THE SECTION 67 QUESTION: ARE FEES FOR INVESTMENT ADVICE FULLY OR PARTIALLY DEDUCTIBLE BY TRUSTS?

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One of the more controversial tax questions in recent memory is whether a trust may fully deduct the fees it pays for investment advice or whether it must treat the fees as miscellaneous itemized deductions that are allowed only to the extent that the total of such deductions exceeds 2% of the trust’s adjusted gross income. The United States Court of Appeals for the Sixth Circuit held in the trust’s favor that such fees are fully deductible under § 67(e) of the Internal Revenue Code.1 Due to the numerous amendments to the Internal Revenue Code since the most recent printing of the official United States Code, and for the sake of clarity, all references to the Internal Revenue Code in this Article will refer to the version found in West’s United States Code Annotated.

1. O’Neill v. Comm’r, 994 F.2d 302, 304 (6th Cir. 1993) (citing § I.R.C. 67(e)).

Subsequently, the United States Courts of Appeals for the Federal, Fourth, and Second Circuits agreed with the Government that such costs are miscellaneous itemized deductions subject to the 2% floor under § 67(a).2 Consequently, the United States Supreme Court has granted the petition for certiorari in the Second Circuit case and will resolve the issue during the Court’s 2007–2008 Term.3

This Article takes the position that fees for investment advice do not satisfy the two requirements under § 67(e)(1) for full deductibility under a “plain meaning” interpretation of the statute. However, the Article concludes that policy considerations weigh in favor of amending § 67(e)(1)

1. O’Neill v. Comm’r, 994 F.2d 302, 304 (6th Cir. 1993) (citing § I.R.C. 67(e)).
3. See Knight, 127 S. Ct. at 3005 (granting certiorari for Rudkin Testamentary Trust, 467 F.3d at 149).
so that all costs incurred in connection with the administration of a trust would be fully deductible.

Part II of this Article provides the statutory background for the current dispute. Next, Part III explores the opinions issued at the trial court and appellate levels for each of the four cases that have reached the United States Courts of Appeals. Part IV discusses the textualist approach to statutory interpretation advocated by several Justices of the Supreme Court and examines *Gitlitz v. Commissioner*, a case that highlights the Court’s textualist approach to interpreting tax statutes. Part IV then evaluates the reported cases against this textualist backdrop and concludes that the Court’s plain meaning interpretation of § 67(e)(1) will be similar to that of the Second Circuit. Finally, in Part V, this Article presents three policy arguments in support of amending § 67(e)(1) so that a full deduction is allowed for a trust’s administrative costs.

II. STATUTORY BACKGROUND

A. Determination of Taxable Income for Individual Taxpayers

Section 1 of the Internal Revenue Code (Code) imposes a tax on the taxable income of all individuals, estates, and trusts. The term “taxable income” generally means gross income less the deductions allowed by chapter 1 of the Code, other than the standard deduction. A taxpayer’s gross income encompasses “all income from whatever source derived” unless Congress has specifically excluded an item of income elsewhere in subtitle A of the Code.

In determining taxable income, individuals first calculate an interim subtotal known as adjusted gross income. As a result, individuals separate the deductions allowed by chapter 1 of the Code into two groups—those deducted from gross income to arrive at adjusted gross income and those deducted from adjusted gross income to arrive at taxable income. The first group, commonly referred to as “above-the-line” deductions, consists

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5. I.R.C. § 1(a)–(e).
6. Id. § 63(a).
7. Id. § 61(a).
9. See id. §§ 62(a), 63(a), (d).
10. See William L. Rudkin Testamentary Trust v. Comm’r, 467 F.3d 149, 152 (2d Cir. 2006).
of the expenses enumerated in § 62(a) and includes such items as the expenses "attributable to a trade or business carried on by the taxpayer"\textsuperscript{11} and losses sustained on the sale or exchange of property.\textsuperscript{12} While above-the-line deductions include the deduction allowed under § 212 for expenses attributable to property held for the production of rent or royalty income, they exclude expenses related to the management of property held for the production of dividend and interest income.\textsuperscript{13}

The second group of deductions, referred to as "below-the-line" deductions,\textsuperscript{14} consists of the taxpayer’s itemized deductions and the deduction for personal exemptions allowed by § 151.\textsuperscript{15} Itemized deductions entail a wide variety of costs, such as state and local income taxes,\textsuperscript{16} charitable contributions,\textsuperscript{17} and expenses of managing investments held for the production of dividend and interest income.\textsuperscript{18}

While the Code restricts the amounts individual taxpayers may report with respect to several itemized deductions,\textsuperscript{19} it is the limitation placed upon miscellaneous itemized deductions that is relevant to the case pending before the United States Supreme Court.\textsuperscript{20} Section 67(a) provides that "[i]n 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 2 percent of adjusted gross income."\textsuperscript{21}

\textsuperscript{11} I.R.C. § 62(a)(1).
\textsuperscript{12} Id. § 62(a)(3).
\textsuperscript{13} Id. § 62(a)(4).
\textsuperscript{14} See Rudkin Testamentary Trust, 467 F.3d at 152.
\textsuperscript{15} See I.R.C. § 63(d); see also id. § 151.
\textsuperscript{16} Id. § 164(a)(3).
\textsuperscript{17} Id. § 170(a)(1).
\textsuperscript{18} See id. § 212(1)–(2) (West 2002). Section 63(b) permits individual taxpayers who do not elect to itemize their deductions on their tax returns to calculate taxable income by taking a standard deduction in lieu of their itemized deductions. Id. § 63(b) (West Supp. 2007). The amount of the standard deduction is primarily a function of the individual taxpayer’s filing status (e.g., head of household). See id. §§ 63(c)(1)–(4), 63(f). While some taxpayers may prefer to take the standard deduction because they do not wish to maintain the records to document their itemized deductions, the decision to itemize deductions as opposed to taking the standard deduction generally comes down to which option will yield the greater total deduction and, thus, the lower amount of taxable income.
\textsuperscript{19} For example, a taxpayer may deduct the total unreimbursed expenses of medical care for the taxpayer, the taxpayer’s spouse, and the taxpayer’s dependents to the extent that such expenses exceed 7.5% of her adjusted gross income. Id. § 213(a).
\textsuperscript{20} See id. § 67(a) (West 2002).
\textsuperscript{21} Id.
Accordingly, § 67(a) establishes a so-called 2% floor for taking miscellaneous itemized deductions into account when calculating taxable income.22

Miscellaneous itemized deductions include all itemized deductions other than those specified in § 67(b).23 Two categories of itemized deductions are noticeably absent from the list in § 67(b): (1) expenses paid or incurred by the taxpayer in her capacity as an employee that are not reimbursed by her employer or a third party;24 and (2) deductions allowed under § 212 that are attributable to property held for the production of income other than rents and royalties.25 As a result of this omission, unreimbursed employee business expenses and expenses associated with the management of income-producing property, such as investment advisory fees and subscriptions to investment-related publications, are treated as miscellaneous itemized deductions. Further, these and any other miscellaneous itemized deductions are combined, and they reduce an individual's taxable income only to the extent that their total exceeds 2% of the individual's adjusted gross income.26


24. Expenses falling within this category include: reasonable travel costs while the taxpayer is conducting business away from home on behalf of her employer, costs of courses taken to maintain or improve job skills, and dues to professional societies. See id. § 162(a)(2) (West Supp. 2007); Treas. Reg. § 1.162-5(a) (1967); Treas. Reg. § 1.162-6 (1960).

25. The Fourth Circuit stated that the majority of itemized deductions for individuals are miscellaneous itemized deductions. Scott v. United States, 328 F.3d 132, 138 (4th Cir. 2003). That statement appears inaccurate. There are twelve categories of itemized deductions listed in § 67(b), including deductions for home mortgage interest, state and local income and property taxes, and charitable contributions, that are not miscellaneous itemized deductions. See I.R.C. § 67(b)(1)–(12) (West 2002). On the other hand, while the Treasury Regulation indicates its list is not meant to be exhaustive, it gives only four categories as examples of miscellaneous itemized deductions. See Temp. Treas. Reg. § 1.67-1T(a)(1)(i)–(iv) (1988). In addition, when one considers taxpayers’ expenditures, it seems likely that they pay more in taxes and mortgage interest than they pay for investment advice and unreimbursed travel and education costs related to their employment.

26. I.R.C. § 67(a). The following example illustrates the operation of the 2% floor in § 67(a): Assume that T has adjusted gross income of $75,000 for 2007. Also assume that, during 2007, T paid $1,000 for investment advice related to his portfolio of stocks and bonds and $600 for continuing education courses to maintain his license to practice law. T’s miscellaneous itemized deductions total $1,600 ($1,000 for the investment advice plus $600 for the continuing education courses). Two percent of T’s
B. Calculation of Taxable Income for Trusts and Estates

In calculating taxable income, trusts and estates follow many of the same Code provisions that govern individual taxpayers. For example, the general definition of taxable income for individuals—gross income minus the deductions allowed in chapter 1, other than the standard deduction—applies to trusts and estates as well as individuals. Like individuals, trusts and estates also include “all income from whatever source derived” in gross income except for those items specifically exempted from taxation elsewhere in subtitle A of the Code. Finally, most of the expenses that are deductible from gross income by individual taxpayers are also deductible by trusts and estates.

However, the taxation of trusts and estates differs in several significant respects from that of individuals discussed above. First, trusts and estates receive very minor deductions for personal exemptions compared to individuals. Estates are permitted a $600 deduction. Trusts, as a general rule, are granted a $100 deduction, but the deduction is increased to $300 for trusts that are required to distribute all of their income currently under their governing instruments. Individuals, on the other hand, may deduct an “exemption amount” for each taxpayer filing the return and each of the taxpayer’s dependents. For the tax year beginning in 2007, the exemption amount is $3,400.

Second, trusts and estates may take a deduction for distributions of adjusted gross income equals $1,500. T’s total miscellaneous itemized deductions exceed 2% of his adjusted gross income by $100. Thus, T will only be able to deduct $100 of the total miscellaneous itemized deductions in arriving at his taxable income.

27. Id. § 63(a) (West Supp. 2007).
31. See id. at 9.
32. I.R.C. § 642(b)(1).
33. Id. § 642(b)(2)(A)–(B).
34. Id. § 151(a)–(c) (West Supp. 2007). Therefore, a married couple who files a joint return and has three dependent children would be entitled to five exemptions.
income that they make to their beneficiaries.\textsuperscript{36} In this regard, trusts and estates are conduits.\textsuperscript{37} To the extent that estates and trusts retain their income, they pay tax on the income; to the extent that they distribute their income, these entities take a deduction to arrive at taxable income, while the recipient beneficiaries include the amounts distributed in their gross incomes.\textsuperscript{38} There is no counterpart to the distribution deduction for trusts and estates in individual income taxation.

Finally, trusts and estates differ from individuals in the determination of adjusted gross income and the miscellaneous itemized deductions allowed for taxable income. With respect to these items, § 67(e) states in relevant part:

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, and

(2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income.\textsuperscript{39}

Unlike individuals, who always calculate adjusted gross income,\textsuperscript{40} the

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\item[36.] See Sherman, supra note 28, at 9. Estates take the deduction pursuant to § 661(a). I.R.C. § 661(a) (West 2002). A trust takes the deduction under either § 651(a) or § 661(a) depending on: (1) whether the trust is required to distribute all of its income currently or to pay or set aside amounts for charitable purposes; and (2) whether it makes distributions of principal. See id. §§ 651(a), 661(a).
\item[37.] See Sherman, supra note 28, at 12.
\item[38.] Id. The amount that each entity is allowed to deduct and the total the recipient beneficiaries are required to include in gross income are limited to the entity’s distributable net income. See I.R.C. §§ 651(b), 652(a), 661(a), 662(a). The determination of distributable net income and the other complex rules of subchapter J governing the income taxation of trusts and estates are beyond the scope of this Article, as they are not relevant to the issue of deductibility of investment advisory fees to be resolved by the Supreme Court. For an excellent overview of subchapter J, one should read Professor Sherman’s article in its entirety. Sherman, supra note 28.
\item[39.] I.R.C. § 67(e)(1)–(2).
\item[40.] See id. §§ 62(a), 63(b), (d) (West Supp. 2007). Adjusted gross income is a key concept in the determination of individual income tax liability. In addition to employing it to limit the amounts of below-the-line deductions that taxpayers may report, see supra notes 19–21 and accompanying text, the Code also employs adjusted
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introductory clause of § 67(e) provides that trusts and estates calculate adjusted gross income for the purpose of determining the amount of miscellaneous itemized deductions subtracted under § 67 to derive taxable income.\footnote{41} If a trust or estate does not have any miscellaneous itemized deductions, then it does not have to calculate adjusted gross income to complete its return.\footnote{42}

Further, § 67(e) provides that when trusts and estates must calculate adjusted gross income, they calculate it in the same manner as individuals, except that they take several above-the-line deductions in addition to those granted to individuals.\footnote{43} It is the above-the-line deduction found in § 67(e)(1) that is at the core of the controversy pending before the United States Supreme Court. The Second, Fourth, Sixth, and Federal Circuits have generally recognized that the statute imposes two requirements for an administrative cost of a trust or estate to be treated as a deduction for adjusted gross income: (1) the cost must have been “paid or incurred in connection with the administration of the estate or trust,” and (2) the cost “would not have been incurred if the property were not held in such trust or estate.”\footnote{44} But when faced with the issue of whether the cost of investment advice provided to a trustee fits within § 67(e)(1), only the Sixth Circuit has concluded that such cost satisfies the second requirement.\footnote{45}

The stakes in the dispute over investment advisory fees are substantial. If the Supreme Court reverses the Second Circuit and concludes that such costs meet both requirements of § 67(e)(1), then trusts and estates will be able to fully deduct the costs in arriving at both adjusted gross income, with modifications, to determine taxpayers’ eligibility for certain tax credits. See, e.g., I.R.C. § 25A(d) (West 2002) (phasing out the Hope Scholarship and Lifetime Learning Credits for married individuals filing joint returns with modified adjusted gross incomes in excess of $80,000 (before adjustments for inflation)).
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If, however, the Court affirms the Second Circuit and concludes that investment advisory fees are not costs “which would not have been incurred if the property were not held in such trust or estate,” then trusts and estates, like individual taxpayers, will only be able to deduct such costs as miscellaneous itemized deductions to the extent they exceed 2% of their adjusted gross incomes.

III. THE CASES AND THEIR REASONING

As discussed above, four different circuits have addressed the question of whether investment advisory fees satisfy the requirements of § 67(e)(1) so that trusts and estates may deduct them in full to arrive at adjusted gross income. Also, as mentioned above, the Sixth Circuit was the first circuit to consider the issue, and it held in the trust’s favor that such fees were fully deductible. Subsequently, the Federal, Fourth, and Second Circuits agreed with the Commissioner that the fees did not fit within § 67(e)(1) and, therefore, were to be treated as miscellaneous itemized deductions that were subtracted to arrive at taxable income to the extent they exceeded 2% of adjusted gross income. For each of the four cases that reached the Courts of Appeals, this Part of the Article examines the opinions issued by both the trial courts and the Courts of Appeals.

A. O’Neill v. Commissioner

1. The Tax Court

The facts were fully stipulated. The William O’Neill, Jr., Irrevocable Trust had been formed in 1965, and in 1979 a former co-trustee entered into an Investment Advisory Agreement with Allen & Leavey Investment

46. The advice concerns investments in stocks, bonds, and other securities that provide income such as dividends, interest, and capital gains from the disposition of these investments. If the advice related to property held for the production of rent or royalty income, the cost would be fully deductible above the line, regardless of § 67(e)(1), because costs attributable to the production of rent or royalty income are listed in § 62(a) as being deductible for adjusted gross income. See supra notes 10–13 and accompanying text.

47. I.R.C. § 67(e)(1).

48. See supra notes 1–2 and accompanying text.

49. See supra note 1 and accompanying text.

50. See supra note 2 and accompanying text.


52. O’Neill, 98 T.C. at 228.
Management, Inc. In 1987, the tax year at issue, none of the individuals serving as co-trustees had expertise in investing large sums of money, and no one had ever been willing to serve as a co-trustee unless an investment advisor had been hired to manage the trust’s investments. In 1987, the trust had assets valued in excess of $4.5 million and incurred $15,374 in fees for investment services pursuant to the agreement. The trust deducted the fees in full on its fiduciary income tax return. The Commissioner determined that the fees were subject to the 2% limitation under § 67(a) and that the trust’s tax deficiency for 1987 was $3,534.

The trust asserted that, in the absence of Treasury Regulations and legislative history pertaining to § 67(e), the court should look to Ohio law “to determine what costs are ordinarily and necessarily incurred in connection with the administration of a trust and thus fully deductible from gross income.” The court noted that the Ohio statutes require trustees to invest trust assets and that, under Ohio law, trustees are held to the prudent person standard of care in making investment decisions. The court explained that, under that standard, courts must “determine whether the trustee acted honestly, in good faith, and with the degree of care and prudence which an ordinary person would exercise in the transaction of his or her own affairs.”

Given the requirement to invest trust assets and the prudent person standard, the trust argued that the trustees had to seek investment advice to fulfill their fiduciary obligations. Accordingly, the trust maintained that the fees were both incurred in connection with the administration of the trust and would not have been incurred if the property had not been held in trust.

The Tax Court rejected the trust’s arguments, stating that “the thrust of the language of section 67(e) is that only those costs which are unique to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions.

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53. Id.
54. Id.
55. Id. at 228–29.
56. Id. at 229.
57. Id. at 228–29.
58. Id. at 229.
59. Id. at 229–30.
60. Id. at 230.
61. Id.
62. Id.
set forth at section 67(a).” The court then cited trustee fees and trust accounting fees required by law or the trust agreement as two examples of costs that would be unique to trust administration. On the other hand, the court noted that “[i]ndividual investors routinely incur costs for investment advice,” so such costs cannot be considered unique to the administration of a trust.

The court also dismissed the trust’s argument— that the fees were incurred to satisfy fiduciary duties— as unsupported by the record. Rather than requiring the trustees to seek investment counsel to avoid a breach of duty, the court pointed out that “the Ohio statutes provide a fiduciary with a detailed list of preapproved investments which would obviate the need to incur investment advice fees.”

The court further asserted that the fact that none of the co-trustees had been willing to serve without the appointment of an investment counselor was not “determinative.” According to the court, § 67(e) was to be applied without taking the “subjective considerations of a fiduciary” into account.

Based on its analysis, the Tax Court held that “investment advice fees incurred by the trust [were] not costs incurred in connection with the administration of an estate or trust that would not have been incurred if the property were not held in such estate or trust.” The court agreed with the Commissioner that the fees were a miscellaneous itemized deduction subject to the 2% floor under § 67(a) and upheld the Commissioner’s determination of the trust’s tax deficiency. The trust appealed to the Sixth Circuit.

2. The Sixth Circuit

Like the Tax Court, the Sixth Circuit noted that, in managing trust assets, trustees are expected to exercise the care and skill that prudent

63. Id. (emphasis in original).
64. Id.
65. Id.
66. Id.
67. Id. at 230–31 (citing OHIO REV. CODE ANN. § 2109.37 (Anderson 1990)).
68. Id. at 231.
69. Id.
70. Id.
71. Id.
investors would exercise in managing their own assets.\footnote{O’Neill v. Comm’r, 994 F.2d 302, 304 (2d Cir. 1993) (citing III SCOTT ON TRUSTS § 227 (4th ed. 1988)).} Like the Tax Court, the Sixth Circuit also acknowledged that the Ohio statutes prescribed a pre-approved list of investments that a trustee could obtain on the trust’s behalf.\footnote{Id.} But the court observed that selecting one of the pre-approved investments did not necessarily satisfy the prudent investor standard.\footnote{Id.} The court stated that the trustee has a duty to diversify the trust’s investments “so as to ‘distribute the risk of loss within the trust.’”\footnote{Id. (quoting Stevens v. Nat’l City Bank, 544 N.E.2d 612, 617 (1989)).} The court further noted that professional assistance could be warranted when the trustee lacks expertise in investments.\footnote{Id.}

Applying these prudent investor rules to the O’Neill trust, the court reasoned that because the co-trustees lacked experience managing large sums of money, they would have placed the assets of the trust at risk had they not consulted an investment advisor.\footnote{Id.} Accordingly, the court concluded “the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees.”\footnote{Id.}

The Sixth Circuit dismissed the Tax Court’s holding that investment advisory fees are not unique to trusts as they are incurred routinely by individual investors.\footnote{Id.} In the Sixth Circuit’s view, individuals, unlike trustees, are neither required to consult advisors nor subject to liability if they act negligently on their own behalf.\footnote{Id.} Therefore, as the fiduciary duties of the co-trustees caused them to seek investment advice, the Sixth Circuit held that the fees would not have been incurred if the property had not been held in trust and were fully deductible to arrive at taxable income under § 67(e)(1).\footnote{Id.}
B. Mellon Bank, N.A. v. United States

1. United States Court of Federal Claims

In this case, the Mellon Bank, acting as a co-trustee for twelve trusts created for the benefit of members of the Richard K. Mellon family, sought refunds of income taxes paid by the trusts for the tax years 1989–1992. At issue was the deductibility under § 67 of the costs for two types of trust services: (1) investment advice, and (2) “accounting, tax preparation, and management services provided by Richard K. Mellon & Sons (RKM & S).” The parties filed cross-motions for summary judgment, which were denied.

Resolution of the issue required the court to interpret § 67(e)(1). The court explained that “[t]he first and foremost tool” in interpreting a statute is the statute’s text, and courts must give that text its plain meaning. Further, if the text resolves the question, then the inquiry ends. Finally, in determining plain meaning, courts must assume statutory words take their ordinary, common meaning unless Congress has provided other definitions for such words.

The court found that the language of § 67(e)(1) is “plain, straightforward, and unambiguous.” The statute establishes two prerequisites for fees to be exempt from the 2% floor in § 67(a): (1) the fees have to “be ‘paid or incurred in connection with the administration of the . . . trust’” and (2) the fees “must be costs ‘which would not have been incurred if the property were not held in such trust.’”

Resorting to Webster’s Third New International Dictionary to define the word “connection,” the court found that the first prerequisite would be

83. Id. at 187–88. Another trust for the benefit of the Richard K. Mellon family, known as the Real Estate Trust, was also a plaintiff in the case. The plaintiffs will be referred to collectively as “Mellon Bank” throughout the discussion of this case.
84. Id. at 188.
85.
86. Id. (quoting Timex V.I., Inc. v. United States, 157 F.3d 879, 882 (Fed. Cir. 1998)) (internal quotations omitted).
87.
88. Id. (citing Hoechst-Roussel Pharm., Inc. v. Lehman, 109 F.3d 756, 758 (Fed. Cir. 1997)).
89.
90. Id. (quoting I.R.C. § 67(e)(1)).
satisfied “if there is a relationship or association between the incurring of the costs and the administration of the trust.” Based on Webster’s definition of the term “would,” which is “used to express frequent, customary, or habitual action,” the court determined that the second prerequisite does not involve the relationship between the administration of the trust and the costs incurred. Instead, the second prerequisite requires an evaluation of whether the costs likely would have been incurred if the assets in question had not been placed in trust.

Mellon Bank raised four arguments in disputing the court’s “plain meaning” interpretation of the second prerequisite. First, relying on the Sixth Circuit’s opinion in O’Neill, Mellon argued that the second prerequisite of § 67(e)(1) is satisfied “if a trustee incurs costs . . . to satisfy state fiduciary obligations,” whether or not “identical costs for identical services” would have been sustained if the funds were not held in trust. Because the investment advisor and RKM & S were hired to fulfill the trustees’ fiduciary obligations, Mellon Bank asserted that the fees paid by the trusts met the second prerequisite.

The court rejected the argument, finding the Sixth Circuit’s opinion flawed in several respects. First, the Sixth Circuit ignored the plain meaning of the statute’s second prerequisite. The Sixth Circuit held that because the fiduciary duties of the trustees caused the investment advisory fees, the fees satisfied § 67(e)(1). But, according to the court, the causal relationship noted by the Sixth Circuit applies to the statute’s first prerequisite—whether the cost was incurred in connection with the administration of the trust. The second prerequisite deals with the separate question of whether the costs would not have been incurred if the property were not held in the trust.

91. *Id.* (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 481 (1976)).
92. *Id.* at 188–89 (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 2616 (1976)).
93. *Id.* at 189.
94. *Id.*
95. *Id.*; see also *supra* notes 75–81 and accompanying text.
97. *Id.* at 189–90.
98. *Id.* at 190; see also *supra* notes 75–81 and accompanying text.
99. *Mellon Bank,* 47 Fed. Cl. at 190; see also *supra* notes 90–91 and accompanying text.
100. *Mellon Bank,* 47 Fed. Cl. at 190; see also *supra* notes 92–93 and accompanying text.
Second, even though individual investors routinely incur fees for investment advice, the Sixth Circuit concluded that the fees fell under § 67(e)(1) because individual investors were neither required to seek advice nor subjected to liability for negligence in managing their own investments. The court agreed with the Sixth Circuit that a trustee has a legal obligation to manage investments with care, whereas an individual investor has no such obligation. However, the court pointed out that the second prerequisite focuses on whether costs would not have been incurred if the assets were not held in a trust rather than legal obligations and fiduciary duties. In the court’s view, the absence of a legal obligation for an individual investor “hardly supports the conclusion that in all situations investment advisory fees ‘would not have been incurred if the property were not held in such trust.’”

Third, the court observed that there was a logical fallacy in holding that investment advisory fees satisfy the second prerequisite if they are incurred to fulfill fiduciary duties. Under the relevant Pennsylvania statute, a trustee was required to “exercise judgment in making investments ‘which men of prudence, discretion and intelligence exercise in the management of their own affairs.’” As the court noted, “Pennsylvania law essentially encourages a trustee to incur costs for investment advice in much the same manner as would a prudent investor in the absence of a trust.” Based on this prudent person standard, the court found it unreasonable to conclude that investment advisory fees incurred by trustees would always constitute costs which “‘would not have been incurred if the property were not held in such trust.’”

Finally, Mellon Bank’s interpretation of the second prerequisite violated a “cardinal principle of statutory interpretation” that courts must “give independent meaning to each statutory provision so as not to render any particular provision superfluous.” Mellon maintained that costs that would “‘not have been incurred if the property were not held in trust’”


103. *Id.*

104. *Id.* (quoting I.R.C. § 67(e)(1)) (emphasis in original).

105. *Id.* at 191.

106. *Id.* (quoting 20 PA. CONS. STAT. § 7302(b) (1975)).

107. *Id.*

108. *Id.* (quoting I.R.C. § 67(e)(1)).

109. *Id.*
were the same as costs incurred by trustees to comply with their fiduciary duties.\footnote{110}{Id. (quoting I.R.C. § 67(e)(1)).} However, as the court stated, all costs incurred to comply with fiduciary duties would necessarily be costs incurred in connection with a trust’s administration, satisfying the first prerequisite of § 67(e)(1).\footnote{111}{Id. at 191–92.} According to the court, the upshot of Mellon’s interpretation was that the same costs would be deductible under § 67(e)(1) whether or not the first prerequisite was included in the statute, rendering the first prerequisite superfluous.\footnote{112}{Id.}

Mellon Bank then claimed that the fees paid to the investment advisors and RKM & S should be viewed as trustee fees because the advisors and RKM & S were acting as agents of the trustees to carry out the trustees’ fiduciary duties.\footnote{113}{Id. at 190.} Because trustee fees were “directly deductible under O’Neill,” Mellon reasoned that the fees paid to the trustees’ agents should similarly be deductible.\footnote{114}{Id.}

In response, the Court of Federal Claims stated that characterizing the costs as trustee fees would not resolve the question of whether the costs would have been incurred outside the context of a trust.\footnote{115}{Id.} The court observed that some tasks performed by a trustee are unique to administering a trust while other tasks are not.\footnote{116}{Id.} The court concluded that “[w]hether costs for particular services can be characterized as trustee fees is not mentioned as a factor in I.R.C. § 67(e)(1) and is simply not relevant to the application of the statute’s plain meaning.”\footnote{117}{Id.}

Mellon Bank’s third argument in favor of its interpretation was that it was supported by the legislative history of the Tax Reform Act of 1986, which enacted § 67(e)(1).\footnote{118}{Id. at 193.} Mellon Bank contended that the legislative history pertaining to the 2% floor for miscellaneous itemized deductions in § 67(a) reveals that the purpose of the floor was to curtail recurring problems associated with “miscellaneous deductions and common errors made by individual taxpayers.”\footnote{119}{Id.} Mellon Bank further argued that because “trusts did not contribute to those problems and errors,” Congress

\begin{itemize}
  \item \footnote{110}{Id. (quoting I.R.C. § 67(e)(1)).}
  \item \footnote{111}{Id.}
  \item \footnote{112}{Id. at 191–92.}
  \item \footnote{113}{Id. at 190.}
  \item \footnote{114}{Id.}
  \item \footnote{115}{Id.}
  \item \footnote{116}{Id.}
  \item \footnote{117}{Id.}
  \item \footnote{118}{Id. at 193.}
  \item \footnote{119}{Id.}
intended to “[exempt] trust expenses from the two percent floor.”

The court rejected this argument on two grounds. First, Congress could have exempted trust expenses from the 2% floor by specifically excluding trusts from the operation of § 67(a) or by including in § 67(e)(1) only the first prerequisite—namely, that expenses be “‘incurred in connection with the administration of the . . . trust.’” Second, the court explained that the legislative history of the Tax Reform Act of 1986 was more consistent with its interpretation of the second prerequisite than that of the trusts. According to the court, Congress enacted the Tax Reform Act of 1986 “to make the tax laws more fair by preventing wealthy and sophisticated taxpayers from using tax shelters or trusts to gain tax benefits unavailable to other individuals.” The court reasoned that its interpretation of § 67(e)(1) “would further Congress’s effort to secure fairness by providing an equivalency in taxation rules between taxation of trusts and taxation of individual taxpayers.” The court claimed that its interpretation would preclude an individual from establishing a trust to obtain deductions for investment expenses the individual would not receive in the absence of a trust.

Mellon Bank’s final argument was that a plain meaning interpretation of § 67(e)(1) could require trustees who provide investment advice in addition to a variety of trust services to apportion their fees between those services that are subject to the 2% floor and those that are not. The trusts contended that apportionment would be both difficult to administer and inconsistent with the IRS’s prior practice of not requiring trusts to unbundle trustee fees for tax purposes. Further, the trusts maintained that determining “whether costs ‘would not have been incurred if the property were not held in such trust’” would be costly and burdensome.

The court responded by observing that both the instant case and the O’Neill case involved fees paid to outside advisors rather than fees paid to trustees for their own services. In both cases, “[t]he IRS . . . [took] the

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120. Id.
121. Id. (quoting I.R.C. § 67(e)(1)).
122. Id.
123. Id. at 194.
124. Id.
125. Id. at 194–95. The trusts were joined in this argument by the American Bankers Association, the amicus in the case. Id. at 194.
126. Id.
127. Id. at 194–95 (quoting I.R.C. § 67(e)(1)).
128. Id. at 195.
consistent position that such fees paid to outside sources are potentially subject to the two percent floor for miscellaneous deductions.”129 With respect to the costs and burdens associated with unbundling trustee fees or determining whether costs would not have been incurred if the property were not held in trust, the court stated that Congress, not the courts, sets tax policy.130 The court’s role is to “apply the statute as written” when its language is “plain and unambiguous and the result is not ‘absurd.’” 131 Given that the court designated its interpretation of § 67(e)(1) as furthering the legislative purpose of “promoting fairness in tax policy,” the result was not absurd.132

Finally, the court disposed of the cross-motions for summary judgment. The court denied Mellon Bank’s motion because it was based on an interpretation of the second prerequisite of § 67(e)(1) that the court had rejected.133 However, the court also denied the Government’s motion for two reasons. First, the Government failed to show why the court should conclude in this case that investment advisory fees would have been incurred in the absence of a trust.134 Second, Mellon Bank presented deposition testimony that the services RKM & S provided to the trusts were similar to those provided to individuals but “more onerous.” 135 This would suggest that some of the fees paid to RKM & S would not have been incurred if the property were not held in trust.136

Subsequently, the parties filed a stipulation that they would not present any evidence as to whether any costs at issue would not have been incurred if the property were not held in trust.137 The Court of Federal Claims then entered judgment in favor of the government.138

2. Federal Circuit

In affirming the Court of Federal Claims, the Federal Circuit issued

129. Id.
130. Id.
131. Id. (quoting Hartford Underwriters Ins. Co. v. Union Planters Bank, 530 U.S. 1, 6 (2000)).
132. Id.; see also supra notes 122–24 and accompanying text.
133. Mellon Bank, 47 Fed. Cl. at 196.
134. Id.
135. Id.
136. Id.
138. Id.
an opinion that largely paralleled the opinion issued by the trial court. Like the Court of Federal Claims, the Federal Circuit found that “section 67(e)(1) unambiguously establishes two requirements for expenditures to qualify for exclusion from the two percent floor.” Further, the Federal Circuit observed that the first requirement concerns the relationship between the costs incurred and the administration of the trust— a requirement that would be satisfied by “[a]ll expenses resulting from the fiduciary obligations of the trustee.”

However, unlike the Court of Federal Claims, the Federal Circuit provided specificity as to the meaning of the second requirement. To meet this requirement, the court declared that expenses have to be “unique to the administration of a trust and not customarily incurred outside of trusts.” Because individuals with substantial portfolios of their own commonly incur investment advisory fees, the court held that such fees fail the second requirement and are not fully deductible.

139. Id. at 1280; see also supra notes 90–93 and accompanying text.
140. Mellon Bank, 265 F.3d at 1280; see also supra note 111 and accompanying text.
141. There were some other differences between the two courts’ opinions, but they were relatively minor. First, the Federal Circuit provided additional maxims governing statutory construction. The court noted that when assessing whether the language of a statute was ambiguous, the court had to consider the specific context in which the statutory language is used and the context of the statute as a whole, as well as the language of the statute itself. Mellon Bank, 265 F.3d at 1280 (quoting Robinson v. Shell Oil Co., 519 U.S. 337, 340–41 (1997)). In addition, absent clear evidence of legislative intent to the contrary, the court had to give effect to the statute’s plain meaning. Id. at 1281 (quoting Thompson/Center Arms Co. v. United States, 924 F.2d 1041, 1044–45 (Fed. Cir. 1991)). The Federal Circuit and the Court of Federal Claims also differed as to which part of § 67(e)(1) was rendered superfluous by Mellon Bank’s interpretation of the statute. In the Federal Circuit’s view, Mellon’s assertion that expenses incurred to satisfy a trustee’s fiduciary obligation were fully deductible was equivalent to stating that all costs incurred in connection with a trust’s administration were fully deductible regardless of whether such costs would have been incurred if the property were not held in trust. Id. at 1280. Thus, the Federal Circuit found that Mellon’s interpretation had eliminated the second requirement, while the Court of Federal Claims faulted Mellon for rendering the first requirement superfluous. Id.; see also supra notes 110–112 and accompanying text.
142. Mellon Bank, 265 F.3d at 1281.
143. Id.
C. Scott v. United States

1. Eastern District of Virginia

The plaintiffs were the trustees and income beneficiaries of a multi-generational testamentary trust administered under the laws of Virginia. The trustees were all individuals who had “no experience in managing large amounts of assets” and who would not have served as trustees “unless the services of a financial advisor were available to assist in financial planning for the trust.”

The trust retained the services of such an advisor and deducted the full amount of the advisor’s fees in preparing tax returns for 1996 and 1997. After the IRS determined the fees should have been treated as miscellaneous itemized deductions subject to the 2% floor and assessed a deficiency for the two years, the trust paid the additional taxes and brought suit for a refund. The parties then filed cross motions for summary judgment.

In deciding the issue, the court discussed the split between the Sixth and Federal Circuits regarding whether the fees fit within § 67(e). However, the court found no need to choose between the two precedents, as the instant case could be distinguished from O’Neill. While Virginia imposed a prudent investor standard upon trustees in managing trust investments, it also provided trustees with “absolute immunity” from liability if the trustees invested in the stocks, bonds, and other securities specified in Virginia statutes. Thus, unlike the trustees in O’Neill, the trustees before the court could not show that they were required to obtain investment counsel to comply with their fiduciary obligations. The court stated that the only thing the plaintiffs had demonstrated was that they incurred the investment advisory fees to preserve principal and income, entitling them to treat such costs as miscellaneous itemized deductions.

145. Id. at 665.
146. Id.
147. Id.
148. Id.
149. Id.
150. Id. at 666–67.
151. Id. at 667.
152. Id. (citing VA. CODE ANN. §§ 26-45.1, 26-40, 26-40.01 (Michie 1992)).
153. Id.
under § 67(a). What the plaintiffs failed to show was that the expenses would not have been incurred if the property had not been held in trust. Accordingly, the court granted the Government’s motion for summary judgment.

2. Fourth Circuit

Additional facts provided by the court indicated that the trust in question had assets worth approximately $25 million and had paid an investment counseling firm $107,055 and $119,943 in 1996 and 1997, respectively. As the court noted, the suits for refunds by the trust and three of the income beneficiaries (collectively referred to as the “taxpayers” by the court) were consolidated because they hinged on the same issue: whether fees paid by trusts for investment advice are fully deductible.

The court listed the two requirements of § 67(e)(1) for costs to be fully deductible “above the line and without regard to the 2% floor.” Because there was no dispute that the investment advisory fees were incurred in connection with the trust’s administration, the court’s task was to determine whether the fees satisfied the second requirement.

The court then enumerated the canons governing the approach to statutory construction. The first step is to determine whether the language of the statute is plain and unambiguous. If the language is unambiguous, and “the statutory scheme is coherent and consistent,” courts must end their inquiry. “When examining statutory language, [courts] generally give words their ordinary, contemporary, and common meaning.” Further, courts determine whether language is ambiguous by referring to
“the language itself, the specific context in which that language is used, and the broader context of the statute as a whole.” 164 Finally, courts “must give effect to every provision and word in a statute and avoid any interpretation that may render statutory terms meaningless or superfluous.” 165

Applying these canons, the court concluded that § 67(e)(1) “is clear and unambiguous” and that it did not have to address any arguments concerning legislative history raised by the parties. 166 The court stated that the verb “would” in the second clause of the statute “expresses concepts such as custom, habit, natural disposition, or probability.” 167 Thus, the court agreed with the Federal Circuit that trust expenses satisfy the second requirement only if they “are unique to the administration of a trust and not customarily incurred outside of trusts.” 168

Based on this interpretation of § 67(e)(1), the court held that fees for investment counsel, which “are commonly incurred outside the context of trust administration, . . . are subject to the 2% floor created by § 67(a).” 169 On the other hand, the court declared that expenses “solely attributable to a trustee’s fiduciary duties,” such as trustees’ fees, costs associated with judicial accountings, and the costs of preparing fiduciary income tax returns, would be fully deductible. 170

Finally, the Fourth Circuit found the taxpayers’ interpretation of the statute deficient in two respects. First, the court claimed that any costs associated with a trust would be deductible under the taxpayers’ position, rendering the second statutory requirement meaningless. 171 Second, the taxpayers were relying on the Sixth Circuit’s holding in O’Neill, which “contain[ed] a fatal flaw” in the Fourth Circuit’s view. 172 While the court agreed with the Sixth Circuit that trustees must frequently seek investment counsel, the court pointed out that “the second requirement of § 67(e)(1)
does not ask whether costs are commonly incurred in the administration of trusts.” To the contrary, the statute focuses on “whether costs are commonly incurred outside the administration of trusts.”

The court agreed with the Federal Circuit that investment advisory fees are commonly incurred by individual taxpayers outside the administration of trusts. Accordingly, the district court’s decision that the fees paid were subject to the 2% floor under § 67(a) was affirmed.

D. William L. Rudkin Testamentary Trust v. Commissioner

1. Tax Court

The majority of facts were stipulated. The William L. Rudkin Testamentary Trust was established in 1967 under the will of Henry A. Rudkin. Henry A. Rudkin’s family founded the Pepperidge Farm Company, a food products company that was sold to the Campbell Soup Company in the 1960s. The trust’s initial funds came primarily from that sale.

The trustee, Michael Knight, consulted Warfield Associates, Inc., an investment advisor, and paid the firm $22,241.31 in fees for tax year 2000. On its return, the trust reported total income of $624,816 and deducted the fees of $22,241 on a line for other deductions of the trust that were not subject to the 2% floor. The Commissioner allowed a deduction for only $9,780 of the fees, representing the portion that exceeded 2% of the trust’s adjusted gross income of $623,050, and determined the trust’s tax.

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173. Id. at 140.
174. Id. (emphasis in original).
175. Id.
176. Id. The Fourth Circuit did not address the effect of the statutory list of securities on the trustees’ fiduciary duties that was decided by the district court. Id. at 140 n.9.
178. Rudkin Testamentary Trust, 124 T.C. at 305.
179. Id.
180. Id.
181. Id.
182. Id. at 306.
183. Id.
deficiency to be $4,448.\footnote{Id. The parties subsequently stipulated that the correct adjusted gross income was $613,263, and the amount deductible under the Commissioner’s position was $9,976. \textit{Id.} However, the parties further stipulated that because of the alternative minimum tax, the deficiency would stand at $4,448 if the Commissioner were sustained. \textit{Id.}}

The trustee claimed that the fees were fully deductible under § 67(e)(1) because they were paid in connection with the trust’s administration and would not have been incurred if the funds were not held in trust.\footnote{\textit{Id. at 308.}} The contention was based on the trustee’s fiduciary duties.\footnote{\textit{Id.}} While an individual may voluntarily choose to seek professional investment advice, the trustee maintained such advice was “a necessary and ‘involuntary’ component of trust administration.”\footnote{\textit{Id. at 308–09.}}

The Commissioner responded that individual investors commonly incur investment advisory fees outside the context of trust administration.\footnote{\textit{Id.}} Accordingly, the Commissioner concluded that the fees failed to meet the second requirement of § 67(e)(1) that they would not have been incurred if the assets had not been held in trust.\footnote{\textit{Id.}}

In its analysis, the Tax Court observed that the issue was “not a matter of first impression.”\footnote{\textit{Id. at 309.}} After reviewing its own precedent in \textit{O’Neill} and the decisions issued by the Sixth, Federal, and Fourth Circuits, the court concluded that the interpretation of the statute expressed in the \textit{Scott} and \textit{Mellon Bank} cases, as well its opinion in \textit{O’Neill}, “remain[ed] sound.”\footnote{\textit{Id. at 309–11.}} Based on its analysis and the fact that an appeal in the instant case would be to the Second Circuit, the court upheld the Commissioner’s determination of the trust’s deficiency.\footnote{\textit{Id.}}

2. \textit{Second Circuit}

The Second Circuit noted that the case presented a question of
statutory interpretation and listed the rules to be followed in ascertaining the meaning of § 67(e)(1). The starting point for courts is the statute’s language. Courts give the words of the statute their ordinary and common meaning unless there is an indication that Congress intended them to have a different meaning. If the language of the statute “is unambiguous and the statutory scheme is coherent and consistent,” courts must end their inquiry into the statute’s meaning. Courts determine whether a statute is unambiguous by referring to the language of the statute, “the specific context in which that language is used, and the broader context of the statute as a whole.” Finally, there is no need for courts to refer to legislative history if the language of the statute is clear and unambiguous.

With these standards in mind, the court then addressed the meaning of the second clause of § 67(e)(1). The trust raised two arguments in favor of an interpretation that permitted full deductibility of the investment advisory fees. The first was based on the statute’s language, and the second was focused on legislative history. The court addressed these in turn.

The trust contended that the statute’s text provides a causal test for administrative costs. Under that test, the court looks solely at whether the cost would have been incurred without the trustee and should disregard whether a “generic individual owner of the same assets [might] have incurred the cost at issue.” A cost that would not have been incurred in the absence of a trustee would be “attributable to the trustee’s performance of its fiduciary duty and . . . fully deductible under § 67(e)(1).” The trust read the phrases, “the estate or trust” and “such trust or estate,” found in § 67(e)(1), to mean that the court should “refer to the specific trust under consideration, its trustee and that trustee’s duties, rather than to the generic trust” indicated by the words “an estate or trust” in the introductory clause of § 67(e).
The court rejected the trust’s causation test as an unreasonable interpretation of the statute.\textsuperscript{205} The court observed that if Congress had intended to establish a test that ignored what an individual owner might have done if the assets were not held in trust, Congress “could have done so in language clearly expressing that intent.”\textsuperscript{206} In the court’s view, the phrase, “if the property were not held in such trust,” requires a court to consider what costs “a hypothetical individual property owner could incur with respect to that property.”\textsuperscript{207} The court expressed its agreement with the Fourth Circuit “that the second prong of § 67(e)(1) does not ask whether the costs at issue are commonly incurred in the administration of trusts or are incurred as a result of a particular trustee’s fiduciary duty.”\textsuperscript{208}

The court was quick to note that, while a court is to focus on the hypothetical situation in which an individual owns the assets, “the statute does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner \textit{would} have incurred the particular cost at issue.”\textsuperscript{209} Nor should a court consider “factual disputes about whether an individual asset owner . . . is insufficiently financially savvy or the assets sufficiently large such that he or she unquestionably would have sought investment advice.”\textsuperscript{210} According to the court, the plain meaning of the

\begin{quote}
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 . . . .
\end{quote}


The court dismissed the argument, stating that the phrase “an estate or trust” in the introductory language of § 67(e) refers to a “generic trust . . . a trust of the type to which § 67(e) is applicable.” \textit{Rudkin Testamentary Trust}, 467 F.3d at 155. Then the court determined that the phrase “the estate or trust” in the first clause of § 67(e)(1) “plainly refers not to a particular trust under consideration, but to the generic estate or trust mentioned in the provision’s introductory language.” \textit{Id.} at 157. The court then concluded that the phrase, “such trust or estate,” “also refers, therefore, to the generic estate or trust mentioned in both the introductory language of § 67(e) and in the first clause of § 67(e)(1).” \textit{Id.}

\begin{itemize}
  \item \textsuperscript{205} \textit{Rudkin Testamentary Trust}, 467 F.3d at 154–55.
  \item \textsuperscript{206} \textit{Id.} at 155.
  \item \textsuperscript{207} \textit{Id.} (quoting I.R.C. § 67(e)(1)).
  \item \textsuperscript{208} \textit{Id.}
  \item \textsuperscript{209} \textit{Id.} (emphasis in original).
  \item \textsuperscript{210} \textit{Id.}
\end{itemize}
second clause is that costs “that could be incurred if the property were held individually rather than in trust” are not fully deductible by the trust in arriving at taxable income.\textsuperscript{211} Put another way, “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.”\textsuperscript{212}

Continuing with the analysis, the court stated that the determination to be made under the statute is “whether the particular cost is one that is peculiar to trusts and one that individuals are incapable of incurring.”\textsuperscript{213} Because individuals are clearly capable of sustaining fees for investment counsel, the court held such fees are not fully deductible under § 67(e)(1) when paid by a trust.\textsuperscript{214} On the other hand, costs that individuals could not have incurred, such as “‘fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns,’ are fully deductible.”\textsuperscript{215}

Although it concurred with the Federal and Fourth Circuits’ treatment of investment advisory fees, the court disagreed in part with their interpretation of § 67(e)(1).\textsuperscript{216} The court objected to their position that costs “customarily” or “commonly” incurred by individuals did not fit within § 67(e)(1) and were subject to the 2% floor of § 67(a).\textsuperscript{217} According to the court, it is unnecessary to determine whether trust administrative costs are commonly or customarily incurred by individuals.\textsuperscript{218} To be more consistent with the statute’s plain language, a court must “determine with certainty that costs could not have been incurred if the property were held by an individual.”\textsuperscript{219}

Turning to the trust’s legislative history argument, the court noted that it did not have to address the argument because it found the statute clear and unambiguous.\textsuperscript{220} Nevertheless, the court did so. The trust
maintained that Congress added the second clause of § 67(e)(1) to prevent a trust from using a “pass-through entity” to avoid the 2% floor of § 67(a), rather than to limit the deductibility of any other administrative cost of a trust.\textsuperscript{221}

Before responding to this contention, the court provided some background on pass-through entities. Partnerships, S corporations, and other so-called pass-through entities generally do not pay tax at the entity level.\textsuperscript{222} Instead, the entity’s income, deductions, gains, losses, and credits pass through to the owners, who report their shares of such items on their own income tax returns.\textsuperscript{223} As the court pointed out, if there were no restrictions on these entities, individuals could place their investments in a pass-through entity and get a full deduction for the cost of investment advice in a two-step process: (1) the entity would receive the investment income and incur the cost of the advice, and (2) the entity would net the full cost of the advice against the investment income and pass through only the net amount to the owner to be reported on the owner’s individual return.\textsuperscript{224}

As the court noted, Congress closed this loophole by enacting § 67(c)(1), which directs the Secretary of the Treasury to adopt regulations prohibiting the use of pass-through entities to indirectly deduct amounts that could not be deducted if paid or incurred directly by individuals.\textsuperscript{225} However, Congress also provided in § 67(c)(3)(B) that § 67(c)(1) did not pertain to estates and trusts except as provided in regulations.\textsuperscript{226} Therefore, absent the second clause of § 67(e)(1), trusts, unlike individuals, would have been able to fully deduct the cost of investment advice incurred by pass-through entities in which the trust had invested.\textsuperscript{227} Thus, the trust argued, the sole purpose of the second clause was to subject only those administrative costs that were incurred by a pass-through entity in which the trust invested to the 2% floor of § 67(a).\textsuperscript{228}

\textsuperscript{221} Id. at 157–58.
\textsuperscript{222} Id.
\textsuperscript{223} Id. at 158.
\textsuperscript{224} Id.
\textsuperscript{225} Id.; see also I.R.C. § 67(c)(1) (West 2002).
\textsuperscript{226} Rudkin Testamentary Trust, 467 F.3d at 158; see also I.R.C. § 67(c)(3)(B).
\textsuperscript{227} Rudkin Testamentary Trust, 467 F.3d at 158.
\textsuperscript{228} Id. at 158–59. To support its position, the trust relied on the following excerpt from the House Conference Report on the Tax Reform Act of 1986:

Pursuant to Treasury regulations, the [two-percent] floor is to apply with respect to indirect deductions through pass-through entities (including mutual
The court dismissed this contention, reasoning that, had Congress intended only to prevent trusts from deducting their full share of administrative costs of pass-through entities in which they had invested, Congress “could have drafted the second clause of § 67(e)(1) more narrowly.”[^229] The court stated:

> [T]he broad statutory language is the best indication that Congress intended to treat those administrative costs that would be subject to the two-percent floor when incurred by an individual as similarly subject to that floor when incurred by a trust. Nothing in the legislative history suggests a clearly expressed congressional intent contrary to the plain meaning of the statute itself.^[^230]

Having concluded that the investment advisory fees did not satisfy the requirements of § 67(e)(1) for full deductibility, the court affirmed the judgment of the Tax Court.^[^231] The trustee petitioned the United States Supreme Court for a writ of certiorari, and the petition was granted.^[^232]

### IV. A CRITIQUE OF THE CASES IN LIGHT OF THE SUPREME COURT’S APPROACH TO STATUTORY INTERPRETATION

After reviewing the reported cases above, the question arises as to which decision the United States Supreme Court is likely to approve when it analyzes the issue. To answer this question, this Part first provides an overview of the textualist approach to statutory interpretation that has

[^229]: Id. at 159.
[^230]: Id. at 159–60.
[^232]: Id. at 159.
become prevalent in the Court’s opinions since the appointment of Justice Scalia.\footnote{233} This Part then reviews *Gitlitz v. Commissioner*,\footnote{234} a case exemplifying the textualist approach in which the Court interpreted Code sections dealing with the discharge of indebtedness of a subchapter S corporation.\footnote{235} Finally, this Part evaluates the reported cases against this textualist backdrop and concludes that the Court’s interpretation of § 67(e)(1) will most likely accord with that of the Second Circuit in *Rudkin Testamentary Trust*.\footnote{236}

\section*{A. Overview of Textualism}

When interpreting a statute, textualists examine its language and consider its meaning in the context in which it is used.\footnote{237} The task of textualists is to determine “how ‘a skilled, objectively reasonable user of words’ would have understood the statutory text, as applied to the problem before the court.”\footnote{238} To ascertain the statute’s meaning, textualists do not limit themselves to the language of the statute being construed or to related statutes.\footnote{239} They can, and do, consult dictionaries, case law, and, in some cases, treatises that existed at the time of the statute’s enactment.\footnote{240}

\begin{itemize}
\item \footnote{234}{*Gitlitz v. Comm’r*, 531 U.S. 206 (2001).}
\item \footnote{236}{See *supra* Part III.D.2.}
\item \footnote{237}{Manning, *supra* note 233, at 108 & n.419.}
\item \footnote{238}{Id. at 109 (quoting Frank H. Easterbrook, *The Role of Original Intent in Statutory Construction*, 11 HARV. J.L. & PUB. POL’Y 59, 65 (1988)).}
\item \footnote{239}{Cunningham & Repetti, *supra* note 235, at 9 (citing WILLIAM N. ESKRIDGE, JR., *DYNAMIC STATUTORY INTERPRETATION* 42 (1994)).}
\item \footnote{240}{Id.}
\end{itemize}
one source to which textualists will not refer is legislative history. Textualists reject the use of such interpretive tools on the basis “that it is difficult, if not impossible, to aggregate individual legislators’ preferences into a coherent collective decision.” As far as textualists are concerned, the words of the statute that was passed by Congress and signed by the President provide the best evidence of Congressional intent.

Under the textualist approach, if the language of a statute is clear, courts must give effect to its “conventional meaning . . . even if it does not appear to make perfect sense of the statute’s overall policy.” Textualists will not consider the purpose of a statute if its text is clear. Absent an absurd result, textualists end their inquiry into the statute’s meaning when the statute is unambiguous.

The Gitlitz case discussed in the next section illustrates the Court’s application of these tenets in interpreting provisions of the Internal Revenue Code.

B. Gitlitz v. Commissioner

The taxpayers, Gitlitz and Winn, were equal shareholders in an S corporation, P.D.W. & A. Under § 1366(a)(1)(A), a shareholder takes a

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241. Id. at 8–9. Textualists make an exception to this rule for determining “the background context of the legislation where such background may be independently verified.” Id. at 9. For Justice Scalia, legislative history includes transcripts of floor debates and committee testimony prior to a statute’s enactment as well as committee reports. Matthew H. Solomson & Sarah M. Brackney, What Would Scalia Do?— A Textualist Approach to the Qui Tam Settlement Provision of the False Claims Act, 36 PUB. CONT. L.J. 39, 42 (2006).


243. Id. at 21 n.84; see Madison, supra note 233, at 703.

244. Manning, supra note 233, at 3–4.

245. Id. at 17.

246. Id. Professor Manning states that the absurdity doctrine is used so infrequently that “it is difficult to distill a single definitive textualist explanation of that doctrine.” Id. at 116. Manning summarizes the absurdity doctrine as follows: “It enforces the most natural meaning of a statute as long as it remains within the limits of Congress’s constitutional authority. But when the most natural meaning of a statute seriously threatens to exceed those limits, textualists will seek a permissible alternative interpretation that avoids that danger.” Id. at 118.


248. Id. at 209–10. An S corporation with respect to any taxable year is “a small business corporation for which an election under section 1362(a) is in effect for such year.” I.R.C. § 1361(a)(1) (West Supp. 2007). S corporations are governed by §§ 1361–1379, which comprise subchapter S of chapter 1 of the Internal Revenue Code.
pro rata share of the corporation’s items of income, loss, deduction, and credit into account in determining individual tax liability for the year.\textsuperscript{249} To avoid income being taxed a second time when it is distributed, a shareholder increases the basis of her S corporation stock for her share of items of income.\textsuperscript{250} Similarly, a shareholder decreases the basis for her share of the items of loss and deduction.\textsuperscript{251} However, a shareholder may not take losses and deductions into account on an individual return to the extent such losses and deductions exceed the sum of the adjusted basis of the stock and the basis in any indebtedness of the corporation to the shareholder.\textsuperscript{252} The losses and deductions that the shareholder may not take into account on her individual tax return for a given taxable year are suspended, and the shareholder may carry them forward indefinitely until she has a sufficient basis against which the suspended losses and deductions may be applied.\textsuperscript{253}

In 1991, when P.D.W. & A. became insolvent to the extent of $2,181,748, its creditors canceled $2,021,296 of its debt.\textsuperscript{254} While income from the discharge of indebtedness is generally included in a taxpayer's gross income under § 61(a)(12), § 108(a)(1)(B) provides relief and excludes such income if the discharge occurs when the taxpayer is insolvent.\textsuperscript{255} The amount excluded is limited to the amount by which the taxpayer is

\begin{itemize}
\item Id. §§ 1361–1379.
\item \textsuperscript{249} I.R.C. § 1366(a)(1)(A); \textit{Gitlitz}, 531 U.S. at 209. Section 1366(a)(1) provides in pertinent part:

\begin{quote}
In determining the tax under this chapter of a shareholder for the shareholder’s taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder’s pro rata share of the corporation’s—

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder . . . .
\end{quote}

\item As a result of this provision, items of income and loss are said to pass through or flow through to the shareholders. \textit{Gitlitz}, 531 U.S. at 209.
\item \textsuperscript{250} I.R.C. § 1367(a)(1)(A); \textit{Gitlitz}, 531 U.S. at 209.
\item \textsuperscript{251} I.R.C. § 1367(a)(2)(B); \textit{Gitlitz}, 531 U.S. at 209.
\item \textsuperscript{252} I.R.C. §§ 1366(d)(1), 1367(a)(2); see \textit{Gitlitz}, 531 U.S. at 209–10.
\item \textsuperscript{253} I.R.C. § 1366(d)(2)(A); see \textit{Gitlitz}, 531 U.S. at 209–10.
\item \textsuperscript{254} \textit{Gitlitz}, 531 U.S. at 210.
\item \textsuperscript{255} I.R.C. §§ 61(a)(12), 108(a)(1)(B) (West 2002 & Supp. 2007); \textit{Gitlitz}, 531 U.S. at 213. Income from discharge of indebtedness is also referred to as income from the cancellation of debt, or COD income. \textit{See Gitlitz}, 531 U.S. at 220 (Breyer, J., dissenting). Hereinafter, such income will be referred to as “COD income.”
\end{itemize}
insolvent. But the relief granted to the taxpayer comes at a price—under § 108(b) the taxpayer must reduce the taxpayer’s so-called tax attributes, such as net operating loss, capital loss carryovers, and the basis of the taxpayer’s property, which would otherwise offset future income. Thus, in tax years subsequent to the year of debt cancellation, with fewer tax attributes to offset individual income, the taxpayer would report higher taxable income and incur a greater tax liability.

In 1991, § 108(d)(7)(A) provided that, “[i]n the case of an S corporation,” subsections (a) and (b) of § 108 “shall be applied at the corporate level.” As discussed above, subsection (a) of § 108 excludes discharge of indebtedness income when the taxpayer is insolvent. Apparently interpreting § 108(d)(7)(A) to mean that the taxpayer whose insolvency was relevant to the exclusion was that of the S corporation, P.D.W. & A. determined that the $2,021,296 of COD income should be passed through as an item of income that was to be excluded by Gitlitz and Winn on their individual returns. Each shareholder then increased the basis of his stock by $1,010,648, reflecting his fifty-percent share of the COD income. The increase in basis permitted each shareholder to deduct his share of the corporation’s 1991 operating losses in addition to losses from prior years that had been suspended under § 1366(d). These losses totaled $1,010,648 for each shareholder. Thus, Gitlitz and Winn were each able to exclude $1,010,648 in COD income and deduct $1,010,648 in losses.

The Commissioner determined that Gitlitz and Winn were not entitled to increase their bases as a result of the debt discharge and denied the shareholders the loss deductions. The Tax Court and the United States Court of Appeals for the Tenth Circuit upheld the Commissioner’s deficiency determination.

In the Supreme Court’s view, the plain language of § 1366(a)(1)(A) permitted the excluded COD income to be passed through as an “item of

257. Id. § 108(b).
259. See supra note 255 and accompanying text.
261. Id.
262. Id.; see also I.R.C. § 1366(d).
264. Id.
265. Id. at 210–11.
income” to the shareholders, resulting in a basis increase and a deduction of suspended losses. In reaching its conclusion, the Court dismissed the argument that the shareholders would receive an unwarranted double windfall by stating: “Because the Code’s plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.”

In addition, the Court rejected the Commissioner’s contention that, under § 108(d)(7)(A), the exclusion of COD income pursuant to § 108(a) and reduction of tax attributes under § 108(b) occur at the corporate level. The consequences of the Commissioner’s interpretation were that COD income did not flow through to the shareholders and the COD income did not increase the basis in their stock, enabling them to deduct suspended losses. In support of his position, the Commissioner cited the following passage from a House Committee Report: “[T]he exclusion and basis reduction are both made at the S corporation level (sec. 108(d)(7)). The shareholders’ basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level.” The majority did not acknowledge the House Committee Report; instead, it stated that there was nothing in the language of § 108(d)(7)(A) to indicate that it “suspend[ed] the operation of [the] ordinary pass-through rules” contained in § 1366(a)(1).

As one can see from the above discussion, Gitlitz clearly illustrates two principal tenets of textualism. First, when the language of a statute is plain and unambiguous, textualists refuse to consider whether the text is consistent with the statute’s apparent purpose. Thus, the majority declined to address the policy concern that the shareholders received a double windfall under its interpretation of §§ 1366(a) and 108(d)(7)(A) because the plain language of the statutes entitled the shareholders to such

266. Id. at 212–16.
267. Id. at 220.
268. Id. at 214 n.6; see also id. at 221 (Breyer, J., dissenting).
269. Id. at 221 (Breyer, J., dissenting).
272. See supra notes 244–45 and accompanying text.
Second, the case highlights the textualists’ rejection of legislative history as an aid in interpreting statutes. Gitlitz offers one final insight: textualists rarely seem to find a statutory ambiguity “in need of solution.” The dissent asserted that the text of § 108(d)(7)(A) yielded two possible interpretations, thus producing an ambiguity. However, the majority saw only one possible interpretation, namely that nothing in § 108(d)(7)(A) indicated that it would affect the pass-through rules of § 1366.

C. The Supreme Court’s Likely Interpretation of § 67(e)(1)

When the Supreme Court examines § 67(e)(1), it undoubtedly will conclude that the statute’s language is clear and unambiguous. Further, the Court should agree with the Federal, Second, and Fourth Circuits that the statute prevents a trust from fully deducting the fees paid to an outside investment advisor. However, when the Court analyzes the statute’s second clause, “which would not have been incurred if the property were not held in such trust or estate,” it should find the Second Circuit’s interpretation in Rudkin Testamentary Trust to be the most consistent with the plain meaning of the text.

As the Second Circuit noted, the clause directs the court to inquire as to “the costs that a hypothetical individual property owner could incur with respect to [the] property” that is held in the trust. Further, as the Second Circuit reasoned, “the plain language of the statute requires certainty that a particular cost ‘would not have been incurred’ if the property” had been held by a hypothetical individual property owner.

273. See supra note 267 and accompanying text.
274. See supra notes 241–43 and accompanying text.
275. Geier, supra note 233, at 449–50; see also Heen, supra note 233, at 776.
276. Gitlitz, 531 U.S. at 222–23 (Breyer, J., dissenting); see supra notes 268–71 and accompanying text.
277. See supra note 271 and accompanying text.
278. See supra note 275 and accompanying text.
279. See supra notes 141–43, 168–69, 213–14 and accompanying text.
280. I.R.C. § 67(e)(1) (West 2002); see supra note 219 and accompanying text.
281. Willaim L. Rudkin Testamentary Trust v. Comm’r., 467 F.3d 149, 155 (2d Cir. 2006); see infra Part V.C.
282. Rudkin Testamentary Trust, 467 F.3d at 156 (quoting I.R.C. § 67(e)(1)); see supra note 212 and accompanying text. In proposed regulations issued on July 27, 2007, the Secretary of the Treasury has adopted the Second Circuit’s interpretation. Prop. Treas. Reg. § 1.67-4(b), 72 Fed. Reg. 41243, 41245 (July 27, 2007); see infra Part V.C.
For a court to be certain that a particular cost would not have been incurred if a hypothetical individual owned the property, the cost must be one that an individual is not able to incur. By holding that § 67(e)(1) "permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner," the Second Circuit is the only court to incorporate the requirement for certainty in its interpretation of the statute.283

While the Second Circuit has appropriately given effect to the plain meaning of § 67(e)(1), the Supreme Court’s opinion should differ from that of the Second Circuit in at least two respects. First, the Court is likely to ignore the Conference Report cited to support the trust’s contention that the statute’s second clause was enacted to prevent trusts from deducting administrative costs of pass-through entities in which they had an ownership interest.284 The Court’s refusal to address the report would accord with the textualists’ rejection of legislative history and the Court’s precedent in Gitlitz.285

The other likely difference concerns the Second Circuit’s statement about trustee fees. The court listed trustee fees among costs that individuals are incapable of incurring, rendering them fully deductible under § 67(e).286 The primary problem with this comment is that it is dictum. The issue before the Second Circuit was whether fees paid by a trustee to an investment advisor were fully deductible, rather than whether trustee fees were fully deductible.287 Similarly, the issue of trustee fees will not be before the Supreme Court, so there would be no good reason for the Court to acknowledge the comment or to address the issue.288

283. Rudkin Testamentary Trust, 467 F.3d at 156; see supra notes 213–214, 219 and accompanying text.
284. See supra notes 221–28 and accompanying text.
286. See supra note 215 and accompanying text.
287. Rudkin Testamentary Trust, 467 F.3d at 151.
288. Whether trustee fees are deductible in full is an interesting question. The Second Circuit seems to assume that the entire trustee fee is deductible merely because it is paid to a trustee. The Second Circuit’s comment reflects an approach to § 67(e) in which an “expenditure [is] exempt from the 2% floor if the label of the expenditure connote[s] a trust relationship, such as trustees' commission or trust accounting fees.” Pamela Champine, Taxing Middle Class Trust(s), 7 FLA. TAX REV. 505, 539 (2006). Among other reasons, Professor Champine is highly critical of the approach because it “allows trusts to circumvent the 2% floor with ease by building their investment advisory fees and similar expenditures into trustees’ compensation.” Id. at 544. The Court of Federal Claims pointed out in Mellon Bank that some tasks trustees perform would still have to be performed outside the trust context so that characterizing a cost...
V. POLICY ARGUMENTS IN FAVOR OF AMENDING § 67(e)

As this Article assumes that the Supreme Court will hold that investment advisory fees paid or incurred by trusts and estates do not satisfy § 67(e)(1), this Part focuses on three policy arguments favoring amendment of the statute so that all costs incurred in connection with the administration of an estate or trust are fully deductible.

A. The Rationale for the 2% Floor Does Not Apply to Estates and Trusts

The first argument in favor of amending § 67(e)(1) is that Congress's objectives in enacting the 2% floor under § 67(a) do not apply to estates and trusts. The Joint Committee on Taxation summarized the reasons for establishing the 2% floor as follows:

The Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures. For taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers frequently made errors of law regarding what types of expenditures were properly allowable under prior law as miscellaneous itemized deductions.

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. At the same time, the Congress concluded that the taxpayers with unusually large employee business or investment expenses should be permitted an itemized deduction as a trustee fee would not answer the question of whether the cost would have been incurred if the property had not been held in trust. See supra notes 115–16 and accompanying text. Following this logic, the Court of Federal Claims would require trusts to allocate trustee fees between the portion that would be fully deductible under § 67(e)(1) and the portion that would be subject to the 2% floor under § 67(a). See supra notes 135–36; see also Champine, supra, at 539–40. In proposed regulations issued on July 27, 2007, the Secretary of the Treasury has adopted a position similar to that of the Court of Federal Claims with respect to the allocation of trustee fees. Prop. Treas. Reg. § 1.67-4(c), 72 Fed. Reg. 41243, 41245 (July 27, 2007); see infra Part V.C.
reflecting that fact . . . .

Accordingly, the Congress concluded that the imposition of a two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor. Also, the percentage floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

The use of a deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.289

Clearly, expenditures incurred in connection with the administration of a trust are for the production of income or returns on trust assets and have no voluntary, personal component as described by the Joint Committee.290 Further, the prudent person standard places limits on the costs that a trustee may incur in managing trust assets, so that the risk of unnecessary expenditures being sustained and wrongly deducted is reduced even further.291 With respect to recordkeeping, the 2% floor affords no relief because the trustee still has a duty to account to the beneficiaries concerning the trust’s property, liabilities, receipts, and disbursements.292 Finally, it is also unlikely that the floor has had that much impact in reducing the IRS’s administrative burden in auditing trusts. Because none of the reasons enumerated for enacting the 2% floor with respect to individuals are valid in the context of trusts and estates, § 67(e)(1) should be amended so that the administrative costs of these entities are not subject

291. See supra notes 59–60 and accompanying text.
292. See UNIF. TRUST CODE § 813(c) (2004).
B. The 2% Floor Is Not Necessary to Promote a Fairer Tax System

The Court of Federal Claims stated that subjecting trusts’ expenses for investment advice to the 2% floor promoted Congress’s purpose of making the tax laws more fair when it enacted the Tax Reform Act of 1986.\(^{294}\) Further, the court observed that a plain meaning interpretation of the second clause of § 67(e)(1) prevented individuals from placing assets in a trust to obtain a full deduction for investment expenses that they would not be entitled to in the absence of a trust.\(^{295}\)

Congress achieved its goal of preventing wealthy individuals from using trusts to realize significant income tax benefits by compressing the tax rate schedule for trusts and estates compared to the rate schedules for individuals.\(^{296}\) For example, for tax years beginning in 2007, no individual, other than one who is married and filing a separate return, is in the top tax bracket of 35% until their taxable income rises above $349,700, while a trust is in the 35% tax bracket when its taxable income exceeds $10,450.\(^{297}\) Thus, virtually all of the income of a trust with beneficiaries whose other taxable income places them in the 35% bracket will end up being taxed at 35%, whether the trust pays tax on the income it accumulates or the beneficiaries pay tax on the income distributed to them.\(^{298}\) Given this rate compression, the 2% floor is unnecessary to promote tax fairness.

Also, due to the so-called grantor trust rules, the second clause of § 67(e)(1) is largely unnecessary to preclude individuals from establishing a trust for their own benefit to obtain a full deduction for investment expenses.\(^{299}\) If an individual set up a revocable trust with the income from the trust to be paid to her annually for her life and the remainder to be distributed in equal shares to her children, she would be considered the
owner of the trust pursuant to § 676(a). Under § 671, if an individual is considered the owner of a trust, then she reports the trust’s items of income, deductions, and tax credits on her individual tax return. In our example, the grantor who established the trust would be considered the owner and would report all of the trust’s items of income, deductions, and tax credits on her individual return. As a result, if the trust paid for investment advice, the individual would report the expense on her return, and the cost of the advice would be subject to the 2% floor, regardless of § 67(e)(1). To avoid being treated as the owner of the trust, the grantor would have to give up virtually any interest in, or power over, the trust.

Because the 2% floor and the second requirement of § 67(e)(1) are not needed to prevent wealthy individuals from exploiting trusts to gain tax benefits, the statute’s second requirement should be deleted.

C. The Allocation of Fiduciary Fees Required by Proposed Regulations Could Pose a Burden to the IRS and Taxpayers

On July 27, 2007, the Secretary of the Treasury issued proposed regulations covering § 67(e). Under these regulations, costs incurred in connection with the administration of an estate or trust that are unique to an estate or non-grantor trust are not subject to the 2% floor for miscellaneous itemized deductions. Adopting the Second Circuit’s interpretation of § 67(e)(1), the regulations state that “a cost is unique . . . if an individual could not have incurred that cost in connection with property not held in an estate or trust.” Finally, the regulations provide that if an estate or non-grantor trust pays a “bundled” fee that covers costs that are unique to such an entity as well as costs that are not, then the estate or non-grantor trust must identify the portion of the cost that is unique to the entity and not subject to the 2% floor. The only guidance

300. Id. § 676(a).
301. Id. § 671.
302. Even if the grantor trust rules did not provide an obstacle, Professor Champine states that the costs of establishing and administering a trust would likely outweigh the tax benefits of being able to fully deduct investment expenses. See Champine, supra note 288, at 530 n.103.
303. Prop. Treas. Reg. § 1.67-4, 72 Fed. Reg. 41243, 41245 (July 27, 2007). As the proposed regulations are to become effective for payments made after the date final regulations are published in the Federal Register, they are not relevant to the case pending before the United States Supreme Court. See id. § 1.67-4(d).
304. Id. § 1.67-4(a).
305. Id. § 1.67-4(b); see supra notes 211–215 and accompanying text.
306. Id. § 1.67-4(c).
The proposed regulations would result in investment advisory costs being treated in the same manner for all estates and trusts, whether the investment advice was packaged with other services provided by the fiduciary or provided by an outside advisor. However, making allocations of fiduciary and other bundled fees could be both costly and burdensome for estates and non-grantor trusts. It could also impose costs on providers of bundled services as they attempt to furnish statements itemizing their fees for services that are unique to estates and trusts. Finally, the apportionment of fees using “any reasonable method” is likely to be difficult for the IRS to administer and enforce.

The burdens imposed by the proposed regulations outweigh the benefits of subjecting the administrative costs of estates and trusts to the 2% floor. This deficit could be eliminated if the second clause of § 67(e)(1) was deleted.

VI. CONCLUSION

Based on the trend in United States Supreme Court opinions toward using textualist methodology to interpret statutes, as illustrated in Gitlitz v. Commissioner, it is expected that the Court will hold that the plain meaning of § 67(e)(1) does not permit estates and trusts to fully deduct the costs they incur for investment advice. However, subjecting the administrative costs of trusts and estates to the 2% floor established by § 67(a) does not constitute sound tax policy. Accordingly, § 67(e)(1) should be amended so that costs incurred in connection with the administration of a trust or estate are fully deductible.

307. Id.

308. By requiring allocations of bundled fees, the proposed regulations ensure that a trust administered by a trustee providing comprehensive services, including investment advice, for a flat fee would not be able to deduct the entire cost of the investment advice as part of the trustee’s fee. Thus, the proposed regulations would eliminate an inequity in tax treatment among trusts and estates that concerned commentators like Professor Champine. See Champine, supra note 288, at 544.