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Interpreting I.R.C. § 67(e): The Supreme Court's Attempt to Nail Investment Advisory Fees to the "Floor"

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INTERPRETING I.R.C. § 67(e): THE SUPREME COURT'S ATTEMPT TO NAIL INVESTMENT ADVISORY FEES TO THE "FLOOR"

Knight v. Commissioner, 128 S. Ct. 782 (2008)

Lindsay Roshkind[*]

In the process of statutory interpretation, a court must determine "whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case. [The court's] inquiry must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent."[1] To determine the amount of an estate or trust's taxable income, Internal Revenue Code § 63 provides "the term 'taxable income' means gross income minus the deductions allowed by this chapter."[2] However, even if a deduction is allowed, § 67(a) may limit the amount of the deduction.[3] Section 67(a) provides "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."[4] This 2% limitation is commonly referred to as the 2% floor. Section 67(e) exempts from the 2% floor "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."[5] Such deductions are not limited and are fully deductible to determine the taxable income of an estate or trust under § 63.[6]

In the instant case,[7] the Petitioner, trustee of a testamentary trust, hired an institutional investment management firm to provide advice about

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1. Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997) (internal quotation marks and citation omitted).
2. I.R.C. § 63(a) (2000).
3. *See id.* § 67(a).
4. *Id.*
5. *Id.* § 67(e)(1).
6. *See* §§ 63, 67(e).
7. Knight v. Comm'r, 128 S. Ct. 782 (2008).

investing the trust's assets.[8] In 2000, the trust paid the firm $22,241 in investment advisory fees.[9] On the trust's fiduciary income tax return for 2000, the trust deducted in full the investment advisory fees paid to the firm.[10] After conducting an audit, the Commissioner of the Internal Revenue Service determined that the investment advisory fees were "miscellaneous itemized deductions subject to the 2% floor" of § 67(a).[11] Therefore, the Commissioner allowed the trust to deduct only the investment advisory fees that exceeded 2% of the trust's adjusted gross income for 2000, resulting in a tax deficiency of $4,448.[12]

The Petitioner sought review of the assessed deficiency in the United States Tax Court, arguing that the Petitioner's fiduciary duty to act as a "prudent investor" required the Petitioner to obtain investment advisory services, and therefore to pay investment advisory fees.[13] Petitioner argued that such fees are unique to trusts and therefore should be fully deductible by reason of § 67(e)(1).[14] The Tax Court rejected this argument, finding that only costs not commonly incurred outside the administration of trusts are fully deductible under § 67(e)(1).[15] Therefore, the Tax Court held that because investment advisory fees were costs commonly incurred outside the administration of trusts, they were deductible only to the extent that they exceeded 2% of the trust's adjusted gross income pursuant to § 67(a).[16]

The Second Circuit Court of Appeals affirmed the Tax Court's judgment, concluding that to determine whether investment advisory fees are fully deductible or subject to the 2% floor of § 67(a), "the statutory language directs the inquiry toward the counterfactual condition of assets held individually instead of in trust," and "demands . . . an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are incapable of incurring."[17] Therefore, the Second Circuit held that the investment advisory fees were subject to the

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8. *Id.* at 786. The trust held approximately $2.9 million in marketable securities. *Id.*

9. *Id.*

10. *Id.* Additionally, the trust reported total income of $624,816. *Id.*

11. *Id.*; § 67(a). *See supra* note 4 and accompanying text.

12. *Knight*, 128 S. Ct. at 786. In 2000, the trust had no miscellaneous itemized deductions other than the investment advisory fees in dispute. *Id.*

13. *Id.* The Petitioner argued he had a duty to act as a "prudent investor" under the Connecticut Uniform Prudent Investor Act. *See* CONN. GEN. STAT. ANN. § 45a-541a (West 2008).

14. *Id.*; § 67(e) provides in relevant part that "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 . . . the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable" and not subject to the 2% floor in § 67(a). § 67(e)(1).

15. Rudkin Testamentary Trust v. Comm'r, 124 T.C. 304, 310–11 (2005).

16. *Id.* at 311.

17. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 151, 155–56 (2006).

2% floor because the fees were "costs of a type that *could* be incurred if the property were held individually rather than in trust."[18]

The United States Supreme Court granted certiorari,[19] recognizing the need to resolve the conflict among the circuit courts.[20] The Court affirmed the Second Circuit,[21] and HELD that § 67(e)(1) exempts from the 2% floor of § 67(a) only those costs incurred by a trust that would be uncommon (or unusual or unlikely) for a hypothetical individual to incur and because investment advisory fees are not such uncommon costs, they are subject to the 2% floor of § 67(a).[22]

The language of § 67(e) begins with a general proposition: "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 . . . ."[23] This means estates and trusts compute their adjusted gross income by deducting costs subject to the same 2% floor that applies to individuals.[24] However, the general proposition is followed by an exception that applies when two conditions are met. First, the cost must be "paid or incurred in connection with the administration of the estate or trust."[25] Second, the cost must be one "which would not have been

18. *Id.* at 155–56.

19. *Knight*, 128 S. Ct. at 787.

20. *Id.* at 786–87.

21. *Id.* at 787.

22. *Id.* at 790–91. While this Comment generally refers to trusts, the analysis applies equally to estates. *See id.* at 785 n.1.

23. I.R.C. § 67(e) (2000). An individual's "adjusted gross income" is calculated first by determining "gross income" under § 61. Section 61(a) defines "gross income" as "all income from whatever source derived." "Adjusted gross income" is then calculated by subtracting from gross income certain "above-the-line" deductions listed in § 62. "Taxable income" is then calculated by subtracting from "adjusted gross income" the itemized or "below-the-line" deductions consisting of all deductions other than "above-the-line" deductions listed in § 62 and the "personal exemption" under § 151. *See* § 63. The majority of "itemized deductions" are "miscellaneous itemized deductions." *See* § 67 (defining miscellaneous itemized deductions). Section 67(a) provides "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." Section 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than the deductions listed under § 67(b). Investment advisory fees are deductible under § 212. Section 212 allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income; [or] (2) for the management, conservation, or maintenance of property held for the production of income." Because § 212 is not listed under § 67(b) as a fully deductible cost, it is a "miscellaneous itemized deduction" and subject to the 2% floor in § 67(a). *See* Temp. Treas. Reg. § 1.67-1T(a) (2008). Therefore, investment advisory fees would be exempt from the 2% floor of § 67(a) only if § 67(e) applies. However, *see infra* notes 127–33 discussing possible argument that § 212 is not applicable by operation of § 263.

24. *Knight*, 128 S. Ct. at 787.

25. § 67(e)(1). "The first [condition], standing alone, would exempt all administration expenses from the 2 percent rule." Dennis I. Belcher, et al., *Recent Developments—2007*, 42ND ANNUAL HECKERLING INST. ON ESTATE PLANNING, UNIV. OF MIAMI SCH. OF LAW 173 (2008).

incurred if the property were not held in such trust or estate."[26] The conflict between the circuits over the application of § 67(e) before *Knight* revolved around the interpretation of the second condition.

In *O'Neill v. Commissioner*,[27] the Sixth Circuit Court of Appeals attempted to interpret the intent of § 67(e).[28] Appellees, co-trustees of an irrevocable trust, appealed the Tax Court's decision that the investment advisory fees paid by the trust were expenses subject to the 2% floor of § 67(a) and therefore deductible only to the extent that they exceeded 2% of the trust's adjusted gross income.[29] On de novo review, the court of appeals reversed and directed judgment on behalf of the trust.[30] The court acknowledged that "[a] trustee is charged with the responsibility to invest and manage trust assets as a 'prudent investor' would manage his own assets."[31] While a state may provide a "'detailed list of pre-approved investments,'" the court stated "the mere selection of an approved investment does not automatically meet the prudent investor standard."[32] The court noted that while individual investors routinely incur investment advisory fees, "they are not required to consult advisors and [they] suffer no penalties or potential liability if they act negligently for themselves."[33] Therefore, the court held the investment advisory fees were deductible in full because the costs were incurred as a result of the trustee's fiduciary duty and thus would not have been incurred if the property was not held in trust.[34]

Eight years later, the Federal Circuit Court of Appeals, in *Mellon Bank, N.A. v. United States*,[35] rejected the standard articulated by the Sixth Circuit in *O'Neill*[36] and focused on interpreting the plain meaning of the statute.[37] In *Mellon Bank*, the trust originally filed a tax return subjecting expenses paid for investment advice to the 2% floor of § 67(a), but after the *O'Neill* decision sought a refund for taxes paid in excess of the taxes

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26. § 67(e)(1). "The second [condition] limits the exemption to a defined class of administration expenses." Belcher, *supra* note 25.

27. 994 F.2d 302 (6th Cir. 1993), *abrogated by* Knight v. Comm'r, 128 S. Ct. 782 (2008).

28. *Id.* at 304.

29. *Id.* at 303.

30. *Id.* at 304–05.

31. *Id.* at 304.

32. *Id.* (citation omitted).

33. *O'Neill*, 944 F.2d at 304 (emphasis omitted).

34. *Id.*

35. 265 F.3d 1275 (Fed. Cir. 2001).

36. *Id.* at 1278; *see also O'Neill*, 994 F.2d at 304.

37. *Mellon Bank*, 265 F.3d at 1279–80. The court noted, "[i]n construing the federal income tax code . . . we are not bound by the fiduciary standards established by state law, and must instead defer to Congress and the plain meaning of the statute." *Id.* at 1280 (citing Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148–49 (1974)).

that would have been paid if the IRS had allowed a full deduction.[38] The Court of Federal Claims interpreted the second condition of § 67(e) to mean that "a trustee's costs are subject to the two percent floor . . . unless the costs occur only in the context of trust administration and are not routinely incurred by individual investors," and the Federal Circuit affirmed.[39] In reaching its decision, the Federal Circuit deferred to Congress and the plain meaning of the statute.[40] The court noted that the first condition of § 67(e) defines "the relationship between the costs and the administration of the [estate or] trust,"[41] and the second condition "focuses not on the relationship between the trust and costs, but the type of costs, and whether those costs would have been incurred even if the assets were not held in a trust."[42] The first condition is satisfied by "[a]ll expenses resulting from the fiduciary obligations of the trustee . . . ."[43] The court noted that the analysis in *O'Neill* ends at the first condition.[44] If this interpretation of § 67(e) were proper, the second condition would be rendered meaningless.[45] In contrast, the second requirement acts as a filter and "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts."[46] Thus, the Federal Circuit held that investment advisory fees were costs routinely incurred outside the context of a trust[47] and therefore, were subject to the 2% floor of § 67(a).[48]

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38. *Id.* at 1277–78.

39. *Id.* at 1277, 1279.

40. *Id.* at 1280. The court stated:

> We must determine 'whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case. Our inquiry must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent. The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole.'

Id. (quoting Robinson v. Shell Oil Co., 519 U.S. 337, 340–41 (1997)).

41. *Id.*

42. *Id.* at 1280–81. Therefore, "only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts" are fully deductible. *Id.* at 1281.

43. *Mellon Bank*, 265 F.3d at 1280.

44. *See id.*

45. *Id.* The court noted that the interpretation of a statute must give full effect to the entire statute. *Id.* (citing Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998)).

46. *Id.* at 1281.

47. Or put another way, investment advisory fees are costs commonly incurred by individuals.

48. *Mellon Bank*, 265 F.3d at 1281–82.

Similarly, in *Scott v. United States*,[49] the Fourth Circuit Court of Appeals focused on statutory interpretation to determine the plain meaning of § 67(e).[50] The appointed trustees did not have experience in managing large assets and refused to serve unless a financial advisor was available to assist in financial planning for the trust.[51] The trustees hired an investment-counseling firm and deducted in full the firm's fees.[52] The IRS concluded the fees were subject to the 2% floor of § 67(a) and assessed a tax deficiency.[53] After paying the deficiency and being denied a refund, the trustees and beneficiaries filed suit in the Eastern District of Virginia.[54] The district court concluded that "while the Virginia legal list [of authorized investments] might not be the best investment[]" in pure financial terms, the trustees were not under an obligation to seek investment advice to discharge their fiduciary obligation.[55] Accordingly, by seeking investment advice, the trustee was not doing anything different from what an individual would do to increase profitability.[56] Therefore, the district court decided the trust's investment advice fees were subject to the 2% floor of § 67(a).[57]

The Fourth Circuit, on de novo review, noted the first step in ascertaining and implementing the intent of Congress "is to determine whether the statutory language has a plain and unambiguous meaning."[58] The court concluded the "text [of § 67(e)] is clear and unambiguous."[59] Consequently, the court must "give words their ordinary, contemporary, and common meaning"[60] and "[w]here possible, . . . must give effect to every provision and word in a statute and avoid any interpretation that may render statutory terms meaningless or superfluous."[61] In interpreting the

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49. (*Scott II*), 328 F.3d 132 (4th Cir. 2003).

50. *Id.* at 138–39.

51. Scott v. United States (*Scott I*), 186 F. Supp. 2d 664, 665 (E.D. Va. 2002). The decedent created a trust providing income to certain beneficiaries with a remainder to others. *Id*. The trust instrument "authorized its trustees to employ investment advisors and to pay those advisors reasonable charges and fees for their services." *Scott II*, 328 F.3d at 135.

52. *Scott II*, 328 F.3d at 135–36.

53. *Id.* at 136. The trustee paid the deficiency and filed a refund claim arguing the fees were not subject to the 2% floor. *Id.* The IRS denied the claim. *Id.*

54. *Id*; *see also Scott I*, 186 F. Supp. 2d at 665.

55. *Scott II*, 328 F.3d at 137. The district court explained that "under Virginia law, trustees could fully satisfy their fiduciary duties by limiting themselves to certain investments specifically authorized by the Virginia legal list." *Id.*

56. *Id.*

57. *Id.*

58. *Id.* at 138–39.

59. *Id.* at 139.

60. *Id*. (citing Williams v. Taylor, 529 U.S. 420, 431 (2000); United States v. Maxwell, 285 F.3d 336, 340–41 (4th Cir. 2002); United States v. Lehman, 225 F.3d 426, 428–29 (4th Cir. 2000)).

61. *Scott II*, 328 F.3d at 139 (citing Freytag v. Comm'r, 501 U.S. 868, 877 (1991)).

meaning of "would" in the context of the second condition of § 67(e)(1),[62] the court found it "expresses concepts such as custom, habit, natural disposition, or probability."[63] Additionally, the court found investment-advice fees "are often incurred by individual taxpayers in the management of income-producing property not held in trust."[64] Therefore, the court held that investment advisory fees are trust-related administrative expenses subject to the 2% floor because they constitute expenses commonly incurred by individual taxpayers.[65]

In the instant case, the Court first analyzed the language of the statute.[66] Chief Justice John G. Roberts, Jr., writing for an unanimous court, laid out the general rule of § 67(e)[67] and the exception provided in § 67(e)(1).[68] The Court of Appeals applied § 67(e) by asking "whether the cost at issue *could* have been incurred by an individual."[69] The Court rejected this approach stating it "flies in the face of the statutory language."[70] The Court noted "[i]f Congress had intended the Court of Appeals' reading, it easily could have replaced 'would' in the statute with 'could,' and presumably would have."[71] Additionally, the Court recognized that if the Court of Appeals' reading were correct, then the first condition[72] would be

62. The second condition of § 67(e)(1) states the cost must be one "which *would* not have been incurred if the property were not held in such trust or estate." I.R.C. § 67(e)(1) (2000) (emphasis added).

63. *Scott II*, 328 F.3d at 139 (citing WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 481 (1976); AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 2042, 2059 (3d ed. 1992)).

64. *Id.* at 140.

65. *Id.* at 139–40. The court noted that by holding a trust's investment advisory fees as fully deductible, the court would render the second condition of § 67(e)(1) meaningless. *Id.* at 140. Therefore, to give effect to the second condition, the court must hold that the investment-advice fees do not qualify for the § 67(e) exception. *Id.* The court concluded by stating the reasoning in *O'Neill* "contain[ed] a fatal flaw." *Id.* Since the fees may be caused by the fiduciary duties of the trust, they are costs commonly incurred in the administration of a trust. *See id.* But the second condition "asks whether [the] costs are commonly incurred outside the administration of trusts." *Id.* (emphasis omitted). Therefore, because investment advisory fees are commonly incurred outside the administration of trusts, they are subject to the 2% floor of § 67(a). *Id.*

66. Knight v. Comm'r, 128 S. Ct. 782, 787 (2008).

67. "'[T]he adjusted gross income of [a] . . . trust shall be computed in the same manner as in the case of an individual.'" *Id.* (quoting § 67(e)). The general rule means "trusts can ordinarily deduct costs subject to the same 2% floor that applies to individuals' deductions." *Id.*

68. The exception to the 2% floor applies when two conditions are met. "First, the relevant cost must be 'paid or incurred in connection with the administration of the . . . trust.'" *Id.* (quoting § 67(e)(1)). "Second, the cost must be one 'which would not have been incurred if the property were not held in such trust.'" *Id.* (quoting § 67(e)(1)).

69. *Id.*

70. *Id.* The statute asks whether the costs "would not have been incurred if the property were not held" in trust, not whether the costs "could not have been incurred." *Id.*

71. *Id.*

72. The first condition is the costs must be "paid or incurred in connection with the

meaningless because

> [i]f the only costs that are fully deductible are those that *could* not be incurred outside the trust context—that is, that could *only* be incurred by trusts—then there would be no reason to place the further condition on full deductibility that the costs be 'paid or incurred in connection with the administration of the . . . trust.'[73]

Rendering part of a statute entirely superfluous is something the Court is "'loath to do.'"[74]

Additionally, the Court acknowledged that in interpreting provisions "'in which a general statement of policy is qualified by an exception, [the Court must] read the exception narrowly in order to preserve the primary operation of the provision.'"[75] The general rule of § 67(e) subjects estates and trusts to the 2% floor established in § 67(a).[76] However, if the Court were to adopt the fiduciary-duty standard articulated by the Sixth Circuit in *O'Neill*,[77] then "most (if not all) expenses incurred by a trust would be fully deductible" and the general rule would be swallowed by the exception.[78] Therefore, the Court rejected this interpretation.[79]

Instead, the Court adopted the standard articulated by the Fourth[80] and Federal Circuits.[81] The Court found "the word 'would' is best read as 'express[ing] concepts such as custom, habit, natural disposition, or probability.'"[82] Accordingly, based on the "direct import of the language in context," the statute asks "whether expenses are 'customarily' incurred outside of trusts."[83] The Court acknowledged that "what is common may

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administration of the . . . trust." *See* § 67(e)(1).

73. *Knight*, 128 S. Ct. at 788 (quoting § 67(e)(1)). The Court could not think of an "expense that could be incurred exclusively by a trust but would nevertheless not be 'paid or incurred in connection with' its administration." *Id.* (quoting § 67(e)(1)).

74. *Id.* at 789 (quoting Cooper Indus., Inc. v. Aviall Servs., Inc., 543 U.S. 157, 166 (2004)).

75. *Id.* (quoting Comm'r v. Clark, 489 U.S. 726, 739 (1989)).

76. *See* § 67(e); *Knight*, 128 S. Ct at 787.

77. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993), *abrogated by* Knight v. Comm'r, 128 S. Ct. 782 (2008).

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

79. *Id.*

80. *See* Scott v. United States (*Scott II*), 328 F.3d 132 (4th Cir. 2003); *supra* notes 49–65 and accompanying text. "Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers." *Scott II*, 328 F.3d at 140.

81. *Knight*, 128 S. Ct. at 789; *see* Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001); *supra* notes 35–48 and accompanying text. Section 67(e) "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Mellon Bank*, 265 F.3d at 1281.

82. *Knight*, 128 S. Ct. at 789 (alteration in original) (quoting *Scott II*, 328 F.3d at 139).

83. *Id.*

not be as easy [to determine] in [all] cases," but recognized "that is no excuse for judicial amendment of the statute."[84] Therefore, the Court held that "§ 67(e)(1) excepts from the 2% floor only those costs that it would be *un*common (or unusual, or unlikely) for . . a hypothetical individual to incur."[85]

Applying this rule to the facts of the case, the Court found "[i]t is not uncommon or unusual for individuals to hire an investment adviser."[86] The Court noted the burden of establishing entitlement to a deduction is on the trustee[87] and the trustee failed to demonstrate such entitlement.[88] The trustee's argument was that he "engaged an investment adviser because of his fiduciary duties" to act as a prudent investor.[89] To satisfy the prudent investor standard, the trustee "must 'invest and manage trust assets *as a prudent investor would*, by considering the purposes, terms, distribution requirements and other circumstances of the trust.'"[90] The standard looks to "what a prudent investor with the same investment objectives handling his own affairs would do."[91] The Court did not doubt that an individual investor in the trustee's position would have sought investment advice.[92] Therefore, the Court noted:

> it [would be] quite difficult to say that investment advisory fees 'would not have been incurred'—that is, that it would be unusual or uncommon for such fees to have been incurred—if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs.[93]

However, in the final paragraph of the Court's opinion,[94] the Court acknowledged "some trust-related investment advisory fees may be fully deductible 'if an investment advisor were to impose a special, additional

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84. *Id.* at 791. The Court draws on the Code's use of "ordinary" as an example of other situations where uncertainty is tolerated. *Id.* (citing Deputy v. du Pont, 308 U.S. 488, 495 (1940) (noting that "[o]rdinary has the connotation of normal, usual, or customary")). *See also* Welch v. Helvering, 290 U.S. 111, 115 (1933) ("Life in all its fullness must supply the answer to the riddle.").

85. *Knight*, 128 S. Ct. at 790.

86. *Id.*

87. *Id.* (citing INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992)).

88. *Id.* The Court stated the trustee argued "that individuals cannot incur trust investment advisory fees, not that individuals do not commonly incur investment advisory fees." *Id.*

89. *Id.*

90. *Knight*, 128 S. Ct. at 790 (quoting CONN. GEN. STAT. ANN. § 45a–541b(a) (West 2008)).

91. *Id.*

92. *Id.*

93. *Id.* at 790–91.

94. This paragraph could be considered dicta.

charge applicable only to its fiduciary accounts.'"[95] The Court reasoned "that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper."[96] In such a case, the Court stated "the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor."[97] Regarding the instant case, the Court found nothing in the record supported a finding that the investment firm charged the trustee more than an individual with similar objectives, and the trust did not assert that its investment objective or balancing of competing interests was distinctive.[98] Therefore, the Court concluded "the investment advisory fees incurred by the Trust [were] subject to the 2% floor."[99]

By adopting the Fourth and Federal Circuits' interpretation of the second condition of § 67(e)(1),[100] the Court has added to the confusion surrounding the exception, rather than clarifying its application. By focusing the inquiry on what expenses are "*un*common (or unusual, or unlikely) for . . . a hypothetical individual to incur,"[101] it is unclear which expenses will qualify for the exception and which expenses will not. While this standard is not as restrictive as the Second Circuit's interpretation,[102] its application is more difficult and burdensome. The Court's standard does not develop a bright line test subjecting *all* investment advisory fees to the 2% floor. Rather, only those fees that are "commonly incurred by individuals" are subject to the floor. During oral argument, the Court struggled with how the "commonly incurred" language would be applied to determine the deductibility of other expenses.[103] Based on the lack of

95. *Knight*, 128 S. Ct. at 791 (quoting Brief for the Respondent at 25, Knight v. Comm'r, No. 06-1286 (U.S., Oct. 11, 2007)).

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.* The Court affirmed the judgment of the Court of Appeals but for different reasons. *Id.* at 785.

100. The Court interpreted the second condition of § 67(e)(1) to mean "§ 67(e)(1) excepts from the 2% floor only those costs that it would be *un*common (or unusual, or unlikely) for . . . a hypothetical individual to incur." *See supra* note 85 and accompanying text.

101. *See supra* note 85 and accompanying text.

102. *See supra* note 69 and accompanying text. By interpreting the second condition as exempting those costs that "could not be incurred by individuals," the Second Circuit was restricting the application of the exception to only those costs that individuals are incapable of incurring. However, the interpretation adopted by the Supreme Court is more expansive and allows full deductibility for expenses that are uncommon or unlikely for individuals to incur.

103. *See* Transcript of Oral Argument at 39–40, *Knight*, 128 S. Ct. 782 (No. 06-1286). The following is an excerpt from oral arguments of a discussion between Chief Justice Roberts and Eric D. Miller, Esq., an assistant to the Solicitor General, who represented the I.R.S.:

certainty in this standard, there is room to argue that certain fees incurred by a trust were for specialized services[104] that are not commonly incurred by individuals. In such a situation, the dicta in the last paragraph of the Court's decision may require the trustee to bifurcate the fee into fees commonly incurred by individuals and fees not commonly incurred by individuals. This potential requirement, created by the dicta of the opinion, adds even more confusion to an already confusing standard: Those fees attributable to services that are common for individuals are subject to the 2% floor of § 67(a), while those fees attributable to specialized services for

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> CHIEF JUSTICE ROBERTS: So how does your customary or commonly incurred test work? Let's say you have two trusts, one $10 million, the other [$]10,000. I think an individual with $10 million might well seek investment advice, but an individual with only [$]10,000 might decide it's not worth it. Would you have a different application of the 2 percent rule for those two trusts?
>
> MR. MILLER: I think if the test is whether—whether the individuals would have—would commonly ordinarily incur that cost, I think one might well look at that because the comparison would be individuals with similar assets, and, as Your Honor knows, there might be a difference depending on the size.
>
> CHIEF JUSTICE ROBERTS: How many—how many individuals do you need? Let's say it's $3 million in the trust, and we think maybe 60 percent of people would hire an investment advisor; 40 percent would think they can do just as well on their own. Is that customarily incurred by individuals?
>
> MR. MILLER: I think it might well be enough that—for something that the Service could clarify through—
>
> CHIEF JUSTICE ROBERTS: Your answer to both questions is "might well be," and that's a fairly vague line when it comes to taxes.
>
> MR. MILLER: The—
>
> JUSTICE SCALIA: And whatever line you—you pick, I guarantee you, trusts are going to break themselves up into mini-trusts that fall under the line. I mean people aren't stupid.
>
> (Laughter.)
>
> CHIEF JUSTICE ROBERTS: Or, even worse, advisors are going to break themselves up into different advisors. There's going to be somebody who says I'm a fiduciary advisor whenever a trustee calls, but, I'm a normal advisor, when it's an individual.

See id.

104. For example, if the trust has an unusual investment objective or required balancing of interests of various parties (i.e. a life beneficiary versus a remainder beneficiary), then these efforts could be specialized services not commonly incurred by individuals.

the trust and not common for individuals are not subject to the 2% floor and are fully deductible by the trust. This standard leaves much to be desired. It suggests that financial advisors have the burden of tracking and separating fees into categories of those common for individuals and those that are not. Whether the IRS will respect the advisor's bifurcation of fees remains unclear.

Additionally, the burden placed on financial advisors to bifurcate fees and the uncertainty of what expenses are "commonly incurred by individuals" conflicts with the goal of § 67.[105] Congress enacted § 67 to reduce (1) the complexity; (2) the need for extensive taxpayer recordkeeping; and (3) the significant administrative and enforcement problems of the IRS.[106] The standard articulated by the Court increases, rather than reduces, the complexity and the need for extensive recordkeeping, and causes administrative and enforcement problems for the IRS. Without further guidance as to how the Court's standard will be applied, the goal of § 67 is compromised.[107]

Additionally, the IRS's proposed regulations provide little guidance as to the application of the Court's standard.[108] The

105. *See* § 67 (2000).

106. Knight v. Comm'r, 128 S. Ct. 782, 785 (2008) (citing H.R. Rep. No. 99-426, 99th Cong. (1985)).

107. Although the following goes beyond the scope of this Comment, I thought it necessary to bring to light an important argument against the constitutionality of the 2% floor. According to the Court, taxable income is an "undeniable accession[] to wealth." *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). A gain-seeking deduction, such as an investment fee, reduces a taxpayer's net accession to wealth. While the Sixteenth Amendment grants Congress the "power to lay and collect taxes on incomes, from whatever source derived," the "incomes" upon which Congress may "lay and collect taxes" is the taxpayer's net accession to wealth; a taxpayer's return above gain-seeking expenses. *See* U.S. CONST. amend XVI.; *see* Comm'r v. Meyer, 139 F.2d 256, 258–59 (6th Cir. 1943) ("It is generally accepted that a return of capital or investment is not taxable under the Sixteenth Amendment."); United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 99 (1936) ("[I]t is income as the word is known in the common speech of men."); Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 5.1 (3d ed.1999) (stating "income" is determined by looking at "common usage, accounting concepts, administrative goals, and finally, judicial reaction to these forces"). Therefore, limiting a gain-seeking deduction to a 2% floor, as in § 67(a), allows Congress to tax more than the taxpayer's net accession to wealth. However, having a 2% limitation on deductions that are not gain-seeking deductions is probably not unconstitutional because such deductions do not affect a taxpayer's net accession to wealth. The argument is that imposing a limit on the deductibility of gain-seeking expenses is unconstitutional. Interview with Daniel Glassman, Esq., Graduate Tax Student, Univ. of Fla., in Gainesville, Fla. (Mar. 5, 2008).

108. One month after the Supreme Court granted certiorari, the IRS issued proposed regulations adopting the approach of the Second Circuit. *See* Belcher, *supra* note 25, at 172. The proposed regulations were issued on July 26, 2007, and certiorari was granted June 25, 2007. *See id.* at 172, 181; *see also* Prop. Treas. Reg. § 1.67-4, 72 Fed. Reg. 41243, 41244 (July 27, 2007); Internal Revenue Bulletin No. 2007-36*, available at* http://www.irs.gov/pub/irs-irbs/irb07-36.pdf.

proposed regulations adopt the approach of the Second Circuit and focus on whether an individual "could not have incurred that cost."[109] Because such an interpretation "flies in the face of the statutory language [of § 67(e)],"[110] trustees cannot use the proposed regulations to determine whether an expense satisfies the § 67(e) exception. Moreover, there is concern that the IRS is not reconsidering the proposed regulations in light

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109. *See* Explanation of Provisions, REG-128224-06, *available at* http://www.irs.gov/irb/2007-36_IRB/ar24.html.

110. *See supra* note 70 and accompanying text. The excerpt below, from the transcript of oral arguments, shows the Court's lack of enthusiasm toward the Second Circuit's interpretation:

> JUSTICE SCALIA: Anything that could not be done of course would not be done. But that doesn't mean that the—that the two words mean the same thing.
>
> MR. MILLER: But—
>
> JUSTICE SCALIA: It's true that one is included within the other, but they don't mean the same thing.
>
> MR. MILLER: Would—I think that the unadorned use of the word "would" here—
>
> JUSTICE SCALIA: What could not happen would not happen, of course. But it doesn't mean that—the two concepts are not the same.
>
> MR. MILLER: I think, when—when you have the word "would," as we have in this statute, that's not qualified in any way, it's ambiguous in the sense that it can mean definitely would not have been incurred, probably would not have been incurred, customarily, ordinarily would not have been incurred, which is the meaning—
>
> CHIEF JUSTICE ROBERTS: You didn't think much of this argument before the Second Circuit adopted it, did you? You didn't argue this before the Court of Appeals?
>
> (Laughter.)
>
> MR. MILLER: We did not argue it before—
>
> CHIEF JUSTICE ROBERTS: So you have a fallback argument.
>
> MR. MILLER: Well, that—that's right.
>
> CHIEF JUSTICE ROBERTS: Well, now might be a good time to fall back.
>
> (Laughter.)

See Transcript of Oral Argument at 28–29, *Knight*, 128 S. Ct. 782 (No. 06-1286).

of the Court's decision.[111] After the Court's decision, the IRS issued Notice 2008-32[112] clarifying how taxpayers should report bundled trust expenses on their 2007 returns.[113] However, the Court's decision did not make any reference to bundled or unbundled expenses.[114] The proposed regulations, as written, have no relation to the standard articulated by the Court. Therefore, to provide clarity to taxpayers, the IRS should issue a new set of proposed regulations based on the language of *Knight* and should allow sufficient time for comments.[115]

Furthermore, the articulated standard, as it applies to the deductibility of trust expenses, could have additional implications. In the past, courts have unanimously agreed that tax preparation fees incurred by a trust are fully deductible.[116] However, tax preparation fees are fees "commonly incurred by individuals,"[117] and therefore, according to the Court's

111. *See* Jeremiah Coder, *IRS Releases Interim Guidance on Bundled Trust Fees*, TaxAnalysts, Feb. 28, 2008, at 2008 TNT 40-2.

112. I.R.S. Notice 2008-32, 2008-3 I.R.B. 279. The I.R.S. issued the notice on Mar. 17, 2008. *Id.*

113. *Id.*; *see also IRS Issues Interim Guidance on Trust Fees Subject to 2 Percent Floor*, TaxAnalysts, Feb. 27, 2008, at 2008 TNT 40-9.

114. The proposed regulations refer to bundled regulations to describe the situation where "an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not." *See* Prop. Treas. Reg. § 1.67-4, 72 Fed. Reg. 41243, 41245 (July 27, 2007). The bundled expenses refer primarily to the situation where a trustee is paid a single fee but the fee includes the trustee's services as trustee and as an investment advisor. *See* Steve R. Akers, *2008 Early Winter Musings: Estate Planning Hot Topics and Current Developments* 36 (Jan. 7, 2008), http://www.abanet.org/rpte/publications/ereport/2008/1/Akers_EarlyWinter.pdf. Such an unbundling requirement would create a "substantial additional administrative requirement in the form of recordkeeping for every trust and estate." *See* Belcher, *supra* note 25 at 189. Additionally, because such "unbundling has never been an industry practice, there is valid concern among corporate trustees that being forced to do so will have an adverse business impact because it will open the door to more 'a la carte' fee negotiations with beneficiaries or other interested parties." Letter from Jeffrey R. Hoops to the Treasury Department, *in AICPA Asks Treasury to Withdraw Proposed 2 Percent Floor Regs in Light of Recent Supreme Court Decision*, TaxAnalysts, Feb. 8, 2008, at 2008 TNT 29-17.

115. *See* Coder*, supra* note 111.

116. *O'Neill* found that investment advisory fees were fully deductible because of the trustee's fiduciary duties. *See* O'Neill v. Comm'r, 994 F.2d 302, 304 (6th Cir. 1993); *see also* Mellon Bank, N.A. v. United States, 265 F.3d 1275, 1279 (Fed. Cir. 2001) (stating "[i]t is undisputed that trustee fees are fully deductible"). Therefore, presumably the *O'Neill* court would agree that tax preparation fees are fully deductible because they relate to the fulfillment of the fiduciary's duties.

117. Arguably the only distinction between fiduciary and individual tax preparation fees relates to the form that is filled out. Trusts file a Form 1041 and Schedule K-1, whereas individuals file a Form 1040. However, some may argue that tax preparation fees are different from investment advisory fees because there is no way to shift the expenses of tax preparation from an individual to a trust. Individuals incur tax preparation fees and such fees are subject to the 2% floor. Additionally, if an individual puts property into a trust, the individual still has to incur tax preparation fees and so does the trust. Therefore, because there is no shift, there is justification for treating tax preparation fees as fully deductible by trusts. However, the counter argument is that

standard, they would be subject to the 2% floor of § 67(a).[118] This result would contradict the unanimous agreement among courts that such fees are fully deductible by trusts.[119] Because the Court's standard does not discuss the impact of the standard on tax preparation fees, it seems that the opinion will not affect the full deductibility of trust tax preparation fees. However, if the Court's standard can be interpreted to subject trust tax preparation fees to the 2% floor, then this injects uncertainty into the applicability of the standard to other questions of deductibility.

However, if the Court had followed the standard articulated by the Sixth Circuit, all expenses incurred by a trust as a result of the trustee's fiduciary duty would be fully deductible under § 67(e).[120] Although this interpretation would have created a bright-line test for applying § 67(e), this standard would render the second condition of § 67(e) meaningless.[121] As the Court pointed out, rendering part of a statute superfluous is something courts are "loath to do."[122] The statute exempts a deduction from the 2% floor only if the expense is incurred in connection with the

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IRC § 641(b) requires the taxable income of an estate or trust be computed in the same manner as in the case of an individual. Therefore, while there is no shift of the burden of paying fees for tax preparation, the law requires that a trust be treated as an individual. Therefore, if an individual is required to have tax preparation fees subject to the 2% floor, so too should a trust. Interview with Daniel Glassman, Esq., Graduate Tax Student, Univ. of Fla., in Gainesville, Fla. (Mar. 21, 2008); Interview with Kristeen Witt, Esq., Graduate Tax Student, Univ. of Fla., in Gainesville, Fla. (Mar. 22, 2008).

118. The Court questioned the validity of the distinction between trust and individual tax preparations fees in oral argument, but did not address the issue in its opinion. *See Knight*, 128 S. Ct. 782 (2008). The following is an excerpt from oral arguments in which Justice David H. Souter addressed attorney Eric D. Miller, an assistant to the Solicitor General, who represented the I.R.S.:

> JUSTICE SOUTER: Yes, but it's the individual who has to file the 1040. What the trustee is filing is the 1041. And—and why do you place—I was going to ask the same question that Justice Alito did, and that is why do you place so much significance either in the label, i.e., it's fiduciary return, or in the peculiar fact that it is a fiduciary who is filing that return?
>
> It's a tax return and—and I think your—the government's argument is that with respect to—to other items that may be disputed, you should regard them at a fairly general level, i.e., investment advice, not fiduciary investment advice. But when you come to the tax return, you don't regard it as a general—at a general level; you regard it at a very specific level, i.e., a fiduciary tax return. It seems to me that the government with respect to the tax return is doing exactly what it criticizes the taxpayer for doing with respect to investment advice. And I don't understand the distinction.

See Transcript of Oral Argument at 31–32, *Knight*, 128 S. Ct. 782 (No. 06-1286).

119. *See supra* note 116 and accompanying text.

120. *See supra* notes 27–34 and accompanying text.

121. *See supra* notes 41–48 and accompanying text.

122. *See supra* note 74 and accompanying text.

trust *and* would not have been incurred by an individual.[123] To satisfy the intent of the statute, both conditions must be given effect. Additionally, if § 67(e) was interpreted to exempt all expenses incurred by a trust from the 2% limitation, the exception would swallow the general rule subjecting estates and trusts to the 2% floor.[124] If the intent of § 67(e) were to exempt from the 2% floor all costs associated with trust administration, then rather than using the complicated language seen in § 67(e), the provision would have been drafted similar to § 68(e)—"This section shall not apply to any estate or trust."[125] This simple statement would have exempted from the 2% floor expenses incurred in the administration of a trust. Because such a simple statement was not used, the intent of § 67(e) must not have been to exempt from the 2% floor all expenses incurred by a trust. Therefore, the Court correctly rejected this standard as the appropriate interpretation of § 67(e).[126]

An alternative solution is to recognize investment advisory fees as capital expenditures that are required to be capitalized under § 263,[127] instead of deducted under § 212.[128] This suggestion was not considered by either party or the Court. Under § 263, expenses should be capitalized if they are used to "increase the value of any property or estate."[129] Arguably, investment advisory fees are paid to increase the value of the estate through the investment of estate assets. Having determined that § 263

123. I.R.C. § 67(e)(1) (2000).

124. *See supra* note 78 and accompanying text.

125. § 68(e).

126. However, although beyond the scope of this Comment, it could be argued that Congress should amend § 67(e) to make § 67(a) not apply to estates and trusts. This would conform § 67(e) with § 68(e). While it has been stated that the purpose of § 67(e) is 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," it does not make sense for taxpayers to put property into a trust simply to avoid the 2% floor of § 67(a). *See* Mellon Bank, N.A. v. United States, 47 Fed. Cl. 186, 193 (2000); *see also* William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 FLA. L. REV. 229, 280 (2007) (stating one of the goals of tax policy is "horizontal equity—the notion that similarly situated taxpayers should pay similar taxes"). The costs associated with the administration of a trust can be significant and the tax generated by income to a trust can be greater than it would be if the property were held by an individual. *See* §§ 1(a)–(d), (e), (i) (indicating that the highest tax bracket for a trust is $7,500 at 35% as opposed to the highest tax bracket for an individual is $250,000 at 35%). Therefore, because it is unlikely that individuals will put property into a trust in order to avoid the 2% floor, maybe Congress should consider amending § 67(e) to exempt estates and trusts from § 67(a).

127. § 263 (stating the general rule for capital expenditures).

128. § 212 (stating the deduction rule for expenses for the production of income). Beyond the issue of whether § 67(a) or § 67(e) applies to investment advisory fees, the question remains whether the fees were ever really deductible under § 212. If § 263 applies, the fees paid for investment advice should never have been deductible under § 212 and therefore § 67 is irrelevant. *See infra* note 134 and accompanying text.

129. § 263(a)(1).

applies, a deduction under § 212 is prohibited in the computation of taxable income under § 63.[130] While most investors would prefer to have a current deduction for the expense under § 212 rather than an offset on the amount of gain recognized in the future,[131] requiring that the expense be capitalized reduces the confusion associated with § 67(e), provides certainty to taxpayers and trustees, and eliminates the need for extensive recordkeeping.[132] Therefore, a possible solution is to recognize that the amounts paid for investment advice must be capitalized and may not be deducted.[133] If the investment advisory fees are capitalized, § 67(e) is irrelevant because it only relates to deductions. Capitalizing the expense would create a bright-line rule that is easy to apply.

Nonetheless, while the Court needed to resolve the conflict among the circuit courts, the standard it articulated has created more confusion than clarification. The Court's decision to interpret § 67(e) as requiring not only a determination of what expenses are "commonly incurred by individuals," but also a bifurcation of expenses, has developed a complex standard that involves extensive recordkeeping and creates difficulty in administration. Such complexity contradicts the goal of § 67. To reduce the complexity and the burden placed on taxpayers, the IRS should provide guidance by issuing new proposed regulations consistent with the Court's analysis. Further, if, after reviewing the Court's analysis, Congress does not think the Court correctly interpreted its intent, then Congress may change the

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130. Section 211 provides: "In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible)." Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

Investment advisory fees are expenses incurred for the production of income and therefore, § 212 applies. However, § 261 in Part IX provides: "In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part." And § 263 provides: "No deduction shall be allowed for—(1) Any amount paid out for . . . betterments made to increase the value of any property or estate." Therefore, because investment advisory fees are paid out to increase the value of property, § 263 prohibits a deduction under § 212 and requires the expense be capitalized.

131. Such a preference reflects the time value of money.

132. Requiring capitalization of the fee would also solve the possible constitutional problem. *See supra* note 107.

133. Note that the capitalization of investment advisory fees would apply to trusts and individuals and not just to trusts. Therefore, individuals would be required to capitalize the expense rather than deduct it subject to the 2% floor. Because the capitalization requirement would apply equally to trusts and individuals, there would be no benefit for putting the property in a trust.

language of § 67(e) to express the correct standard. Until then, the Court's vague and unworkable standard—a test whose flaws Chief Justice Roberts seemed to envision[134]—is destined to create more problems than it solves.

134. *See supra* note 103.