounts, NASD Conduct Rule 2510(a) states, "[n]o member shall effect with or for any customer's account in respect to which such member or his agents or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account."[106]

The New York Stock Exchange[107] ("NYSE") also has a churning rule which provides: "No member or allied member or employee of a member organization exercising discretionary power in any customer's account shall (an no member organization shall permit any member,

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[102] *See* SEC website, *supra note* 11, at http://www.sec.gov/answers/churning.htm (last visited February 21, 2006).
[103] *See also* Black and Gross, *supra* note 97.
[104] NASD views churning as a violation of a brokers duty of fair dealing.
[105] *See* NASD Conduct Rule 2310-2, NASD Manual, *supra* note 100.
[106] *See* NASD Manual, *supra* note 100, at Conduct Rule 2510(a).
[107] The NYSE regulates brokers who are authorized to trade on its exchange.

allied member, or employee thereof exercising discretionary power in any customer's account to) effect purchases or sales of securities which are excessive in size or frequency in view of the financial resources of such customer."[108] Thus, if a broker exercises control over his client's account, he has a duty to refrain from excessively trading or churning the account.

iii. Material Misrepresentations:

Brokers may be liable for fraud or negligence if a client seeks their advice about selling or holding a security, and the broker provides false or misleading information.[109] Federal securities laws provide guidance on the standard of conduct that brokers owe to their clients with regards to disclosure of information. Section 17(a) of the SEA of 1933, makes it unlawful for any person, by the use of the mails or interstate commerce, "in the offer or sale of any securities: (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any transaction, practice, or course of business that operates or would operate as a fraud or deceit upon the purchaser."[110] Section 17(a) does not apply to purchases of securities. An individual is a seller under Section 17(a) even though he does not own the security being sold, so long as: (1) he solicits the transaction and (2) his solicitation is motivated by personal financial gain.[111] The second prong is satisfied if the person anticipates a share of the profits, even though he may not receive a salary or a commission for his selling efforts.[112]

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108 *See* NYSE Rule 408(c), *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_1&manual=/nyse/nyse_rules/nyse-rules/ (last visited on February 21, 2006).
109 *See* Black, *supra* note 15, at 36.
110 SEA of 1933 §17(a), 15 U.S.C. §77q.
111 Norman S. Poser, *Broker-Dealer Law and Regulation*, 3rd Ed. (supplemented 2005), §3.01[B].
112 *Id.*, *citing Meadows v. Securities and Exch. Commn.,* 119 F.3d 1219, 1225-1226 (5th Cir. 1997).

In addition, Section 9(a)(4) of the SEA Act of 1934 provides guidance on false or misleading statements. Section 9(a)(4) makes it unlawful for any dealer or broker "to make, regarding any security registered on a national securities exchange, for the purposes of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable grounds to believe was so false or misleading."[113] Section 9(a)(4), unlike Section 17(a), applies to both fraudulent purchases and sales.[114] However, the scope of 9(a)(4) is narrower than Section 17(a) in that: (1) it applies only to exchange-listed securities; (2) it prohibits fraudulent misstatements but not omissions; (3) it requires that the broker have the specific purpose of inducing the purchase or sale of the security; and (4) it expressly requires that the broker know or have reason to know of the falsity of the statement.[115]

<u>B. Fiduciary Duties Owed by Investment Advisors</u>:

In stark contrast to the duties owed by brokers, investment advisors are held to a fiduciary duty standard—regardless of the degree of control investment advisors exercise over a client's account. The principal that investment advisors owe their clients a fiduciary duty is not expressly mandated by the IAA, but in *SEC v. Capital Gains Research Bureau, Inc.*,[116] the United States Supreme Court held that Section 206 of the Act imposes fiduciary duties on investment advisors by operation of law.[117] Section 206 of the IAA states, in relevant part, "[i]t shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of

[113] SEA of 1934 §9(a)(4), 15 U.S.C. §78i(a)(4).
[114] *See* Poser, *supra* note 111.
[115] *Id.*
[116] 375 U.S. 180, 191 (1963).
[117] *Investment Advisors: Law & Compliance*, Matthew Bender & Company, Inc. (2005), §9.02.

business which operates as a fraud or deceit upon any client or prospective client."[118] An investment advisor may violate Section 206(2) if he fails to act with "the utmost good faith" with respect to his clients, and or fails to satisfy its affirmative duty to disclose all material facts and conflicts of interest.[119] In general there are three main fiduciary duties which are enforceable under IAA §206: (1) disclosure; (2) best interests of clients; and (3) fairness.[120]

*Disclosure.* The first fiduciary duty, of disclosure, requires investment advisors to disclose all material facts about the advisory relationship.[121] The standard for materiality is: whether there is a substantial likelihood that a reasonable client would attach importance to it.[122]

*Acting in Client's Best Interests*. Investment advisors also has a duty to act only in the best interests of its clients, which requires that the advisor place his clients interests above his own interests when a conflict arises.[123] If a conflict may be present, the investment advisor must disclose the existence of any conflict and obtain his client's consent to the applicable agreement.[124] Courts and the SEC have placed a great deal of emphasis on the duty to disclose all material conflicts of interest.[125]

*Fairness*. An investment advisor also has a fiduciary duty to treat each client fairly.[126] What this fiduciary duty requires is that the investment advisor make certain that he does not benefit one client to the disadvantage of another.[127]

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[118] 15 U.S.C. §80b-6.
[119] *See SEC v. Capital Gains*, *supra* note 116 at 192; and *Investment Advisors*, *supra* note 117.
[120] *See Investment Advisors, supra* note 117.
[121] *Id*.
[122] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1987); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
[123] *See Investment Advisors, supra* note 117.
[124] *Id.*
[125] *Id.*
[126] *Id*.
[127] *Id.*

*Duty of Care*. The SEC has also has read an implied duty of care into Section 206.[128] Investment advisors must exercise due care when recommending securities, however, this duty does not extend to the eventual success or failure of his recommendations.[129] It is currently unclear how thoroughly an investment advisor must investigate the securities he recommends.[130] Investment advisors are required to familiarize themselves with the facts which provide the basis for their recommendations and verify them if the source of the information has a substantial interest in the security in question.[131] Courts have held investment advisers liable for failing to disclose they were relying on third-party analysis, especially when the accuracy and comprehensiveness of the information was in question.[132]

*Suitability*. Investment advisers also have an implicit duty under the IAA, to provide only suitable investment advice to their clients.[133] The suitability doctrine has arisen predominantly from SEC enforcement actions. A typical situation is where the client's circumstances called for conservative or low-risk investments or when the adviser represented that the investments would be low risk.[134] Other cases have involved aggravating factors, such as the investment in securities of the advisor or its affiliates, or the use of margin.[135] The SEC has articulated policy statements regarding suitability obligations of investment advisors and the steps which advisers should take in satisfying those obligations.[136]

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[128] *Id*.
[129] *Id*. *citing, Jones Mem'l Trust v. Tsai Inv. Servs., Inc.,* 367 F. Supp. 491, 497, 500 (S.D.N.Y. 1973) (standing for the idea that duty of care does not oblige an advisor to "prevent any decline in the client's portfolio").
[130] *Id*.
[131] *Id*.
[132] *Id.; See also, People v. Goldsmith,* 86 N.Y.S.2d 12 (1948) (adviser concealed a material fact by failing to disclose that his market letter was based not on recognized sources, but on comic strips).
[133] *Id*. at §9.03.
[134] *Id*.
[135] *Id*.
[136] *Id*.

## VI.
## Policy Considerations

In light of the preferable tax treatment of brokerage fees as compared with investment advisory fees, the higher standard of fiduciary duties owed by investment advisors versus brokers, and Congress' failure to consider the implications of favorable tax treatment for brokerage fees, Congress should revisit the issue. Specifically, the law should be changed to level the playing field by allowing a basis adjustment for investment advisory fees or grant preferential treatment to those fees.

Because of the tax law's impact on taxpayer behavior, it is critical that the tax laws do not provide incentives to retain financial services providers who have limited fiduciary duties to their clients. For some investors, brokers may be the most optimal investment professional if that investor simply needs a transaction executed. Other investors may be best suited to hire investment advisors to manage their accounts. Congress should be concerned with the class of investors who are unaware of the differences between brokers and investment advisors.[137] With a tax policy that favors brokers, the investor motivated by tax concerns conceivably could choose brokerage services without knowledge of the fiduciary consequences. If an investor is uncertain on which type of account to open, the tax law should not favor of a brokerage accounts due to the provisions in the IRC.

There is also a danger that financial services providers will encourage investors to open brokerage accounts because it translates into lower fiduciary obligations on the part of the companies. Vanguard's website, for example, provides information on how cost basis is calculated: "[y]our cost basis is generally the price you paid for your shares. Make sure you include reinvested dividends or capital gains distributions as part of your cost basis, since these

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[137] *See* Black, *supra* note 15, at 35.

are considered purchases or shares. Sales charges or transaction fees you paid when you bought your shares are also part of your cost basis. (Other fees charged by a mutual fund, such as account maintenance fees, don't affect your cost basis)."[138] While Vanguard is not explicitly stating that investors should open brokerage accounts, the website does note an advantage in incurring brokerage fees as opposed to account maintenance fees. Further, account representatives could potentially mention to investors that their commissions will be added to the security's basis, and therefore will not be as costly as investment advisory fees. The savvy investor likely will understand the differing fiduciary relationships of brokers and investment advisors, but those investors will also be better prepared to recognize potentially fraudulent activity and account irregularities. Less sophisticated investors, however, are not likely to understand the fiduciary relationships of various investment advisors and may not be able to identify misconduct.

Understandably, one of Congress' goals in enacting the 1986 Code was simplicity.[139] Simplicity should not, however, come before protecting investors from fraudulent conduct. Even assuming, *arguendo*, that the IRS has valid reasoning for providing preferential tax treatment for brokerage fees versus investment advisory fees, the fiduciary duty issues cannot be ignored. It is relatively simple and sensible to adjust a security's basis for acquisition or disposition costs (brokerage fees). Because investment advisory accounts are usually geared towards maintenance and management, it may be difficult and impractical to allow a basis adjustment for those types of fees. In attempting to simplify the Code, Congress failed to consider the implications of heavily favoring brokers fees over investment advisory fees. Congress should completely

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[138] *See* http://flags hip2. vanguard.com/VGApp/hnw/content/ PlanEdu/ General/PEdGPTaxSav CalcCostBasisContent.jsp (last visited February 21, 2006).

[139] Whether or not that was achieved is a matter of significant academic question.

reverse its position and encourage the use of investment advisors as opposed to brokers. The next section will propose ways Congress could rectify this inequity.

## VII.
## Proposed Revisions to the Internal Revenue Code

Having set forth the basic premise that the IRC improperly provides favorable tax treatment to brokerage fees, this section will propose some alternatives to the IRC's current provisions.

One idea would be to disallow basis adjustments for brokerage fees. This approach would certainly be met with a great deal of opposition, especially considering the drastic consequence this provision would have on taxpayers' capital gains. Further, brokerage firms would no longer be able to tell their clients that commissions would be a proper basis adjustment. From a fairness standpoint, it seems counter-intuitive to repeal a long-standing rule that brokers commissions are a proper basis adjustments. Thus, instead of altering the treatment of brokerage fees, it is likely more advantageous to address alternatives to the current IRC provisions dealing with investment advisory fees.

Congress could revise the tax laws to allow a basis adjustment for investment advisory fees, thereby granting equal treatment for the both types of fees. That proposal would be logically sound because investment advisory fees are incurred in managing capital assets (securities), and should therefore be proper adjustments to basis. Further, it would place investment advisory fees on the same footing as brokerage fees and would eliminate the preferential treatment of brokerage fees.

Another idea would be to treat investment advisory fees as itemized deductions, instead of miscellaneous itemized deductions—thereby eliminating the two-percent floor requirement of IRC § 67(a). It is doubtful that this revision would be codified because it would significantly decrease the adjusted gross incomes of taxpayers who use investment advisors. From a policy standpoint, however, this revision would encourage taxpayers to seek investment professionals who owe them a higher level of fiduciary duty. Further with the heightened fiduciary duties, there may be a decline in securities disputes; or alternately, investors will have an easier time recovering monies lost from unscrupulous behavior.

A less desirable alternative would be to decrease the floor to one-percent of a taxpayer's adjusted gross income, as the House of Representatives proposed for the 1986 Code.[140] With a lower floor, taxpayers would be more likely to get some tax advantage from using investment advisors. Even so, the disparity with regards to brokers' fees would still be significant considering there is a proper basis adjustment without regard of a taxpayer's decision to itemize his deductions nor his adjusted gross income.

Finally, Congress could revert back to President Reagan's proposal[141] of imposing a floor on investment advisory fees, but categorizing those deductions as "above-the-line" deductions—thereby eliminating the need to itemize deductions in order to recognize such tax benefit. Again, an imposition of a floor would prejudice those taxpayers whose investment advisory fees do not exceed the floor.

Optimally tax laws should be rewritten to grant preferential treatment to investment advisory fees. However, the most practical and reasonable revision would be to treat investment advisory fees as proper adjustments to basis. Since Congress was concerned with simplicity in the tax laws, this proposal would be consistent with that strong policy consideration. Recognizing investment advisory fees as proper basis adjustments would arguably be simpler than the current tax law because it would eliminate taxpayers' need to calculate the two-percent

[140] *See supra* note 84 and accompanying text.
[141] *See supra* note 87 and accompanying text.

floor and to decide whether to itemize their deductions. Further, this revision would provide an element of consistency in the tax treatment of investment advisory and brokerage fees. Eliminating the preferential treatment of brokerage fees would have a positive impact on the securities industry by accounting for the fiduciary duty implications of brokers versus investment advisors.

## VIII. Conclusion

Due to the volume of Americans investing in securities markets,[142] there needs to be as much protection as possible to prevent misconduct. While the primary burden for protecting investors rests on the SEC, tax laws could be an important source of aid. The current tax law is seriously flawed in that it provides a considerable motivation for taxpayers to retain brokers rather than investment advisors to manage their investment accounts. Brokers are required to meet a level of fiduciary duty that is significantly lower than that of investment advisors, yet brokerage fees are granted preferential tax treatment. At a minimum, the IRC should be modified to treat investment advisory fees and brokerage fees equally as proper adjustments to basis. A better alternative would be to amend the IRC to grant preferable tax treatment for investment advisory fees. Investors deserve investment professionals who are held to a high level of fiduciary duty; Congress should revise the tax laws with this in mind.

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[142] *See* Wilkins, *supra* note 2.