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ADMINISTRATIVE EXPENSES OF TRUSTS: WHAT DID CONGRESS MEAN?

I. INTRODUCTION

When the United States Supreme Court recently decided *Knight v. Commissioner*,[1] it resolved an issue that has divided Circuit Courts of Appeal[2]: should the investment advisory fees incurred by trusts and estates receive preferential treatment as compared to the same fees incurred by individuals? The Court answered, generally, no.[3] The issue turns on the interpretation of § 67 of the Internal Revenue Code.[4] Section 67(a) imposes a general restriction on "miscellaneous itemized deductions," a category that includes investment advisory fees incurred by individuals.[5] The amount of such deductions is reduced by two percent of adjusted gross income.[6] Section 67 generally treats trusts and estates the same as individuals in computing adjusted gross income,[7] such that investment advisory fees are not generally deductible unless they exceed the two-percent floor. However, § 67(e)(1) creates an exception for expenses paid or incurred in connection with the administration of a trust or estate that "would not have been incurred if the property were not held in such trust or estate."[8] The interpretation of this exception is particularly important to large trusts that incur sizeable investment advisory fees, and hence, the exception has generated significant commentary among estate planners. A number of courts have litigated the issue, with Circuit Courts of Appeal being divided both in result and analysis.

This Note examines the Court's decision in light of the taxpayer's arguments and the government's arguments regarding the interpretation of § 67(e). Part II explains the statutory scheme. Part III discusses in depth the background of § 67(e), Congress's general goals when enacting the statute, and the proposed interpretations of congressional intent. Part IV examines the proposed interpretations of the statute and the approach adopted by the Supreme Court. Part

1. 128 S. Ct. 782 (2008). For purposes of clarity, this Note will refer to the instant case as *Knight v. Commissioner* (or some conspicuous variation thereof) as this was the caption of the case just decided. However, while en route to the Supreme Court, the case was captioned as *William L. Rudkin Testamentary Trust v. Commissioner*. 467 F.3d 149 (2d Cir. 2006). At times this Note will refer to the lower court's treatment of the case, yet in the text, this Note will continue to refer to the case as *Knight v. Commissioner*.

2. *See infra* notes 59–64 and accompanying text.

3. *See Knight*, 128 S. Ct. at 791.

4. I.R.C. § 67 (2000).

5. *See id.* § 212 (providing a deduction for expenses incurred "for the management, conservation, or maintenance of property held for the production of income," which includes fees incurred for investment advice); *id.* § 67(b) (providing that deductions under § 212 are miscellaneous itemized deductions).

6. I.R.C. § 67(a).

7. *Id.* § 67(e).

8. *Id.* § 67(e)(1).

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V examines the practical ramifications of the Supreme Court's interpretation of the statute, considering the nature of the trust and the effect of the issue on the field of estate planning. Part VI briefly outlines the relevant portions of the proposed regulations addressing the issue. Part VII examines some interesting issues raised in the opinion. Finally, Part VIII concludes, arguing that the Court's interpretation was the only reasonable resolution.

II. THE STATUTORY SCHEME

The first step in calculating "taxable income" is to determine "gross income," which is broadly defined as "all income from whatever source derived."[9] Certain "above-the-line deductions" are taken from gross income in arriving at "adjusted gross income."[10] From adjusted gross income, the taxpayer may take "below-the-line deductions," termed "itemized deductions," which are those deductions authorized by the Code but not listed in § 62(a) as above-the-line deductions.[11] Section 67 of the Internal Revenue Code places a two-percent floor on what is termed "miscellaneous itemized deductions."[12] Miscellaneous itemized deductions include all itemized deductions other than those items specifically listed in § 67(b)—such as interest expenses, casualty or theft losses, charitable contributions and gifts, and medical expenses.[13] Under this section, deductions for these items are "allowed only to the extent that the aggregate of such deductions exceeds [two] percent of adjusted gross income."[14]

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9. *Id.* § 61(a).

10. *Id.* § 62(a).

11. *Id.* § 63(d) ("For purposes of this subtitle, the term 'itemized deductions' means the deductions allowable under this chapter other than—(1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by [§] 151.").

12. *See id.* § 67. Section 67 provides,

> (a) General rule
>
> In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds [two] percent of adjusted gross income.
>
> . . . .
>
> (e) Determination of adjusted gross income in case of estates and trusts
>
> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—
>
> (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income.

Id. § 67(a), (e).

13. *Id.* § 67(b).

14. *Id.* § 67(a).

An even larger obstacle to taking a miscellaneous itemized deduction than the two-percent floor is the alternative minimum tax (AMT).[15] The AMT disallows miscellaneous itemized deductions listed in § 67(b) in their entirety.[16] Therefore, taxpayers whose tax liability is calculated under the AMT will not be able to deduct *any* investment advisory fees, regardless of whether they exceed two percent of adjusted gross income.

In computing an individual's adjusted gross income, expenses incurred for investment advisory fees are deductible under § 212.[17] Because these fees are miscellaneous itemized deductions, they are subject to the two-percent floor. These fees are also completely disallowed for AMT purposes. Section 67(e), in general, requires that income of a trust or estate be taxed in the same manner as an individual. Therefore, it follows naturally that all expenses related to the estate that fall outside of the list in § 67(b), including investment advisory fees, are limited by the two-percent floor and are disallowed under the AMT. However, § 67(e)(1) provides an exception for trusts and estates: The two-percent floor does not apply to expenses "incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate."[18] The interpretation of the second prong of this exception—what constitutes expenses "which would not have been incurred if the property were not held in such trust or estate"[19]—has been the subject of substantial debate. The Court's decision addressed this issue in the context of investment advisory fees.[20]

II. BACKGROUND OF § 67(e)

A. Purpose of the Two-Percent Floor

Although legislative history indicates Congress's objectives in imposing the floor on miscellaneous itemized deductions, there is ultimately no justifiable purpose apart from raising revenue. Congress imposed the two-percent floor on itemized deductions for the purpose of limiting personal deductions.[21] Congress

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15. A trust must calculate its tax liability under the regular tax and the alternative minimum tax (AMT) and pay whichever tax is higher. The AMT imposes a flat twenty-six percent tax rate on a trust's income between $22,500 and $175,000, and imposes a twenty-eight percent tax rate on the taxable excess that exceeds $175,000. *See id.* § 55(d)(1)(C) (providing a $22,500 exemption amount for trusts); *id.* § 55(b)(1)(A)(i) (providing the tax brackets under the AMT).

16. *Id.* § 56(b)(1)(A)(l) (disallowing any miscellaneous itemized deductions, as defined under § 67(b), for purposes of computing tax liability under the AMT).

17. *See id.* § 212. Section 212 provides a deduction for ordinary and necessary expenses incurred "(1) for the production or collection of income; [and] (2) for the management, conservation, or maintenance of property held for the production of income." *Id.*

18. *Id.* § 67(e)(1).

19. *Id.*

20. *See* Knight v. Comm'r, 128 S. Ct. 782, 785 (2008).

21. *See* S. REP. NO. 99-313, at 78–79 (1986), *reprinted in* 1986-3 C.B. 3 ("[S]ome miscellaneous expenses allowable under present law are sufficiently personal in nature that they would have been incurred apart from any business or investment activities of the taxpayer.").

observed that individuals erroneously deducted more than was allowed for these itemized deductions.[22] For example,

> [c]ommon taxpayer errors have included disregarding the restrictions on home office deductions, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscriptions to widely read publications outlining business information without a sufficient business or investment purpose.[23]

Furthermore, allowing the itemized deductions imposed extensive recordkeeping duties.[24] The report noted, "Since many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the Congress concluded that the complexity created by prior law was undesirable."[25] However, § 67 does not further this purpose. In order to reduce the record-keeping burden on taxpayers, Congress simply capped that deduction. This is no benefit to taxpayers who still have to keep records of deductible transactions in order to determine whether they exceed two percent of adjusted gross income and, if so, by how much. The only solution to eliminating the record-keeping burden is to eliminate the deduction.

The original House and Senate versions of the bill did not include the second prong in § 67(e)(1), so the original version only limited deductions of costs which were not "paid or incurred in connection with administration of the estate or trust."[26] The language in the second prong was not added until later in the legislative process.[27] During oral argument in *Knight*, Justice Ginsburg asked Mr. Miller, counsel for the government, whether it is appropriate to limit the effect of the second prong so as to allow more taxpayers to fall within the exception, because it was added at the very last minute.[28] Mr. Miller responded by stating that the clause must be given full effect regardless of the timing.[29] In the *Knight* opinion,

22. *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (1987) [hereinafter JOINT COMMITTEE]. This problem is particularly characteristic of problems arising with individual income tax deductions rather than deductions for costs incurred by a fiduciary of an estate or trust. *See id.* For example, a person may deduct the expense of business journals and newspapers as an investment management expense when, in actuality, this literature was purchased for the individual's personal enjoyment. This is unlikely to occur in the context of trusts or estates.

23. *Id.* at 78 n.52.

24. *Id.* at 78.

25. *Id.* The Supreme Court in *Knight* glossed over the legislative history of § 67, but it did mention the recordkeeping work and the administrative difficulty imposed by the prior tax system. *See Knight*, 128 S. Ct. at 785 (citing H.R. REP. NO. 99-426, at 109 (1985)).

26. *See* Brief for Petitioner at 32, *Knight*, 128 S. Ct. 782 (2008) (No. 06-1286), 2007 WL 2428375.

27. *See id.*

28. Transcript of Oral Argument at 26, *Knight*, 128 S. Ct. 782 (2008) (No. 06-1286), *available at* http://www.supremecourtus.gov/oral_arguments/argument_transcripts/06-1286.pdf.

29. *Id.*

however, the Supreme Court did not discuss any effect of the timing of the second clause in its interpretation.

B. General Goals of Congress in the Tax Reform Act of 1986

In *Mellon Bank, N.A. v. United States*,[30] the Federal Circuit noted two of Congress's goals in the Tax Reform Act of 1986.[31] First, Congress wanted "to increase fairness, economic efficiency, and simplification of the tax system."[32] Congress was concerned that some taxpayers were able to manipulate the tax code to exclude or deduct items that differed only slightly from what other taxpayers treated as taxable.[33] Although Congress wanted the tax code to be simple, it observed that complexity may be necessary with regard to those taxpayers who take advantage of certain tax preferences—so the government can accurately determine their income and tax them at the appropriate rate.[34]

Second, Congress intended "to eliminate or reduce the tax benefit of placing assets in a trust."[35] In its brief in *Knight*, the government argues that by enacting the Tax Reform Act of 1986, Congress moved toward its articulated goals "largely by closing loopholes and reducing marginal rates in order to make economically inefficient tax-avoidance schemes less attractive."[36] The government also contended in its brief that preventing trusts from fully deducting advisory fees furthers Congress's goal of reducing the tax benefit of placing assets in trust and sheltering income at lower tax rates.[37]

C. Fairness in Comparison to Individuals

Arguably, an inconsistency exists in striving for the goal of a fair tax system while also limiting the deduction of an individual for certain expenses, but not doing the same for a trust or estate. Congress enacted the Tax Reform Act of 1986 in order to address concerns that the prior tax system was fundamentally unfair.[38] One of the general goals of the legislation was to assure a fairer, more efficient, and

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30. 265 F.3d 1275 (Fed. Cir. 2001).

31. *See id.* at 1281.

32. *Id.* (citing S. REP. NO. 99-313, at 3 (1986), *reprinted in* 1986-3 C.B. 3).

33. *Id.* (citing H.R. REP. NO. 99-426, at 57 (1985), *reprinted in* 1986-3 C.B. 2).

34. *Id.* (citing S. REP. NO. 99-313, at 4 (1986), *reprinted in* 1986-3 C.B. 3).

35. *Id.* ("[T]he tax benefits which result from the ability to split income between a trust or estate and its beneficiaries should be eliminated or significantly reduced." (quoting S. REP. NO. 99-313, at 868 (1986), *reprinted in* 1986-3 C.B. 3) (internal quotation marks omitted).

36. Brief for Respondent at 11, Knight v. Commissioner, 128 S. Ct. 782 (2008) (No. 06-1286), 2007 WL 1520971 (citing H.R. REP. NO. 99-426, at 54–61 (1985), *reprinted in* 1986-3 C.B. 2).

37. *Id.* at 12. Legislative history indicates that Congress addressed its goal of fairness and reducing the tax benefits of placing assets in trusts by revising the tax brackets for trusts. *See* S. REP. NO. 99-313, at 868 (1986), *reprinted in* 1986-3 C.B. 3 ("[T]he bill attempts to reduce the benefits arising from the use of trusts and estates by revising the rate schedule applicable to trusts and estates . . . ."). However, this is not the *only* way for Congress to address these legitimate goals.

38. *See* discussion *supra* Part II.B.

simpler tax system.[39] In *Mellon Bank*, the Federal Circuit mentioned that another goal—related to this general goal of fairness—was to "equate the taxation of trusts with the taxation of individuals."[40] The express goal of equating taxation of trusts and individuals favors the government's interpretation of the statute.[41] Individuals may deduct ordinary and necessary expenses incurred "for the management, conservation, or maintenance of property held for the production of income."[42] Although these are two very different entities—particularly with regard to a trustee's fiduciary duty—allowing the same deductions for both a trust and an individual only seems fair.

D. Limiting Deductions Through Pass-Through Entities

In *Knight*, the trustee argued that Congress added the second prong to § 67(e) in order to parallel the restriction on the indirect deduction of expenses of pass-through entities included in § 67(c).[43] Section 67(c)(1) directs that regulations be issued "which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual."[44] Section 67(c)(3)(B) explains that this disallowance is not applicable to trusts and estates except as provided in the regulations.[45] Arguably, the second prong of § 67(e)(1) was added with the narrow purpose of subjecting trusts to the same restraint on deduction through pass-through entities as that applied to individuals in § 67(c)(1).

Turning to the Conference Report, Congress appears to have added the second prong with administration expenses of pass-through entities in mind:

> [T]he floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs. The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of present-law grantor trust and pass-through rules. In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid or incurred in connection with the administration of the estate or

39. *See supra* text accompanying note 32.

40. *Mellon Bank*, 265 F.3d at 1281. *But see* John M. Janiga & Louis S. Harrison, *Deducting Fees for Investment Advice*, TR. & EST., Apr. 2007, at 42, 47 ("[T]here is nothing in the legislative history to the TRA '86 that supports [the *Mellon Bank* statement regarding individual and trust equality].").

41. *See infra* notes 83–99 and accompanying text.

42. I.R.C. § 212(2) (2000).

43. *See* Petition for Writ of Certiorari at 25, Knight v. Comm'r, 128 S. Ct. 782 (2008) (No. 06-1286), 2007 WL 906695.

44. I.R.C. § 67(c)(1).

45. *Id.* § 67(c)(3)(B).

> trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision. [46]

Possibly, Congress intended to allow trusts to continue fully deducting all administrative costs that were traditionally deducted and incurred in connection with a trust or estate, excepting those costs incurred through pass-through entities and other similar unforeseen costs.[47] As the Second Circuit pointed out in *Knight*, the available legislative history does not provide clear insight into congressional intent, and the statutory language does not articulate this proposed narrow purpose of the second prong.[48] Rather, the court found that the broad language of the statute indicates that Congress intended the two-percent floor to apply to administrative costs incurred by individuals and trusts alike.[49] The Supreme Court did not address this issue in *Knight*.

E. Reference Point

One point of disagreement over the interpretation of § 67(e) has been whether the point of reference is a general trust or the specific trust at issue. The statute allows a deduction for costs related to "the administration of *the* estate or trust and which would not have been incurred if the property were not held in *such* trust or estate."[50] In *Knight*, the trustee contended that the words "such trust" in § 67(e)(1) referred to the particular trust seeking the deduction as opposed to a generic trust, as indicated in the introductory language of § 67(e).[51] The trustee read the statute as requiring a court to consider whether a particular cost would have been incurred had that particular trust property never been placed into a trust.[52] Such a reading of the statute would require the IRS to make an individualized determination of whether the hypothetical owner of that property would have incurred an investment

46. H.R. REP. NO. 99-841, pt. 2, at 34 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4122.

47. One commentator opined that § 67(e)(1) "seems to be concerned more with the origin of certain costs (i.e., that indirect expenses coming to the trust or estate from other pass-through entities would remain subject to the 2% limitation) rather than a wholesale abandonment of prior statutory practice." Craig Janes, *Fiduciary Administrative Expenses: How Much is Deductible?*, EST. PLAN., Nov. 2005, at 21, 25.

48. *See* William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 159 (2d Cir. 2006) ("Nothing in the legislative history suggests a clearly expressed congressional intent contrary to the plain meaning of the statute itself.").

49. *Id.* at 159–60.

50. I.R.C. § 67(e)(1) (emphasis added).

51. *Rudkin*, 467 F.3d at 155.

52. *Id.*

advisory fee had the property not been in a trust. The government cannot effectively administer the tax law using this case-by-case determination: the point of reference should be whether investors would generally incur investment advisory fees.

The Second Circuit rejected the trustee's interpretation as unreasonable, finding the correct point of reference to be a generic trust.[53] Rather than adopting a subjective inquiry into whether the investment advisory fees would have been incurred, the Second Circuit read the statute to demand an objective inquiry as to whether the cost "is one that is peculiar to trusts [in general] and one that individuals are incapable of incurring."[54] Basically, the court adopted the government's interpretation that the expense is deductible only if it is one that could not possibly have been incurred by an individual.[55] The court determined that the reference point of § 67(e)(1) is the individual and that the rules that apply to individual taxpayers also apply to trusts and estates.[56] This conclusion was based on the broad and inclusive introduction of § 67(e): "For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual . . . ."[57] The court relied on this general introductory language and concluded that "nothing in the statute indicates that Congress intended to make applicability of the deduction dependent on what costs are peculiarly incurred by a specific trust."[58]

IV. THE INTERPRETIVE DILEMMA

The decision in *Knight v. Commissioner* resolved a pronounced circuit split regarding the interpretation of the second prong of § 67(e)(1) and its application to investment advisory fees. Examination of the interpretations by the different circuits sheds light on the Court's resolution of the issue. Although some circuits found the statutory language to be clear and unambiguous, courts still produced three different interpretations of the statute.

The first circuit to decide the issue was the Sixth Circuit, which held that investment advisory fees are fully deductible because they are necessary to satisfy the trustee's fiduciary duties.[59] The Fourth and Federal Circuits, on the other hand, found investment advisory fees to be subject to the two-percent floor because they are not unique to trusts and estates; such fees are commonly incurred by individuals.[60] The final circuit to address the issue was the Second Circuit, which

53. *See id.* at 157 ("'[S]uch trust' is best understood as referring to the generic trust of § 67(e)'s introductory language . . . .").

54. *Id.* at 156.

55. *See id.*

56. *Id.*

57. I.R.C. § 67(e) (2000).

58. *Rudkin*, 467 F.3d at 157.

59. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993).

60. *See* Scott v. United States, 328 F.3d 132, 140 (4th Cir. 2003); Mellon Bank, N.A. v. United States, 265 F.3d 1275, 1281–82 (Fed. Cir. 2001).

adopted the narrowest interpretation of the statute.[61] The Second Circuit held that investment advisory fees are subject to the two-percent floor because an individual holding the property *could* incur such costs.[62] Noting this stark split in the circuits, the United States Supreme Court granted certiorari in *Knight v. Commissioner*,[63] and then adopted an interpretation similar to that of the Fourth and Federal Circuits.[64]

A. The Taxpayer's Argument

In *Knight v. Commisioner*, the trust's argument was based on the fact that a trustee's fiduciary duty is distinctive and requires balancing of the needs of current and future beneficiaries, according to the terms of the trust.[65] In the lower court, the trust argued that the second prong of § 67(e) "sets forth a 'but for' causal test: if the cost would not have been incurred without the trustee, then it is attributable to the trustee's performance of its fiduciary duty and is thus fully deductible under § 67(e)(1)."[66] To the Supreme Court, the trust argued that payments to a third party for performance of fiduciary services done on behalf of the trustee constitute trustee fees, and that investment advisory fees are simply the trustee's fees for services delegated to professionals.[67] The trust contended that a trustee without expertise must seek investment advice in order to comply with fiduciary obligations.[68] The trust drew particular attention to the fact that the trustee faces liability to the beneficiaries if these demanding requirements are not met.[69] At oral argument, it

61. *See Rudkin*, 467 F.3d 149.

62. *See id.* at 155–56.

63. Knight v. Comm'r, 127 S. Ct. 3005 (2007) (mem.). Taxpayers in other circuits did not have a clear rule and thus were at risk of incurring penalties, deficiencies, and interest if they chose to deduct these fees. *See* Janes, *supra* note 47, at 27. Janes notes that taxpayers may be assessed with an "accuracy-related penalty" for the understatement of their tax burden; however, as a defense, taxpayers may point to the "substantial authority standard." *Id.*; *see also* 26 C.F.R. § 1.6662-4(a)–(d) (2007) (setting forth the substantial authority standard). This prior circuit split also created unequal taxation across the circuits, creating an incentive for trusts to migrate or change their situs to the Sixth Circuit. Petition for Writ of Certiorari, *supra* note 43, at 5. Congress has not given sufficient attention to this issue since it was first raised in 1982, and Congress has made no attempt to clarify the statute's meaning. *See* Janiga & Harrison, *supra* note 40, at 48.

64. *See* Knight v. Comm'r, 128 S. Ct. 782, 789–90 (2008) (noting that a court's focus in determining if § 67(e)(1) excepts a certain cost is whether "it would be [an] *un*common (or unusual, or unlikely) [cost] for such a hypothetical individual to incur"); *supra* text accompanying note 60.

65. *See* Transcript of Oral Argument, *supra* note 28, at 7.

66. *See* William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 154 (2d Cir. 2006).

67. *See Knight*, 128 S. Ct. at 786; Mellon Bank, N.A. v. United States, 265 F.3d 1275, 1279 (Fed. Cir. 2001) ("It is undisputed that trustee fees are fully deductible.").

68. *Knight*, 128 S. Ct. at 786.

69. *See* Transcript of Oral Argument, *supra* note 28, at 51–52 ("Trust investment advice is always distinct from the investment advice that's given to individuals, both because of the demanding legal obligations specifying certain factors that have to be taken into account by the trustee in investing and because of the risk of personal liability."). Counsel for the trust supported this argument by referring to the Uniform Prudent Investor Act, which does not permit safe, conservative investments that many individuals choose to make. *See id.* at 52; *infra* notes 78–80 and accompanying text (discussing the

appeared that the Justices were sympathetic to the trust's case. Justice Souter commented that an investment advisor provides advice that may absolve the trustee from liability, "something that the individual investor does not provide for or need to provide for."[70] Justice Scalia explained that although the advice given to a trustee and to an individual may be the same "in substance," advice given to a trustee on how to fulfill his responsibilities under the trust is unique, looking to the objectives of the trust instrument.[71]

The trust urged the Court to adopt the interpretation of the Sixth Circuit—the only circuit court that found in favor of the taxpayer on the issue at hand.[72] In *O'Neill v. Commissioner*, the Sixth Circuit held that investment advisory fees paid by a trust are eligible for full deduction under the second prong of § 67(e).[73] The court emphasized the duty of a trustee "to invest and manage trust assets as a 'prudent investor' would manage his own assets."[74] The trustee's responsibility includes the duty to diversify investments in order to distribute risk.[75] The court distinguished individual investors from fiduciaries—fiduciaries have an obligation to the trust beneficiaries to invest prudently and skillfully, whereas individuals have no such obligations with regard to their own investments.[76] The court focused on the trustee's qualifications and experience—it recognized the necessity of professional advice for an inexperienced trustee in order to comply with fiduciary obligations.[77] Thus, the court seems to have interpreted § 67(e)(1) to mean that the costs would not have been incurred if the property had not been held in *such* trust, in the context of the particular trust at issue.

The adoption of the Uniform Prudent Investor Act in most states makes the argument based on fiduciary obligations especially relevant.[78] The Act requires prudent care in managing trust assets as well as consideration of factors such as inflation, tax consequences, expected return, and liquidity.[79] A common individual trustee likely will not have the expertise to invest trust funds in accordance with the prudent investor act of the state in which the trust is located, will need to consult

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Uniform Prudent Investor Act).

70. Transcript of Oral Argument, *supra* note 28, at 34.

71. *See id.* at 35. Justice Scalia reasoned, "[O]nly a trustee seeks advice as to how he can fulfill his responsibilities under the trust." *Id.*

72. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993).

73. *See id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *See id.*

78. Forty-four states, the District of Columbia, and the U.S. Virgin Islands have adopted different versions of the Uniform Prudent Investor Act. *See* UNIF. LAW COMM'RS, A FEW FACTS ABOUT THE . . . : UNIFORM PRUDENT INVESTOR ACT, http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Mar. 6, 2008) (listing states that adopted the Act).

79. UNIF. PRUDENT INVESTOR ACT § 2(a) (1995) ("A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.").

investment advisors, and will incur fees for the advisor's services.[80] *O'Neill* recognized a distinction between trusts—whose trustees are often *required* to obtain investment advice according to the trustee's fiduciary duty—and individuals—who are free to do as they please.[81] However, this distinction is somewhat tenuous. Simply because trustees incur the costs does not mean that individuals would not.[82] In fact, like many trusts, the individual investor will balance the need for a current return and the importance of future appreciation and saving for retirement or for future generations.

B. The Government's Argument

During oral argument in *Knight*, the government offered two interpretations of § 67(e)(1). The first interpretation was based on its most recent success in the Second Circuit, which gave the most restrictive interpretation of the statute.[83] The government's fallback argument was that the interpretation given by the Fourth and Federal Circuits was the proper interpretation of the statute.[84] In the lower court's decision, the Second Circuit held that investment advisory fees incurred by a trust never satisfy the second prong of § 67(e)(1) and are not fully deductible.[85] The Second Circuit proffered the following construction:

> [T]he plain meaning of § 67(e)(1)'s second clause excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust. In other words, for the trust to avoid the two-percent floor and have advantage of the full deduction, the plain language of the statute requires certainty that a particular cost 'would not have been incurred' if the property were not held in trust.[86]

This restrictive interpretation departs from the plain language of the statute by substituting the words *could not* for *would not* and ignoring the use of the terms *the trust* and *such trust* that seem to refer to the specific trust at issue.[87]

80. *See id.* § 9 (authorizing trustees to delegate investment and management functions).

81. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993); *supra* text accompanying notes 70–71 (noting the Court's discussion of the same distinction during oral argument in *Knight*).

82. During oral argument in *Knight*, Chief Justice Roberts commented that investment advisory fees are not unique to trusts because an individual "may have exactly the same objectives as a trustee." Transcript of Oral Argument, *supra* note 28, at 13.

83. *See id.* at 26–29.

84. *See id.* at 29–30.

85. William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 159–60 (6th Cir. 2006).

86. *Id.* at 155–56.

87. The *Rudkin* court justified this construction by stating that where a statute is ambiguous, courts should resolve controversies regarding deductions in favor of the government. *Id.* at 157. The Second Circuit derived this principle from the following language in *New Colonial Ice Co. v. Helvering*: "Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed." 292 U.S. 435, 440 (1934).

The government's fallback argument in *Knight* proffered the interpretation of the Federal and Fourth Circuits—that an expense fulfills the second prong of § 67(e)(1) if it is not commonly or customarily incurred by individuals.[88] The Federal Circuit in *Mellon Bank, N.A. v. United States*[89] and the Fourth Circuit in *Scott v. United States*[90] determined that fees for investment management and advice did not fall into the exception created by § 67(e)(1).[91] The Federal Circuit explained that, in order to meet the second prong of § 67(e)(1), a trust's expense must be "unique to the administration of a trust and not customarily incurred outside of trusts."[92] Because an individual taxpayer is likely to incur investment advisory fees when investing large sums of money, the Fourth and Federal Circuits ruled that these fees do not meet the second prong and are not fully deductible.[93]

In response to the trust's argument that payments to a third party for performance of fiduciary services constitute "trust fees" and meet the second prong of § 67(e)(1),[94] the Federal Circuit noted that if a trustee chooses to hire outside consultants to satisfy the trustee's fiduciary duties, rather than investing without professional advice, the trustee "must accept the tax consequences of his choice."[95]Although the fiduciary obligations of trustees play a large role in the fees incurred by the trust for administration expenses,[96] the court in *Mellon Bank* determined that it was "not bound by the fiduciary standards established by state law" and the only binding authority was the intent of Congress and the statute's

The policy underlying the Court's ruling in *New Colonial Ice* was that Congress is given broad power to tax income and a taxpayer must point to a specific, applicable statutory provision in order to claim a deduction. *See id.* Here, however, there *is* a specific statutory provision authorizing the deduction—§ 212 provides a deduction for investment advisory fees. I.R.C. § 212 (2000). Although § 67(a) limits that deduction, § 67(e) provides an exception for administrative expenses that specifically applies to trusts and estates, which have historically deducted administrative expenses such as investment advisory fees. *See id.* § 67(a), (e); Janes, *supra* note 47, at 23–24. Therefore, because there is a specific provision for a deduction, the *Rudkin* court was free to resolve ambiguity to effect congressional intent, without a preference for the government.

88. *See* Transcript of Oral Argument, *supra* note 28, at 29–30.

89. 265 F.3d 1275 (Fed. Cir. 2001).

90. 328 F.3d 132 (4th Cir. 2003).

91. *See id.* at 140; *Mellon Bank*, 265 F.3d at 1281.

92. *Mellon Bank*, 265 F.3d at 1281. The Court construed the second prong of § 67(e)(1) as focusing "not on the *relationship* between the trust and costs, but the *type* of costs, and whether those costs would have been incurred even if the assets were not held in a trust." *Id.* at 1280–81 (emphasis added).

93. *See Scott*, 328 F.3d at 140 ("Investment-advice fees . . . are often incurred by individual taxpayers in the management of income-producing property not held in trust."); *Mellon Bank*, 265 F.3d at 1280–81.

94. *See Mellon Bank*, 265 F.3d at 1279.

95. *Id.* at 1281.

96. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993). *O'Neill* recognized that trustees with no investment experience likely must seek investment advice in order to comply with the fiduciary duty of a prudent investor. *Id.*; *see also supra* notes 78–80 and accompanying text (discussing the prudent investor standard for trustees).

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plain meaning.[97] Therefore, the Fourth and Federal Circuits rejected the argument that all expenses resulting from the fiduciary obligations are fully deductible, explaining that this construction would render the second prong superfluous.[98] The Fourth Circuit explained,

> All trust-related administrative expenses could be attributed to a trustee's fiduciary duties, and the broad reading of § 67(e)(1) urged by the taxpayers would treat as fully deductible any costs associated with a trust. But the second clause of § 67(e)(1) specifically limits the applicability of § 67(e) to certain types of trust-related administrative expenses. To give effect to this limitation, we must hold that the investment-advice fees incurred by the [t]rust do not qualify for the exception created by § 67(e).[99]

The trust in *Knight* criticized the analysis of the Fourth and Federal Circuits on the ground that the second prong of § 67(e)(1) was enacted to prevent trusts from deducting the administrative expenses of pass-through entities as trust expenses—expenses that would have been incurred regardless of whether the property was held by an individual or a trust.[100] Therefore, the trust contended, even if the Court allowed a deduction for all fiduciary-related expenses, the second prong would not be rendered superfluous because it would still prevent the trust from deducting expenses incurred by a pass-through entity.

V. PRACTICAL RAMIFICATIONS

In its petition for writ of certiorari in *Knight v. Commissioner*, the trust articulated the far-reaching effects of § 67(e) and the difficulties caused by its uncertain interpretation.[101] According to one estimate, trusts and estates reported

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97. *Mellon Bank*, 265 F.3d at 1280 (citing Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148–49 (1974)). "The propriety of a deduction does not turn upon equitable considerations . . . . Rather, it depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." *Id.* (quoting *Nat'l Alfalfa*, 417 U.S. at 148–49) (internal quotation marks omitted). Arguably, the court's refusal to consider fiduciary standards in reliance on *National Alfalfa* is misplaced. In *National Alfalfa*, the taxpayer argued that a corporate transaction was the practical equivalent of a debt discount under I.R.C. § 163(1), entitling it to a deduction. *See Nat'l Alfalfa*, 417 U.S. at 142. The Court refused to rely on equitable considerations in determining whether a provision allowing a deduction applied. *See id.* at 148–49. In *Mellon Bank*, the taxpayers were referring not to mere equitable considerations but to legal obligations required by law. *See Mellon Bank*, 265 F.3d at 1279–80. Congress must have been aware of the fiduciary obligations of trustees when enacting the statute, and because these obligations have become more uniform and clearly articulated, *see supra* note 78, they significantly impact the effect of § 67(e).

98. *See Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280 (citing Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998)).

99. *Scott*, 328 F.3d at 140.

100. *See* William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 157 & n.3 (6th Cir. 2006); Petition for Writ of Certiorari, *supra* note 43, at 24–25.

101. *See* Petition for Writ of Certiorari, *supra* note 43, at 1–3.

over $129 billion of gross income in 2006.[102] As of 2005, more than $1 trillion in assets were held in trusts and estates in the United States.[103] Trusts spend billions of dollars on investment advisory fees annually.[104] Therefore, the tax treatment of investment advisory fees is of paramount concern to both trust beneficiaries and the financial services industry.

A. Combined Fee—Resistance to Break Down "Trustee Fee"

Faced with the loss of these deductions, estate planners may form trusts naming corporate trustees, such as banks and investment brokers, that can manage the investments in-house and charge a single trustee fee.[105] This plan relies on the courts' indication that a trustee's fee is fully deductible.[106] However, not only is this strategy unlikely to be acceptable to the IRS,[107] but it may also be an obstacle to a corporate trustee's obligation to comply with fiduciary standards and avoid conflicts of interest. Thus, the corporate trustee will likely charge a separate fee for investment advice or stipulate in an agreement that the trustee fee includes fees for investment advice by the trustee or its subsidiary; the agreement will also disclose the breakdown of the trustee fee accordingly.[108]

In its brief in opposition to the trustee's appeal from the Court of Federal Claims in *Knight*, the government maintained that § 67(e) requires a trustee to separate fiduciary advisory and management fees from other trustee fees.[109] In *Mellon Bank, N.A. v. United States*, the trustee responded to a similar argument by contending that allocating previously unbundled trustee fees would be exceedingly

102. I.R.S., STATISTICS OF INCOME TAX: STATS-INCOME FROM TRUSTS & ESTATES tbl.1 (2006), http://www.irs.gov/pub/irs-soi/06fd01.xls.

103. Petition for Writ of Certiorari, *supra* note 43, at 1–3 (citing F.D.I.C., TRUST INST. INFO: 2005 FDIC TRUST REPORT, http://www.fdic.gov/bank/individual/trust/report2005.html).

104. *See* I.R.S., *supra* note 102, at tbl.1. For 2006, nearly $5.7 billion was deducted on fiduciary income tax returns as "other deductions" not subject to the two-percent floor; more than $1.6 billion was deducted for "allowable miscellaneous deductions"; and over $4.2 billion was deducted for "fiduciary fees." *Id.* These categories most likely comprise investment advisory and management fees.

105. *See* Janiga & Harrison, *supra* note 40, at 48.

106. *See id.* ("Given that the Federal Circuit, Second Circuit and Fourth Circuit have all indicated that trustee's fees are fully deductible, such an approach might be viable.").

107. *See* Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. 41,243, 41,245 (July 27, 2007) (to be codified at 26 C.F.R. § 1.67-4) (requiring trustees to unbundle fees).

108. For example, the South Carolina Code imposes a duty of loyalty on a trustee and provides that a conflict-of-interest transaction is voidable absent certain circumstances. *See* S.C. CODE ANN. § 62-7-802(a)–(b) (1987). The statute further provides, "An investment by a trustee in securities of an investment company . . . to which the trustee, or its affiliate, provides [investment advice] is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the [Prudent Investor Act]." *Id.* § 62-7-802(F). However, the trustee may be compensated by the trust for its investment advisory services "if the trustee at least annually notifies the [trust beneficiaries] of the rate and method by which the compensation was determined." *Id.*

109. Brief for the Appellee at 50 n.14, William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149 (2d Cir. 2006) (No. 05-5151), 2006 WL 4706659; *see also* Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. at 41,245 (requiring trustees to unbundle fees).

costly.[110] The court in *Mellon Bank* acknowledged that unbundling fees may be expensive but noted that Congress has authority to establish tax policy.[111] The court explained, "The IRS has considerable leeway in adopting procedures and regulations for enforcement of I.R.C. § 67(e)(1) so as to keep the cost of compliance reasonably contained."[112]

Because the Supreme Court in *Knight* decided that investment advisory fees are not exempt from the two-percent floor,[113] a trustee will need to separate fully deductible costs from investment advisory fees and other fees that are subject to the two-percent floor.[114] The government will apply the "substance-over-form" doctrine, which for tax purposes makes the actual substance of the cost the deciding factor rather than how the trust labels the particular cost.[115] If the substance of the trust fee is costs incurred for investment management and advice, corporate trustees will be required to break down that fee to show investment advisory fees as separate from the trustee's fee.

B. *Nature of the Trust*

The impact of the deductibility of investment advisory fees on a particular trust arguably depends on the way the trust is structured—specifically, the amount of income that the trust is required to distribute. A trust may deduct all of the income that it distributes as required by the trust agreement.[116] Therefore, a trust that distributes most of its income will have a lower adjusted gross income and therefore a lower two-percent floor.[117] As a result, such a trust will be able to deduct much of its investment advisory fees.[118] In contrast, a trust that does not distribute much of its income will have a higher adjusted gross income and, consequently, a higher two-percent floor.[119] For this type of trust, the loss of the deduction of investment

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110. *See* 47 Fed. Cl. 186, 194–95 (2000).

111. *See id.* ("[W]ith respect to complaints about potential costs that would result from legislation, it is the responsibility of Congress, and not the courts, to establish tax policy.").

112. *Id.* at 195.

113. *See* Knight v. Comm'r, 128 S. Ct. 782, 791 (2008).

114. Faced with the possibility that some investment advisory fees may be deductible and other trust-specific advisory fees may not, Justice Scalia noted in oral argument in *Knight* that courts should not be involved in deciding what portion of the fee should be allocated to maximizing total return and what should be allocated to other services unique to trusts. *See* Transcript of Oral Argument, *supra* note 28, at 37. Justice Scalia opined, "That's just a crazy way to run a tax system, it seems to me." *Id.*

115. *See, e.g.*, Rogers v. United States, 281 F.3d 1108, 1116 n.4 (10th Cir. 2002) ("Under the substance-over-form doctrine, the IRS and the courts may recharacterize a transaction in accordance with its substance, if the substance of the transaction is demonstrably contrary to the form." (quoting DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 46–47 (1999)) (internal quotation marks omitted).

116. *See* I.R.C. § 651(a) (2000) (allowing a deduction for income "required to be distributed currently"); *id.* § 661(a) (same).

117. For a brief discussion regarding the calculation of adjusted gross income see *supra* text accompanying notes 9–14.

118. *See* Janes, *supra* note 47, at 21.

119. *Id.* at 21–22.

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advisory fees has a significant impact on the trust's tax liability.[120] Furthermore, large trusts that accumulate income rather than distribute it will likely be subject to the AMT.[121] For those trusts whose tax liability is calculated under the AMT, all investment advisory fees will be disallowed. Thus, the statute apparently encourages a trust arrangement where income is distributed rather than invested.[122]

C. *Proposed Regulation*

The IRS issued new proposed regulations on July 27, 2007, to address the applicability of the two-percent floor to certain costs incurred by an estate or trust.[123] These regulations were irrelevant to the Supreme Court's ruling in *Knight*, but if adopted, they will apply to future trusts and estates.[124] The proposed regulations generally follow the Second Circuit's restrictive interpretation of § 67(e) in *Rudkin*.[125] They provide that a cost is "unique" to an estate or trust, and therefore not subject to the two-percent floor, "if an individual *could* not have incurred that cost in connection with property not held in an estate or trust."[126] The regulations apply the substance-over-form doctrine and explain that in order to determine if an expense qualifies, the taxpayer should look to the type of product or service rendered rather than to the manner in which such cost is labeled or characterized.[127] The regulation proceeds to enumerate a non-exclusive list of expenses that the IRS classifies as unique:

> Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest

120. *See* Janiga & Harrison, *supra* note 40, at 43 ("If the trust has a large amount of [investment advisory fees], the loss of deduction for regular tax purposes can be substantial.").

121. *See supra* notes 15–16 and accompanying text.

122. However, in reality the statute may not encourage distribution of trust income because the beneficiary of a trust that distributes most of its income will still have to pay income tax on that distribution. *See* I.R.C. § 61(a)(15).

123. *See* Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. 41,243 (July 27, 2007) (to be codified at 26 C.F.R. § 1.67-4).

124. At oral argument in *Knight*, Mr. Miller, arguing on behalf of the government, conceded that the IRS was not entitled to *Chevron* deference—because the IRS had not yet issued a regulation—but he sought deference to what he described as "the consistent position of the Service since the statute was enacted that the investment advice be subject to the 2 percent floor." Transcript of Oral Argument, *supra* note 28, at 47.

125. *See supra* text accompanying notes 53–58.

126. Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. at 41,245 (emphasis added). Now that the Supreme Court has rejected the Second Circuit's interpretation, the IRS may change this regulation to follow the Supreme Court's interpretation and to avoid being challenged as an invalid interpretation of the statute. *See* Knight v. Comm'r, 128 S. Ct. 782, 787–88 (2008).

127. *See* Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. at 41,245.

> or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters.[128]

Noticeably absent from this list are legal fees, which have customarily been deductible for trusts and estates.[129] Under the proposed regulations, legal fees will now be subject to the two-percent floor because individuals can, and frequently do, incur them.[130] Most likely, the portion of legal fees considered fully deductible will be those fees charged for services listed in the proposed regulation—drafting and filing fiduciary accountings; judicial filings; fiduciary income tax returns; performing services related to a will contest; and meeting with beneficiaries.[131] Furthermore, individuals incur costs related to accountings, income tax preparation, and bond premiums, but these expenses are characterized as "fiduciary" under the proposed regulations and therefore considered "unique."[132] Investment advisory fees are usually incurred in order to comply with the fiduciary obligations of the trustee.[133] Thus, it seems inconsistent that these expenses are not also characterized as "fiduciary" expenses, and therefore "unique."[134] The regulations then list examples of expenses the government does not consider unique, which includes products or services rendered in connection with "[c]ustody or management of property; advice on investing for total return."[135] Essentially, the line drawn by the proposed regulations between unique and nonunique costs is vague, but it is nonetheless an attempt at providing certainty to the taxpayer.

The proposed regulations also require fiduciaries to unbundle their fees for management of a trust or estate.[136] This requirement will have a significant impact

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128. *Id.*

129. *Carol Cantrell's Take on Proposed Regs—A Cleaner Version*, STEVE LEIMBERG'S EST. PLAN. NEWSL. Archive Message #1155 (Leimberg Info. Servs., Inc.), July 30, 2007, at 6, http://leimbergservices.com [hereinafter *Carol Cantrell's Take*].

130. *Id.*

131. *See supra* text accompanying note 128.

132. *Carol Cantrell's Take*, *supra* note 129, at 7.

133. *See supra* notes 78–80 and accompanying text (discussing the Prudent Investor standards).

134. However, the investment advisor would charge the same fee for the same advice, regardless of the reason for seeking that advice.

135. Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. 41,243, 41,245 (July 27, 2007) (to be codified at 26 C.F.R. § 1.67-4). The regulations also subject to the two-percent floor costs incurred for "the defense of claims by creditors of the decedent or grantor." *Id.* However, the IRS has recognized that these costs, particularly those incurred in connection with a bankruptcy estate, are fully deductible under § 67(e). *See* I.R.S. Chief Couns. Mem. 200630016 (June 30, 2006), *available at* http://www.irs.gov/pub/irs-wd/0630016.pdf ("[D]eductions for expenses paid or incurred in connection with the administration of an individual's estate in bankruptcy that would have not been incurred if the property were not held by the bankrupt estate is treated as allowable in arriving at adjusted gross income.").

136. Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. at 41,245. Specifically, the proposal provides the following regarding bundled fees:

> If an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense

on lawyers, accountants, and corporate trustees who manage trust assets. Carol Cantrell, co-counsel for the Rudkin Trust, recently lamented, "The once sacrosanct 'trustee fee' that four U.S. appellate courts unanimously agree is fully deductible in all cases is now largely subject to the 2-percent floor just like all the rest of the trustee's administrative expenses."[137] Under the proposed regulations, corporate trustees will no longer be able to easily charge a "trustee fee" for their services but will be required to segregate these costs into at least two separate fees.

VII. THE SUPREME COURT'S OPINION

The Supreme Court began its analysis by rejecting the proposed interpretations of both parties. It vigorously criticized the Second Circuit's interpretation, which was espoused by the government: "This approach flies in the face of the statutory language."[138] The Court explained that if Congress intended the statute to mean costs that "could not have been incurred" by an individual, it presumably would have written just that, because "could" and "would" have different meanings.[139] Furthermore, because costs that *could* not be incurred by an individual would only be incurred in the administration of a trust or estate, the Second Circuit's interpretation renders the first prong of § 67(e) meaningless.[140]

After dispensing with the trust's proposed interpretation, the Court identified two procedural obstacles to the trustee: (1) the taxpayer had the burden of proving its claim of a deduction[141] and (2) the Court will narrowly construe an exception to a "general statement of policy" so as to preserve the legislature's overall

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> that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

Id.

137. *Carol Cantrell's Take*, *supra* note 129, at 5.

138. Knight v. Comm'r, 128 S. Ct. 782, 787 (2008). During oral argument, after debating with Justice Scalia regarding the Second Circuit's interpretation and the difference between the words "would" and "could," the following discussion ensued between Mr. Miller, arguing on behalf of the government, and the Chief Justice:

> CHIEF JUSTICE ROBERTS: You didn't think much of this argument before the Second Circuit adopted it, did you? You didn't argue this before the Court of Appeals?
> (Laughter.)
> MR. MILLER: We did not argue it before—
> CHIEF JUSTICE ROBERTS: So you have a fallback argument.
> MR. MILLER: Well, that—that's right.
> CHIEF JUSTICE ROBERTS: Well, now might be a good time to fall back.
> (Laughter.)

Transcript of Oral Argument, *supra* note 28, at 29.

139. *Knight*, 128 S. Ct. at 787 ("The fact that an individual could not do something is one reason he would not, but not the only possible reason.").

140. *Id.* at 788–89.

141. *See id.* at 790.

objective.[142] The Court described the trustee's proposed causation test as circular: The statute exempts from the two-percent floor costs caused by the trustee's fiduciary duties, but the only costs a trustee may incur are those that the trustee has a fiduciary duty to incur.[143] Therefore, under the trust's interpretation, almost all of a trust's administrative costs would be fully deductible because they would be caused by the trustee's fiduciary duty. With this meaning, "§ 67(e)(1)'s exception would swallow the general rule."[144] Although the Court took note of the trust's argument pertaining to the state's prudent investor act, it did not discuss how the prudent investor standard distinguishes trustees from individuals.[145] Instead, the Court twisted the trust's argument against it, noting that the standard was based on what a prudent *individual* investor would do having the same investment objectives.[146] Then, the Court found the inquiry to be whether a hypothetical individual investor, having the same investment objectives as the trust, would not commonly or customarily incur these fees.[147] The Court, like the Federal and Fourth Circuits, found that the trustee's interpretation would render the second prong superfluous because it would in effect be the same inquiry as the first prong.[148] Accordingly, the Court found the trustee's proposed interpretation invalid.

Chief Justice Roberts, writing for the Court, adopted an interpretation similar to that of the Fourth and Federal Circuits, explaining,

> The text requires determining what would happen if a fact were changed; such an exercise necessarily entails a prediction; and predictions are based on what would customarily or commonly occur. Thus, in asking whether a particular type of cost "would *not* have been incurred" if the property were held by an individual, § 67(e)(1) excepts from the 2% floor only those costs that it would be *un*common (or unusual, or unlikely) for such a hypothetical individual to incur.[149]

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142. *See id.* at 789 ("The [t]rustee's reading is further undermined by our inclination, [i]n construing provisions . . . in which a general statement of policy is qualified by an exception, [to] read the exception narrowly in order to preserve the primary operation of the provision." (quoting Comm'r v. Clark, 489 U.S. 726, 739 (1989)) (alterations in original) (internal quotation marks omitted)).

143. *See id.* at 788. A trustee cannot comply with the trustee's fiduciary duty if the trustee incurs an expense that is not reasonably necessary. *See supra* note 79 and accompanying text.

144. *Knight*, 128 S. Ct. at 789.

145. *See id.* at 790–91.

146. *See id.*

147. *Id.* at 790–91.

148. *See id.* at 788–89 ("[W]e see no difference in saying, on the one hand, that costs are 'caused by' the fact that the property is held in trust and, on the other, that costs are incurred 'in connection with the administration' of the trust.").

149. *Id.* at 789–90.

The Court found that the dictionary meaning of "would" is understood here as "express[ing] concepts such as custom, habit, natural disposition, or probability."[150] Applying this interpretation, the Court noted that "it is not uncommon or unusual" for individual investors to incur investment advisory fees.[151] Because nothing indicated that the investment advisor to the Rudkin Trust "charged the [t]rustee anything extra, or treated the [t]rust any differently than it would have treated an individual with similar objectives, because of the [t]rustee's fiduciary obligations," the investment advisory fees were not "distinctive" and were therefore subject to the two-percent floor.[152]

The standard articulated by the Court will at times require a case-by-case analysis of the investment advisory fees incurred by a particular trust in order to determine if those costs meet the second prong of § 67(e)(1). For example, if a trust has an "unusual investment objective" or necessitates "a specialized balancing of the interest of various parties," then to the extent that the trust incurred investment advisory fees for these unique purposes, such fees would meet the second prong of § 67(e)(1).[153] Another example of a fee that would be exempt from the two-percent floor is an additional fee that is only charged to fiduciary accounts.[154] These special or unique circumstances may warrant individualized examination of a trust, and corporate trustees may read this opinion and then characterize fees for investment advice as being charged for the unique needs of the fiduciary account.

One troubling aspect of the Federal and Fourth Circuit's decisions revealed during the oral argument in *Knight* is that the test depends on whether people commonly or customarily incur investment advisory fees for a property of a particular size.[155] Chief Justice Roberts asked Mr. Miller,

> [H]ow many individuals do you need [in order for a cost to be considered customarily incurred]? Let's say it's $3 million in the trust, and we think maybe [sixty] percent of people would hire an investment advisor; [forty] percent would think they can do just as well on their own. Is that customarily incurred by individuals?[156]

150. *Id.* at 789 (quoting Scott v. United States, 328 F.3d 132, 139 (4th Cir. 2003)) (alteration in original) (internal quotation marks omitted).

151. *Id.* at 790.

152. *Id.* at 791.

153. *Id.*

154. *Id.*

155. *See* Transcript of Oral Argument, *supra* note 28, at 19. Counsel for the trust criticized the commonly or customarily incurred test because of the "imponderables" that it presents: "What is usually done? Do trusts of different sizes have different rules? When a trust's assets come below a certain point, what about that?" *Id.*

156. *Id.* at 39–40. Mr. Miller responded by stating that the IRS could clarify this through regulations. *Id.* at 40, 44.

Justice Stevens said that this case-by-case analysis is "the most normal reading of the language [and is] probably the most unwise reading, also."[157]

This problem of uncertainty is also inherent in the test articulated by the Supreme Court: whether a cost would be uncommon for a hypothetical investor to incur. The Supreme Court failed to address the question of whether the size of the trust or estate influences the outcome under the standard it articulated. In other words, is it uncommon or unusual for a hypothetical investor to incur investment advisory fees similar to a trust of this particular size? The Chief Justice conceded in the opinion, particularly given the absence of regulatory guidance, that this could present itself as a nebulous standard in some cases; however, he refused to depart from the language of the statute—as both parties had done—simply to achieve ease of administration.[158] Chief Justice Roberts declared, "Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, but that is no excuse for judicial amendment of the statute."[159]

VIII. CONCLUSION

The Supreme Court's interpretation, although not without its problems, is the only interpretation that will give full effect to the language of the statute. Legislative history is unclear. In some ways it supports the taxpayer's contentions as to congressional intent, such as by intending that § 67(e) avoid deductions through pass-through entities. However, the legislative history, particularly the goals of the Tax Reform Act of 1986, tends to more strongly support the government's position. If Congress intended to allow investment advisory fees to be fully deductible, it could have addressed these expenses directly. There is no mention of these expenses in the legislative history. The statutory language requires that any expenses incurred in connection with the administration of the estate or trust be taxed in the same manner as an individual unless it would not have been incurred if the property were not held in such trust or estate. Investment advisory fees are regularly incurred by individuals, thus failing to satisfy the second prong of § 67(e)(1). Therefore, in order to tax the estate in the same manner as an individual with regard to investment advisory fees, these fees must be subject to the two-percent floor imposed under § 67(a). Although this standard may not be a certain, bright-line rule—which is preferred in the tax code—that is the language Congress chose to use, and only Congress can rewrite the law.

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157. *Id.* at 17.
158. *See Knight*, 128 S. Ct. at 791.
159. *Id.*

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