

**SECOND CIRCUIT IMPOSES STRICT LIMITATION ON
TRUST'S INCOME TAX DEDUCTION FOR INVESTMENT ADVICE**

A trust or estate, like an individual, can deduct miscellaneous itemized expenses only to the extent that they exceed two percent of its adjusted gross income. Int. Rev. Code ' 67(a). The two-percent floor does not apply, however, to expenses that are both “paid or incurred in connection with the administration of the estate or trust” and that would not have been incurred if the property were not held in such estate or trust.@ Int. Rev. Code ' 67(e)(1). The second part of this exception has generated substantial litigation, with a most significant lack of consistent analysis.

The second prong of the exception from the two-percent floor has now been reviewed by the Tax Court (twice), and the U.S. Courts of Appeals for the Second, Fourth, Sixth and Federal Circuits (as well as the Court of Federal Claims and two Federal district courts.) A casual reviewer would note that the Sixth Circuit has permitted a trustee to deduct the cost of investment advice free from the two-percent limitation, and that all of the other courts are aligned against that view. A closer analysis, however, shows that the courts that have rejected the deduction of investment advice without regard to the two-percent floor have adopted two very different standards. Now, the U.S. Court of Appeals for the Second Circuit has thrown its weight behind a third analysis in *Rudkin Testamentary Trust v. Commissioner*, ___ F.3d ___, 2006 WL _____ (2nd Cir. Oct. 19, 2006), *aff'g*, 124 T.C. 304 (2005).

The Split in the Circuits

One can best understand the Second Circuit's analysis if one first has the context provided by the opinions of the other major courts that have considered this issue: the Tax Court, the Fourth Circuit, the Sixth Circuit and the Federal Circuit.

The Tax Court was the first court to review this issue. The Tax Court held in *O'Neill v. Commissioner*, 98 T.C. 227 (1992), *rev'd*, 994 F.2d 302 (6th Cir. 1993), *nonacq.* 1994-2 C.B. 1, that the two-percent floor applies to expenses of a trust that unless those expenses are "unique" to the trust. An expense that is "unique" to being incurred in a fiduciary context is one that can never be incurred outside of the trust.

The Sixth Circuit reversed the Tax Court in the first appellate opinion on the issue. The Sixth Circuit stated that a trustee has a fiduciary duty to manage trust assets as a "prudent investor," under applicable state law, and that fees for investment advice were therefore "necessary to" the trust's administration and "caused by" the fiduciary duty of the trustee. The Sixth Circuit agreed that individual investors often incur costs for investment advice, but noted that "they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." 994 F.2d at 304. Thus, the Sixth Circuit held that the exception to the two-percent floor applied to costs attributable to the trustee's fiduciary duty, and therefore not required outside the administration of trusts. The court rejected consideration of whether similar expenses were often incurred outside of a trust context.

The Federal Circuit in *Mellon Bank, N.A. v. United States*, *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), held that investment advisory fees were not deductible by the trust in that case, but it adopted a standard that, while recalling the standard of the Tax Court, added an ambiguous second aspect. The Court of Appeals for the Federal Circuit examined both the language of the statute and the legislative history, and held that that the second clause of Section 67(e)(1) "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.*" 265 F.2d at 1280-1281 (emphasis supplied.) The Federal Circuit rejected the taxpayer's contention that all costs arising out of the trustee's fiduciary duties should be deductible without regard to the two-percent floor, because they are incurred because of the trust relationship. The court held that such an interpretation would render the first clause of Section 67(e)(1) superfluous, because any cost that is "paid or incurred in connection with the administration of the . . . trust" would always arise out of the trustee's fiduciary duty. See discussion in the October, 2001 issue of this Reporter.

The Fourth Circuit then joined the Federal Circuit in holding that investment-advice fees incurred by a trust are subject to the two-percent floor in *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003). See discussion in the June, 2003 issue of the Reporter. The Fourth Circuit noted that the text of the Code was "clear and unambiguous," and concluded that trusts expenses are deductible without regard to the two-percent floor only if they are not "expenses commonly incurred by individual taxpayers." 328 F.3d at 139-40. The court noted that the statute speaks of expenses that "would" not have been paid but for the trust, and that the word "'would'" in the

context of §67(e)(1) expresses concepts such as custom, habit, natural disposition, or probability.” The court then concluded that, because fees for investment advice are commonly incurred by persons other than trusts, their deduction must be limited by the two-percent floor.

Background of *Rudkin Testamentary Trust*

William Rudkin created an irrevocable trust for the benefit of his family and funded it with the proceeds of the sale of his interest in Pepperidge Farm Corporation to Campbell Soup Company. The trustees were expressly authorized by the trust instrument to invest in any type of investment that was suitable for fiduciary investment, and to employ such advisors as the trustees deemed appropriate. Applicable state (Connecticut) law imposed the prudent investor standard on the trustees, who were not themselves skilled investors.

The trustees then hired an investment advisor to manage the trust assets. The trustees paid the advisor more than \$28,000, and deducted the payments as miscellaneous itemized deductions.

The IRS stated that the deductions were subject to the two percent floor. The Tax Court, in a reviewed opinion, held for the government.

The Tax Court explained that it had previously held that the two percent floor applied to fiduciary expenses for investment advice, but that its opinion had been reversed in *O’Neill v. Commissioner*. Since that time, two other circuits had agreed with the Tax Court that the two percent floor applied to fiduciary expenses for investment advice. *Mellon Bank, N.A. v. United*

States and Scott v. United States. The court apparently wanted to use the reviewed decision in *Rudkin* to reaffirm its original analysis.

The Tax Court stated that the investment expenses paid by the Rudkin trust were clearly paid or incurred in connection with the administration of a trust or estate, but that they were not incurred because the taxpayer was a trust. The court stated that Section 67(e) is designed to permit the trust to deduct without regard to the two-percent floor, only “those costs which are *unique* to the administration of an estate or trust” and that individual investors routinely incur costs for investment advice as an part of their investment activities. Therefore, the court stated, such expenses could never be deemed unique to the administration of an estate or trust, even if the fiduciary feels compelled to incur such expenses in order to meet the prudent person standards imposed by state law.

Second Circuit Affirms Both Holding and Standard

The Second Circuit affirmed the holding of the Tax Court, and created its own standard that, while using language slightly different from that of the Tax Court, is fundamentally the same as the lower court’s approach.

The Sixth Circuit rejected the trustee’s argument that the Code reflected a legislative intent to allow a full deduction for the administrative costs of a trust that are attributable to the fiduciary duty of the trustee. The court stated that Congress could clearly have created a "but for" causal test, but that the language of the Code does not do so. The court interpreted the phrase "if the

property were not held in such trust" as directing the inquiry away from the specific taxpayer trust and to the hypothetical ownership of the property by an individual.

That is, the introductory language of § 67(e) takes as its point of reference the rules that apply to individual taxpayers, and by using the phrase, "if the property were not held in such trust," Congress has aimed the inquiry at the costs that a hypothetical individual property owner could incur with respect to that property. We therefore agree with the Fourth Circuit's statement in *Scott* 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. It focuses the inquiry, instead, on the hypothetical situation where the assets are in the hands of an individual.

The court stated that the Code does not focus on whether an individual asset owner is financially un-savvy or a trust fund sufficiently large, that the trustee should seek investment advice. Instead, the court stated that "the plain meaning of § 67(e)(1)'s second clause" applies the two-percent floor to any expenses of at type that could be incurred if the property were held individually. The statute, the court stated, demands an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are "incapable of incurring."

The court, however, expressly rejected the focus by the Federal and Fourth Circuits on whether the costs were "not customarily incurred outside of trusts." The court held that Section 67(e)(1) is more restrictive than the Federal and Fourth Circuits had held.

The court stated that the Federal and Fourth Circuits had properly focused on the hypothetical situation of costs incurred by individuals as opposed to trusts, but that these courts had looked at whether the given expense is "customarily" or "commonly" incurred by individuals. The Second Circuit held that Section 67(e) requires a determination that the particular expense "could not have been incurred if the property were held by an individual." The court insisted that the use of the word "such" in the statutory statement "which would not have been incurred if the property were not held in *such* trust or estate" (emphasis supplied) referred to the generic trust to which the introductory language of Section 67(e) refers, rather than to the actual litigant.

The court then twice emphasized the strength of the government's analysis. The court stated that, even were the Code's language not clear "and the Trust's alternative interpretation were not unreasonable," the court would have reached the same conclusion under the rules of statutory interpretation. The general rules of statutory construction require that any ambiguity in a statute creating a tax deduction must be construed in favor of the government, and against the taxpayer. Citing *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1966) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Therefore, if the court found the statute ambiguous, it would have to hold for the government.

Furthermore, the court stated that it did not need to resort to the legislative history, because it found the statute to be unambiguous, but that if it had been required to consider the legislative history, it would have held for the government. The taxpayer argued that the legislative history showed that Congress added the second clause of Section 67(e)(1) to restrict a trust's use of pass-

through entities to avoid the two-percent floor. The court, however, stated that “nothing in the legislative history suggests a clearly expressed congressional intent contrary to the plain meaning of the statute itself.”

Editor’s Comments

The Second Circuit’s “incapable of incurring” standard appears to be fundamentally the same as the Tax Court’s “unique to the administration of an estate or trust” standard, but far stricter than the Fourth Circuit’s standard of “not commonly incurred by individuals” or the Sixth Circuit’s standard of “incurred because of the trustee’s duties.”

The Federal Circuit actually has an ambiguous standard, though it is often grouped with the Fourth Circuit on this issue. The Federal Circuit standard simultaneously requires that expenses be “unique to the administration of a trust” and that they be “not customarily incurred outside of trusts.” “Unique,” however, means “being the only one” and an expense that is “unique to the administration of a trust” can never be incurred outside of the trust. “Customarily,” on the other hand, means “based on or established by custom” or “commonly practiced, used, or observed.” It connotes a high degree of frequency, but not exclusivity. An expense that is “not customarily incurred outside of trusts” necessarily must occasionally be incurred outside of trusts, even though perhaps only rarely. Thus, the Federal Circuit standard is unique in that it is unintelligible.

It is unlikely that the Supreme Court will refuse any request for certiorari, and simply wait for the Treasury to issue regulations setting for the correct interpretation of Section 67(e)(1). Once

issued, the Supreme Court will give these regulations substantial weight, based on its holdings in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) and *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005). This split of opinions leaves trustees and their advisors with relatively few choices. Those taxpayers in the Sixth Circuit (Kentucky, Michigan, Ohio and Tennessee) can deduct investment expenses without regard to the two-percent floor, and be confident of a victory on appeal, if not at trial. Those taxpayers in the Fourth Circuit (Maryland, North Carolina, South Carolina, Virginia and West Virginia) or the Second Circuit (Connecticut, New York and Vermont) should probably deduct their expenses subject to the two-percent floor, recognizing that they are unlikely to win at either trial or Connecticut, New York, Vermont.

Those taxpayers in any of the other eight circuits can either deduct investment expenses subject to the two percent floor and concede this issue to the Treasury, thereby avoiding interest, penalties and litigation costs, or deduct investment expenses without regard to the two percent floor and hope that their circuit follows the lead of the Sixth Circuit, rather than that of the Tax Court and the Second, Fourth and Federal Circuits. The answer will likely depend upon the size of the deduction disallowance under Section 67(e), the liquid assets available to the trustee to fund the litigation and the circuit in which the case will be appealed.