No. 06-1286

IN THE

Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether costs for trust and estate investment management and advisory services incurred in order to fulfill a trustee's unique fiduciary obligation with respect to investment of the assets of a trust or estate are fully deductible from trust or estate income under 26 U.S.C. § 67(e) as costs "which would not have been incurred if the property were not held in such trust or estate."

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The opinion of the United States Court of Appeals for the Second Circuit (Petition Appendix ("Pet. App.") 1a-19a) is published at 467 F.3d 149. The decision of the Tax Court (Pet. App. 20a-30a) is published at 124 T.C. 304.

JURISDICTION

The judgment of the Court of Appeals was entered on October 18, 2006. Pet. App. 1a. A timely Petition for Rehearing was denied on January 19, 2007. Pet. App. 31a-32a. The Petition for Writ of Certiorari was filed on March 23, 2007, and granted by this Court on June 25, 2007. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

RELEVANT STATUTORY PROVISION

Section 67(e) of the Internal Revenue Code, 26 U.S.C. § 67(e), provides 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. . .
>
> shall be treated as allowable in arriving at adjusted gross income.

The full text of 26 U.S.C. § 67 as amended is set out in Appendix A, Appendix ("Pet. Br. App.") 1a. The full text of 26 U.S.C. § 67 (1986) as originally adopted in the Tax Reform Act of 1986 is set out in Appendix B, id. 5a.

INTRODUCTION

This case concerns whether expenses paid by the trustees of a nongrantor trust or estate for professional investment management are deductible in full from the trust's or estate's income for trust or estate income tax purposes.[1] Our position is that under the clear congressional language of 26 U.S.C. § 67(e), such "investment advice" fees are fully deductible.

The Internal Revenue Code (the "Revenue Code" or the "Code") has long treated "the trust as an entity for producing income comparable to a business enterprise . . . and permits deductions of management expenses of the trust. . ." *Bingham's Trust v. Commissioner*, 325 U.S. 365, 374 (1945). More than thirty years ago, Congress made clear that "costs paid or incurred in connection with the administration of the estate or trust" were deductible from trust or estate income – much as they are from the income of taxable corporations – even when similar fees were not fully deductible from individual income. 26 U.S.C. § 57(b)(2)(B)(i) (1977).

In the Tax Reform Act of 1986 (the "1986 Act" or the "Act"), Congress added a second clause to this statutory language. The relevant provision, codified at 26 U.S.C. § 67(e)(1), now permits the deduction in full of "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.*" Id. (emphasis added). If trust and estate investment advice fees are such costs, they may be deducted in full from trust or estate

[1] The statutory provision involved in the question here, 26 U.S.C. § 67(e), applies only to nongrantor trusts, and only such trusts are at issue in this case. So-called grantor trusts are generally trusts in which the grantor retains certain powers or interests. See, *e.g.*, 26 U.S.C. § 674(a) (grantor trust created where grantor retains the authority to determine who will receive the income or corpus of the trust). They are often utilized for estate planning purposes, but are deemed to have no independent income tax significance and are disregarded and treated as mere conduits for income tax purposes. All their income is taxed to their grantor every year. Cf. *Helvering v. Clifford*, 309 U.S. 331, 335 (1940) (where grantor retains "dominion and control" over property, he or she remains its owner); *Corliss v. Bowers*, 281 U.S. 376, 371 (1930) (Holmes, J.) ("taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed"). Generic references to "trusts" throughout this brief refer only to nongrantor trusts.

income for trust or estate income tax purposes. If not, they are subject to a limitation on deductibility, as similar expenses are under the 1986 Act when incurred by individuals, a limitation that would result in the reduction of trust corpus not just once, but year after year. Trust and estate investment advice fees are perhaps the largest single cost involved in the administration of most trusts and estates. The question before the Court is therefore one of great significance, particularly for the beneficiaries that trusts and estates are created and designed to protect.

Respondent Commissioner of Internal Revenue (the "Commissioner") argues that trust and estate investment advice fees are no longer deductible in full. But there is no indication in the text, structure or history of § 67, the 1986 Act, or the Code more broadly, that Congress had a purpose to work such a significant change in the way trusts and estates are taxed. Rather, as its text makes clear, Congress sought to ensure full deductibility in § 67 for all costs incurred in the administration of a trust or estate that are caused by the fact that the property is held in that trust or estate.

Trust investment advice fees meet that test.[2] Such fees are different in kind from similar fees incurred by individuals. Trust investment advisors must always take into account the unique fiduciary obligation of the trustee to invest the trust or estate assets for the benefit of all the beneficiaries in light of the purposes, terms, distribution requirements and other circumstances of the particular trust or estate. This may include among other things balancing competing interests of differently situated beneficiaries. Fees incurred for such advice are therefore always incurred because assets are in the trust – the particular type of advice would not have been needed, and the corresponding fee would not have been incurred, "if the property were not held in such trust or es-

[2] While the statute is applicable to trusts and estates, this case involves a trust. References to "trusts" throughout this brief are intended to encompass both trusts and estates unless context indicates otherwise.

tate." These fees are, therefore, fully deductible under the statute. This interpretation of § 67(e) is confirmed by the structure, history and purposes of § 67 and the Internal Revenue Code more broadly. It is, indeed, the only plausible reading of the statutory text.

STATEMENT

1. The William L. Rudkin Testamentary Trust ("Trust" or "Rudkin Trust") was established in 1967 under the will of Henry A. Rudkin, Sr. ("Rudkin" or "Henry Rudkin"). Rudkin, with his wife Margaret, founded Pepperidge Farm, maker of cookies and other food products. The Trust was funded with some of the proceeds of the 1961 sale of Pepperidge Farm to the Campbell Soup Company.

The Will and its First Codicil (the "Trust Documents") require all the trust income to be paid out each year for the benefit of a class of income beneficiaries. Pet. App. 35a.[3] Upon its expiration, "the principal of the trust" will be distributed to certain living descendants of Henry Rudkin (the remainder beneficiary class). Pet. App. 36a.

The Trust is designed to last for generations. The Trust expires twenty-one years after the death of the last survivor of Henry Rudkin's descendants living at the time of his death (or, if it occurs earlier, upon the deaths of William L. Rudkin and all of his descendants). Pet. App. 36a. The youngest of Rudkin's descendants who were living at the time of his death, Katharine Rudkin Allsopp, is now 49 years old. If she

[3] The Trustees of the Trust ("Trustees") must pay or apply "so much of the net income of the trust as [they] deem necessary or desirable in their discretion for the support, comfort and education" of any or all members of an income beneficiary class comprising Rudkin's son William L. Rudkin, his wife or widow, and his descendants and their spouses, "in accordance with [the Trustees'] understanding of the individual and varying needs and resources from time to time of the members of such class." Pet. App. 35a. Any remaining Trust income must be placed into separate trusts for the individual members of that income beneficiary class. Id.

lives to be eighty, the Trust will not expire until 2059.[4]

2. Unlike individuals who often invest their own funds, putting their assets into a range of mutual funds or other standard investment vehicles without hiring investment advisors, a trustee who is not an experienced investor is under an affirmative fiduciary duty to delegate his or her investment functions to a qualified and competent agent. See Restatement (Third) of Trusts: Prudent Investor Rule ("Restatement 3d") § 171 cmts. a, f-h, at 140-41, 143-45, and § 227 cmt. j, at 38-41 (1992). A trustee's failure to obtain competent investment assistance when such assistance is necessary subjects the trustee to the risk of substantial personal liability to the beneficiaries.[5]

Because of their fiduciary obligations, many trustees utilize the services of professionals to provide trust investment management and advisory services. Internal Revenue Service ("IRS") statistics indicate that fees for this purpose may be the single largest expense connected with the administration of trusts and estates, with several billion dollars in fees

[4] The Trust Documents specify that during the pendency of the Trust, the Trustees retain discretion to distribute principal should they deem it "necessary or desirable" either "for the education, support, comfort or welfare" of one or more members of the income beneficiary class, or "to advance the best interests of such member or members [of that class] in any business venture in which such member or members may be engaged or in which such members may wish to engage." Pet. App. 45a-46a. The Trustees are also required to distribute portions of the trust principal to any persons or organizations designated by Rudkin's son William during his life or in his will if it was duly admitted to probate (except for William Rudkin himself or his estate or their creditors). Pet. App. 36a. At the beginning of the tax year at issue in this case, 2000, the Trust had assets worth $2,884,542; at the beginning of the final quarter of that year, it had assets worth $2,226,222. Joint Appendix ("J.A.") 24, 27.

[5] See generally Restatement 3d §§ 205, 208-211, Reporter's Notes, at 166-173 and cases cited therein (describing the trustee's liability for both actual losses and failure to realize the gains that would have been realized if the trust assets had been invested properly).

paid each year for such services.[6]

3. The Trustees of the Rudkin Trust ("Trustees") have unique fiduciary obligations in their management of the Trust assets:

The Trustees are subject to the Connecticut Uniform Prudent Investor Act ("UPIA"). Conn. Gen. Stat. §§ 45a-541a to 45a-541*l*. That statute utilizes the "prudent investor" standard which requires trustees to invest and manage trust assets "by considering the purposes, terms, distribution requirements and other circumstances of the trust," id. § 45a-541b(a), and to evaluate "investment and management decisions respecting individual assets . . . not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Id. § 45a-541b(b). The statute requires the Trustees to consider ten enumerated circumstances in investing and managing Trust assets, including "the nature and estimated duration of the trust." Id. § 45a-541b(c). Conn. Gen. Stat. §45a-541b(c) provides in full:

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[6] See Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 5 (IRS 2007) (Fiduciary Income Tax Returns, Income, Deductions, and Tax Liability, by Tax Status, and Size of Gross Income, Filing Year 2005) available at http://www.irs.gov/pub/irs-soi/05fd01.xls. The IRS does not publish data that precisely disaggregate these costs. For the most recently reported year, IRS data show a total of $5.6 billion in deductions on fiduciary income tax returns for a category known as "other deductions not subject to the two-percent floor." Id. at col. 32 & n.1. The largest component of that category was likely deductions for fees for trust and estate investment advisory and management services like the deduction taken here. The data also show a total of $1.5 billion for what are called "allowable miscellaneous deductions." Id. at col. 34. Under rulings of the Fourth and Federal Circuits described below, some trusts and estates categorized their fees for investment advice in that category, and, again, such fees were likely the largest single type of deduction within that category. Finally, the data show $4.0 billion deducted in that one year for trustees' and other fiduciaries' fees. Id. at col. 26. These fees, too, are primarily for investment advice and management. To the extent it is relevant to this case, these categories will be described more fully below.

> Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) General economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions, strategies and distributions; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property and real property; (5) the expected total return from income and the appreciation of capital; (6) related trusts and other income and resources of the beneficiaries; (7) needs for liquidity, for regularity of income and for preservation or appreciation of capital; (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries; (9) the size of the portfolio; and (10) the nature and estimated duration of the trust.

The State of Connecticut monitors the Trustees' compliance with their obligations. The Connecticut Probate Court has appointed a guardian *ad litem* to protect the interests of the unborn beneficiaries of the Trust. See *Estate of Henry A. Rudkin*, Order of the Probate Court for the District of Fairfield, Fairfield Probate Court Records, Vol. 288, p. 644 (December 21, 1970). The Trustees are required to file a detailed principal and income trust accounting with the guardian and the Probate Court every three years. See Conn. Gen. Stat. § 45a-177.

3. The "prudent investor" standard has been adopted in all 50 States and the District of Columbia.[7] That standard

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[7] Versions of the Uniform Prudent Investor Act have been adopted by 44 States and the District of Columbia. See Uniform Law Commission, A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Aug. 17, 2007) (listing States). Five of the remaining States have adopted versions of the prudent investor standard. See Del. Code. Ann.

does not allow the Trustees to invest the Trust assets as individuals would, or do, invest their own assets. Thus, for instance, an inexperienced investor, or one not wishing to devote time to learning about different investment alternatives and monitoring their status on an ongoing basis, may reasonably decide to invest his or her own funds solely in "safe" investments such as Treasury obligations, high-quality tax-exempt municipal bonds, or federally-insured savings accounts. If he or she were a trustee, however, that same course of decision would likely breach the fiduciary duty.[8] Similarly, an individual may reasonably decide to concentrate his or her personal investments in a single class of stocks or securities because he or she is particularly knowledgeable about or impressed by investments in that area. He or she may not do so as trustee, however, even if he or she is

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tit. 12, § 3302 (2007); Fla. Stat. § 518.11 (2007); Ga. Code Ann. § 53-12-287 (2007); La. Rev. Stat. Ann. § 9:2127 (2007); N.Y. Est. Powers & Trusts Law § 11-2.3 (2007). In Kentucky, the prudent investor standard is applicable only in certain circumstances. Ky. Rev. Stat. Ann. §§ 286.3-277, 386.454(1), 386.502 (2006).

The universal adoption of the prudent investor standard marks the rejection of the traditional "prudent person" rule, see *Harvard College v. Amory*, 26 Mass. 446, 469 (1830), as a description of fiduciary obligation. The prudent person standard had been criticized by "scholars and practitioners familiar with modern portfolio theory." See Schanzenbach and Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J. L & Econ. (forthcoming 2007) (manuscript at 5-9, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id==868761). "Assessing the prudence of a particular investment . . . requires consideration of the portfolio as a whole, the beneficiary's tolerance of risk, and the purpose of the trust. . . . [Investments] favored under the old prudent [person] rule[] expose[d] the trust fund to considerable inflation risk." Id. at 8.

[8] See Restatement 3d § 227 cmt. e, illus. 11, at 22 (not "prudent" to invest solely in short-term bank and federal obligations); *Baker Boyer Nat'l Bank v. Garver*, 719 P.2d 583 (Wash. Ct. App.), review denied, 106 Wash. 2d 1017 (1986) (not "prudent" to invest solely in tax exempt securities); *Hurst v. Security-First Nat'l Bank* (*In re Bouffleur's Estate*), 26 Cal. Rptr. 173 (Cal. Ct. App. 1962) (not "prudent" to invest solely in building and loan savings accounts not exceeding $10,000).

seeking the same financial result, and even if he or she has "made his [or her] own fortune" from such investments.[9]

Nor may the fact that the trust property is not diversified when originally placed in the trust, or that the particular trust instrument permits investments otherwise generally considered inappropriate for trusts, relieve the trustee of his or her duty to prudently diversify the trust investments.[10] Likewise, the inclusion of an investment or type of investment in a statutory "legal list" of investments permitted to fiduciaries does not relieve the fiduciary of the duty to invest prudently, including on a diversified basis, in such permitted investments.[11]

Further, an otherwise "prudent" investment may become imprudent in light of changing circumstances, including the nature and mix of other investments in the trust's portfolio, the availability of other possible investments, and the safety, stability and profitability of the instrument, entity or industry in which the trust has invested. Thus, while an individual is free to leave investments largely unattended over time, the trustee's fiduciary duty requires ongoing monitoring and analysis of the trust's investments and the investment market generally in order to ensure that the trust portfolio retains a properly diversified balance of expected risks and returns to provide for the interests of the various beneficiaries.[12]

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[9] See Restatement 3d § 227 cmt. e, illus. 12, at 23; *Buder v. Sartore*, 774 P.2d 1383, 1386 (Colo. 1989) (under the "prudent investor" rule, "[t]he trustee may not subject his trust property to hazards which a man dealing with his own property might consider warranted if to do so would create danger to the trust estate").

[10] Restatement 3d § 228 cmt. f, at 106 ("[T]he fact that an investment is permitted does not relieve the trustee of the fundamental duty to act with prudence. The fiduciary must still exercise care, skill and caution in making decisions to acquire or retain the investment.").

[11] See Restatement 3d § 228 cmt. c, at 102-103.

[12] See Restatement (Second) of Trusts § 231 cmt. b, at 551 (1959); Restatement 3d § 227 cmt. d, at 14 and cmt. e, at 20; Bogert, *The Law of Trusts and Trustees*, § 612 at 20 (3d ed. 2000).

Trustees, unlike individuals, must also ordinarily invest in a way that balances the interests of the various beneficiaries and that takes account of other parameters like the duration of the trust and its purposes.[13] Trustees owe a duty not merely to the trust's remainder beneficiaries to grow the principal through appreciation, but to the current, future and contingent income beneficiaries as well to earn income required to serve the trust's purposes. That dual duty is one of the strongest known in the law. As then-Chief Judge Cardozo said in the classic explication of the fiduciary duty under the common law, and as this Court is well aware:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Meinhard v. *Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.).

4. Trusts and estates, like individuals and certain other entities, must pay a tax upon their "taxable income." See 26 U.S.C. § 1(e). Trusts and estates with income above a certain level must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, called a fiduciary income tax return.

Taxable income for both individuals and trusts is derived, first, by taking "gross income," defined as "all income from whatever source derived," 26 U.S.C. § 61(a), and deducting in full certain expenses that are enumerated by statute (called "above-the-line" deductions) in order to arrive at a figure for "adjusted gross income" ("AGI"). See 26 U.S.C. § 62(a). Taxable income is calculated by subtracting from AGI other deductions that are also enumerated by statute. These are

[13] See Restatement 3d § 227 cmt. i, at 32-38.

called "itemized" or "below-the-line" deductions. See 26 U.S.C. § 67(b) and Code sections cited therein.

Since the adoption of the Tax Reform Act of 1986, a subset of these itemized deductions, called "miscellaneous itemized deductions," has been deductible by individuals only to the extent that these deductions' aggregate "exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a).[14] These miscellaneous itemized deductions are, in other words, no longer fully deductible; the 1986 Act imposed a threshold, referred to among tax specialists as the "two-percent floor," on their deductibility. Congress limited the deductibility of these miscellaneous itemized deductions to prevent taxpayers from deducting expenses with "characteristics of voluntary personal expenditures," S. Rep. 99-313 at 78 (1986), that lacked "a sufficient business or investment purpose." Id. at 78 n.18; H.R. Rep. 99-426 at 109 n.8 (1985). Many expenses are, of course, deductible in our net-income-based system of taxation because "they may constitute costs of earning income." H.R. Rep. 99-426 at 110. But Congress was concerned that individuals were erroneously claiming deductions for things like home office expenses, magazine subscriptions and safe deposit services, and deducting items with "personal" aspects that "would have been incurred apart from any business or investment activities of the taxpayer." S. Rep. 99-313 at 78-79 & n.18; H.R. Rep. 99-426 at 109 n.8. Congress was also concerned about the recordkeeping and auditing burdens for both individuals and the IRS involved in assuring that these deductions were not taken erroneously. See S. Rep. 99-313 78-79 & n.18 (1986); H.R. Rep. 99-426 109-110 & n.8 (1985). The two-percent floor is a rough way of eliminating the personal component from an individual's deductions without the IRS having to make detailed, fact-intensive inquiries unwarranted by the sums in-

[14] These "miscellaneous itemized deductions" include those itemized deductions not listed in 26 U.S.C. § 67(b). There are over fifty such miscellaneous itemized deductions listed throughout the Code.

volved in each case.

The Code permits both individuals and trusts and estates an itemized deduction for investment management and advisory fees.[15] Individuals, however, may not ordinarily deduct investment management and advisory fees in full in calculating their taxable income. Rather, under Treasury Regulations such fees are treated as "miscellaneous itemized deductions" that are subject to the two-percent floor. See 26 CFR 1.67-1T(a)(1)(ii) (1988).

The Internal Revenue Code, however, has long recognized that the tax treatment of expenses of trusts and estates does not present the same concerns as the tax treatment of expenses of individuals. Thus, for example, in the preexisting law in place at the time the 1986 Act was passed, all "costs incurred in connection with the administration of trusts and estates," including investment advice fees, were deductible by trusts and estates in arriving at AGI. 26 U.S.C. § 57(b)(2) (1977). That is, these costs were given an "above-the-line" deduction though similar costs incurred by individuals were not. Below-the-line deductions are not allowable in calculating something called the Alternative Mimimum Tax (AMT), which becomes payable when one's income tax would otherwise fall below a level set by statute. Above-the-line deductions are. This provision of law therefore meant that these costs were deductible for trusts and estates required to pay AMT, but that similar ones were not deductible by individuals required to do the same.

In the 1986 Act, in the same section of the Code where it imposed the two-percent floor, Congress, consistent with this prior approach, thus provided a special rule for trusts and estates for the tax treatment of certain costs. The 1986 Act provided, in language codified at 26 U.S.C. § 67(e), that:

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[15] See 26 U.S.C. § 212(2) ("In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred . . . for the management, conservation, or maintenance of property held for the production of income. . . "); 26 CFR 1.212-1(g).

> 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 in arriving at adjusted gross income.

Pub. L. No. 99-514, § 132(a), 100 Stat. 2085, 2114-15 (1986), Pet. Br. App. 6a-7a.

Section 67(e) thus creates an exception to the two-percent floor for certain deductions of trusts and estates. To come within that exception, a cost must fall within each of the two clauses, or prongs, of the statute: First, it must be a "cost[] which [is] paid or incurred in connection with the administration of the estate or trust"; and second, it must be one "which would not have been incurred if the property were not held in such trust or estate." (The fact that § 67(e) treats these costs as deductible in calculating AGI, that is, as "above the line" deductions, means that they will reduce not only ordinary income tax, but the AMT where it is applicable. It is thus also the successor provision to the former § 57(b)(2) described above.)

5. The Trustees here themselves lack the skills and training necessary to make the investment decisions required by their fiduciary obligations. In order to comply with these obligations, the Trustees therefore engaged Warfield Associates, Inc., ("Warfield"), an SEC registered investment advisor in New York, to manage the Trust assets.[16] Warfield charged the Trust an annual fee of 0.8% of Trust assets, billed quarterly. During 2000, the tax year at issue here,

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[16] The Trust Documents provide that the Trustees may "employ such agents, experts and counsel as they may deem advisable in connection with the administration and management" of the Trust. Pet. App. 41a. This delegation is expressly permitted by the Connecticut statute, see Conn. Gen. Stat. § 45a-541i(a).

Warfield charged, and the Trustees paid, quarterly fees totaling $22,241.31 for Warfield's services. J.A. 24-27. In calculating the Trust's taxable income on the Trust's Form 1041, the Trustees included a deduction for the full amount of Warfield's fees because they were costs incurred in connection with the Trust's administration that "would not have been incurred if the property were not held" in the Rudkin Trust. J.A. 12 (line 15a), 13.

Respondent, the Commissioner of Internal Revenue ("the Commissioner"), disallowed this full deduction, permitting the Trust to deduct these fees only to the extent that they exceeded two percent of the Trust's adjusted gross income.[17] The parties agree that fees paid for investment management and advisory services are "costs which are paid or incurred in connection with the administration of the estate or trust" within the meaning of the first prong of § 67(e).[18] In the Commissioner's view, however, these fees failed to meet the statute's second prong. He issued a Notice of Deficiency to the Trust in the amount of $4,448.[19]

Petitioner Trustee Michael J. Knight petitioned the Tax Court for a redetermination of deficiency. See 26 U.S.C. §§ 6212, 6213, 6214 and 7442. The Tax Court sustained the Commissioner's position in reliance on its previous decision in *O'Neill v. Commissioner*, 98 T.C. 227 (1992), rev'd 994 F.2d 302 (CA6 1993). The Sixth Circuit in fact reversed in *O'Neill*, holding that "certain expenditures *unique* to trust administration are excepted from the two percent floor" by §

[17] The Trust had no other miscellaneous itemized deductions subject to the two-percent floor that could have been aggregated with these costs. See J.A. 12.

[18] See Pet. App. 6a; *Ungermann Trust v. Commissioner*, 89 T.C. 1131 (1983) (a very broad range of costs are included within the universe of costs covered by this statutory language).

[19] The parties subsequently discovered and agree that there was an error of approximately $11,000 in the calculation of adjusted gross income in the Trust's return. The amount of the alleged deficiency, though, was ultimately not altered by this correction. See Pet. App. 3a.

67(e), 994 F.3d at 303 (emphasis in original). The court of appeals there concluded that the trust investment advice fees at issue were among them because "the investment advisor fees paid by the Trust were costs incurred because the property was held in trust." Id. at 304. As the court explained, the costs were "caused by the fiduciary duties of the co-trustees. . . . [F]iduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." Id.

The Tax Court, however, chose to follow the decisions of the Federal Circuit in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (CAFed 2001), and the Fourth Circuit in *Scott v. United States*, 328 F.3d 132 (CA4 2003).[20] In those cases, those two courts of appeals concluded that only costs of a type not "customarily" or "commonly" incurred by individuals were fully deductible by trusts and estates. 265 F.3d at 1281 (costs that "that are unique to the administration of a trust and not customarily incurred outside of trusts"); 328 F.3d at 139-140 (quoting this language then equating it with a rule that "expenses commonly incurred by individual taxpayers" are not fully deductible). The Tax Court concluded that its original opinion in *O'Neill*, echoed by the Federal and Fourth Circuits in *Mellon Bank* and *Scott*, "remain[ed] sound." Pet. App. 29a.

6. Petitioner appealed to the Second Circuit. Before that court, the Commissioner relied upon *Scott* and *Mellon Bank*, contending that costs incurred in connection with the administration of trusts and estates are fully deductible only if they are not "commonly" or "customarily" incurred by individual taxpayers. Brief for Appellee at 3-4, 22-24, *Testamentary Trust of William L. Rudkin v. Commissioner*, 467 F.3d 149 (CA2 2006) (No. 05-5151-ag) ("Gov't CA2 Br.") (quoting *Scott* and *Mellon Bank*); see also id. at 22 (arguing

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[20] The Tax Court deems itself bound to follow the decisions of a Circuit Court of Appeals only when an appeal in the case before it lies to the same court. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970).

that the statute "treats as fully deductible only those trust-related administrative expenses that are not natural, customary, or probable outside of the context of trusts."). The Commissioner has long and repeatedly argued that "if a trust-related administrative expense is also customarily or habitually incurred outside of trusts, then it is subject to the two-percent floor." Brief for Appellee at 27, *Mellon Bank v. United States*, 265 F.3d 1275 (CAFed 2001) (No. 01-5015) ("Govt. *Mellon* Br."); Brief for Appellee at 27, *Scott v. United States*, 328 F.3d 132 (CA4 2003) (No. 02-1464) ("Govt. *Scott* Br.").

A two-judge panel of the Second Circuit affirmed, but on reasoning that differed from that of the Tax Court, that urged by the Commissioner, or that adopted by any of the three courts of appeals to have decided the issue previously, each of whose reasoning the court below rejected.[21] The court concluded that the "plain meaning" of the statute "excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust." Pet. App. 11a (emphasis in original); see also Pet. App. 12a-13a. Applying that test, the court ruled that "investment-advice fees are . . . a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust." Pet. App. 12a.

The court of appeals subsequently denied rehearing and rehearing en banc, Pet. App. 31a-32a, and on June 25, 2007, this Court granted certiorari.

7. After this Court granted certiorari in this case, the Commissioner issued a proposed regulation under the authority of 26 U.S.C. § 7805, purporting to interpret § 67(e). 72 Fed. Reg. 41,243, 41,245 (July 27, 2007), Appendix C,

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[21] Judge Sotomayor wrote the opinion, joined by Judge Hall; Judge Feinberg, who was originally on the panel, recused himself after oral argument. See Pet. App. 2a n.*.

Pet. Br. App. 8a-15a (text of notice of proposed rulemaking and notice of public hearing, including full text of proposed regulation 26 CFR 1.67-4).[22] The proposed regulation says that only expenses that are "unique to" trusts and estates are fully deductible, but, remarkably, it defines "unique" to mean that only costs that "*could not have*" been incurred by an individual "in connection with property not held in an estate or trust" are fully deductible. Id. at 13a (Proposed 26 CFR 1.67-4(b)) (emphasis added). That is, the Commissioner has abandoned his longstanding position that the statutory language means that only costs of a type not "commonly" or "customarily" incurred outside trusts are fully deductible. The Commissioner now proposes a position similar to that adopted by the Second Circuit below, that the phrase "would not have been incurred if the property were not held in such trust and estate" should be read to mean "could not have been incurred by an individual." The proposed regulation does not mention or address the fact that this is a departure from the Commissioner's longstanding position with respect to the interpretation of the statute.[23]

Under the proposed regulation, the Commissioner appears to take the position for the first time that the costs for *some* trust investment fees *are*, indeed, deductible in full. The only investment advisory fees that the proposed regulation states it would subject to the two-percent floor are fees paid for "advice on investing for total return," that is investing to achieve the largest return without regard to whether that return is the result of production of income or apprecia-

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[22] The Commissioner informed the Court prior to the grant of certiorari in this case that issuance of a proposed regulation was imminent. See Brief of Respondent in Opposition ("Opp.") at 5-6 (stating that a notice of proposed rulemaking "should be ready for publication in the Federal Register by July 2007").

[23] The notice of proposed rulemaking also does not mention the grant of certiorari in this case, but only the need to resolve the Circuit split on the question presented. Pet. Br. App. 10a-11a.

tion of principal.[24] Pet. Br. App. 14a (Proposed 26 CFR 1.67-4(b)). The proposed regulation specifies that there are circumstances in which only a "portion . . . of the . . . investment advisory" fee may be subject under the regulation to the two-percent floor. Id. 15a (Proposed 26 CFR 1.67-4(c)).

Under modern portfolio theory, individuals are supposed to invest for "total return," but many trusts and estates traditionally could not because of their need for both income and growth of principal in order to "balance the competing interests of differently situated beneficiaries." Restatement 3d § 227 cmt. c, at 13. Thus, "only when beneficial rights do not turn on a distinction between income and principal is the trustee *allowed* to focus on total return . . . without regard to the income component of that return." Id. cmt. i, at 35 (emphasis added). See also id. §§ 183, 232, 239, 240 (describing duty of trustee to deal impartially with beneficiaries and to balance income and principal to serve interests of successive beneficiaries).

The line proposed by the Commissioner indicates that he now recognizes that trust investment advice fees are not subject to the two-percent floor when they purchase advice about investing in a manner distinct from that undertaken by individuals. See also Pet. App. Br. 13a (determination of deductibility under the proposed regulation turns on "the type of product or service rendered to the estate or trust"). As described above, they always do.

SUMMARY OF ARGUMENT

Like other significant income producing entities, trusts and estates have long been permitted to deduct for income tax purposes investment advice fees paid to assist with the management of property held for the production of income. That rule comports with the Revenue Code's broad basic policy to tax only net income. Section 67(e) preserved trus-

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[24] See Restatement 3d § 227 cmt. e, at 18 (defining investment for "total return").

tees' ability to do so. That construction is confirmed by the text, structure and history of the section, the Act in which it was adopted, and the Code of which it is a part. There is no basis for the assertion that Congress intended in § 67(e) to work the significant change to trust and estate taxation that the Commissioner posits, a change that would have serious consequences for the very beneficiaries trusts and estates are designed to protect.

I. 26 U.S.C. § 67(e) requires a determination of whether costs incurred in connection with the administration of a trust or estate "would not have been incurred if the property were not held in such trust or estate." This is a straightforward causation test. It means that all expenses that are caused by the fact that the property is held in the trust or estate are deductible in full. Trust investment advice fees are caused by the fact the property is held in trust. They are incurred in fulfillment of the trustee's unique fiduciary duty, a duty not applicable to individuals investing their own funds. The advice for which trustees pay is tailored precisely to the distinctive requirements imposed by that fiduciary duty. By contrast, costs that would be identical regardless of whether the property was owned by an individual or a trust, for example expenses for routine maintenance of real property, are subject to the two-percent floor. This is not only the best reading of the statute's text, it provides a rule that fits coherently within the Internal Revenue Code, serves the purposes intended by Congress, and is workable and fair.

The text and structure of the Revenue Code, the 1986 Act, and § 67 itself confirm this reading. Section 67 was intended to subject expenses with a "personal" aspect to the two-percent floor. Trust investment advice fees do not have this aspect. Congress also did not intend to impose the two-percent floor on trust and estate investment advice expenses to prevent individuals from establishing trusts and estates to circumvent the two-percent floor that would otherwise apply to their deductions. Congress recognized that trusts and estates are not subject to such abuse, and indeed, its consistent provision, both before and since the 1986 Act, of deductions for costs incurred in connection with the administration of trusts and estates demonstrates that Congress is not concerned about their misuse in that way. It makes the most sense therefore to read § 67(e) to preserve the full deductibility of trust and estate investment advice fees, perhaps the largest single cost incurred in connection with trust and estate administration, rather than to work the significant change to their tax treatment urged by the Commissioner.

II. Because the statute has a plain meaning, and no other textually supportable interpretation of § 67(e) has been proposed, this Court need not employ the tools used for addressing statutory ambiguity. However, if the statute were found to be ambiguous, applicable rules of interpretation would support Petitioner's reading. The legislative history of § 67 confirms that Congress did not intend the two-percent floor to apply broadly to trust and estate administrative expenses and that the primary purpose of the limitation in § 67(e) was to address the administrative expenses associated with what is called a "pass-through entity" (for example a partnership) that happens to be owned by a trust or estate. Administrative costs of pass-through entities are not fully deductible when such entities are owned by individuals, and the legislative history of § 67(e) makes clear that the specific purpose of that provision was to ensure that they likewise cannot be fully deducted when the pass-through entity happens to be owned by a trust or estate. Further, if the statute were ambiguous, under a venerable canon of construction it would be necessary to resolve any doubt "against the Government and in favor of the taxpayer." *United States v. Merriam*, 263 U.S. 179, 188 (1923).

III. Any construction of the statute under which trust investment management fees are not deductible in full would violate the congressional purpose and would do grave harm both to those who are the beneficiaries of trusts and estates and to the financial services industry by discouraging trustees from engaging the services of precisely the professional advisors best able to assist them with fulfillment of their fiduciary obligations. This Congress cannot have silently intended.

IV. Only Petitioner's interpretation of the statute offers a coherent approach to the Commissioner's longstanding treatment of costs incurred in connection with the administration of trusts and estates. The Commissioner has long taken the position that fees for the preparation of fiduciary income tax returns (but not parallel individual returns) and trust attorney fees (but not individuals' attorney fees), among others, are fully deductible and not subject to the two-percent floor. This can be explained only by the relationship of those particular expenses to the fulfillment of the trustee's fiduciary duty. The same rule should apply with respect to trust investment fees, recognizing their full deducibility because they are, like those other expenses, caused by the fact that the property is held in the trust.

V. The statutory language will not support any of the other proposed readings of § 67(e). The Commissioner's new proposed interpretation is obviously textually unsupportable. "Would not have been incurred" simply does not mean "could not have been incurred." In addition, the bewildering difficulty of case-by-case factual determinations and corresponding detailed recordkeeping and auditing under the test now proposed by the Commissioner is utterly contrary to the purpose of § 67 to reduce such costs. The position taken by the Fourth and Federal Circuits, asking not whether a cost actually would "have been incurred if the property were not held in such trust or estate," but whether that type of cost is commonly incurred outside of trusts, is, similarly, both countertextual and unworkable in application.

VI. Finally, even under the test adopted by the Fourth and Federal Circuits or the one now proposed by the Commissioner, the trust investment fees in this case would not be subject to the two-percent floor, but would be fully deductible. Individuals do not "customarily" or "commonly" place assets under management, paying a percentage-of-assets management fee. Further, trust investment fees are peculiar to trusts and estates and cannot be incurred by individuals. Even under the principle articulated in the Commissioner's proposed regulation, the trust investment advice fees in this case would be fully deductible.

ARGUMENT

I. EXPENSES CAUSED BY THE FACT THAT THE PROPERTY IS HELD IN TRUST, INCLUDING THE TRUST INVESTMENT ADVICE FEES AT ISSUE HERE, ARE FULLY DEDUCTIBLE UNDER § 67(e).

A. The Text of § 67(e) Establishes a Straightforward Causation Test Readily Satisfied Here.

Section 67(e) permits the deductibility in full of "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." 26 U.S.C. § 67(e). This establishes a straightforward causation test. The text's plain meaning requires an inquiry into whether a particular expense of a particular trust or estate was caused by the fact that the property was held in the trust or estate.

Applying this test, the trust investment advice fees at issue in this case are deductible in full. Trust investment advice fees are caused by the fact that property is held in the trust. They are incurred in fulfillment of the trustee's fiduciary obligation, and the advice for which they pay is tailored precisely to the distinctive requirements imposed by that fiduciary duty. The trust investment management fees in this case, for example, were incurred in order to obtain advice on investing trust assets in compliance with the Trustees' particular fiduciary duties. They purchased something different from similar costs that might have been incurred by an individual. The fees therefore would not have been incurred had the property not been held in trust.

An individual may incur a *similar type* of cost, but an individual will not incur the trust investment advice costs that are incurred by a trustee to ensure that he or she meets his or her fiduciary responsibilities. The statute does not ask whether similar costs are capable of being incurred by individuals or whether similar costs are customarily or commonly incurred by individuals. Rather, the statute asks whether *these costs would have been incurred* if the property were not held in this trust. The trust investment fees at issue here would not have been.

This common-sense approach to the statute creates a bright-line rule that Congress plainly intended. On one side of the line are costs caused by the fact that the property is held in the trust or estate. These remain fully deductible. On the other side are costs that would have been incurred regardless of who owned the property held in trust – for example, expenses for routine maintenance of real property when it happens to be owned by a trust but could equally have been owned by an individual. In that situation, the expenses are identical regardless of whether the owner is an individual or a trust or estate and in either event they are subject to the two-percent floor. Similarly, the expenses § 67(e) was in fact specifically designed to subject to the two-percent floor, administrative costs associated with certain entities such as partnerships in which a trust or estate, like an individual, may have ownership interests, see *infra* at 32-36, are identical whether the property (there the partnership interest) happens to be owned by an individual or by a trust or estate. (Those costs of what are called "pass-through" entities, including partnerships, will be explained in more detail below.)

B. The Text and Structure of the Revenue Code, the 1986 Act, and § 67 Itself Confirm This Reading.

This reading of § 67(e) is confirmed by the legislative history of both § 67(a), imposing the two-percent floor, and § 67(e) itself. See *infra* 31-38 (discussing legislative history). But this Court need not resort to legislative history, because only this reading of § 67(e) is consistent with the text and structure of the Revenue Code, the 1986 Act and the other provisions of § 67.

1. Expenses Caused by the Fact Property is Held in the Trust or Estate Lack the Personal Character of the Expenses Whose Deductibility Congress Sought to Limit With the Two-Percent Floor Adopted in § 67.

The purposes for which the two-percent floor itself was adopted would not be served by imposing it on the costs at issue here.

The Revenue Code reflects a broad basic policy to tax net income. Accordingly, costs like investment management fees, which contribute to the production of income, have long been deductible from the income of individuals and entities alike for income tax purposes. And even when Congress has found reason to limit the deductibility of such costs for individuals, it has retained them for entities like trusts and estates. Thus, before 1986, though Congress had limited the deductibility of such expenses for individuals in calculating their Alternative Minimum Tax (AMT), it preserved the principle of their deductibility in the same circumstances for trusts and estates. See *supra* at 12.

The two-percent floor was concerned with addressing abuse and misapplication of the net income system by individuals. It was included in a Title of the Act entitled "Individual Income Tax Provisions," see 100 Stat. at 2085, and the specific provision imposing it, § 67(a), entitled "General Rule," states that "*in the case of an individual*, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." See id. at 2114, Pet. Br. App. 5a (emphasis added).

As the placement of section 67 in the Act indicates, this two-percent floor is essentially a rule for individuals, and it arises from issues peculiar to individual taxpayers. The two-percent floor was adopted out of a concern that individual taxpayers were frequently deducting expenses with some "voluntary personal" characteristic, erroneously claiming deductions or deducting expenses that would have been incurred even if they did not contribute to the taxpayer's income-producing activities. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* at 78 (1987) (hereinafter "Blue Book"); see *FPC v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472 (1973) (such a General Explanation provides "a compelling contemporary indication" of the meaning of a statute). This included expenses such as education expenses, subscriptions to business or trade journals, and safe-deposit box fees for boxes that could hold both personal and investment-related items. See Blue Book at 78-79 & n.52.

The two-percent floor on deductions served as a kind of "rough justice" disallowing a fixed part of an individual's miscellaneous itemized deductions in the aggregate on the theory that some portion of the expenses were actually personal in character. It employed the two-percent floor rather than requiring case-by-case determinations in order to reduce the burden upon the IRS and the individual taxpayer imposed by the need to verify that individuals' miscellaneous itemized deductions were properly claimed. Blue Book at 78. On its face, the text of the proviso in § 67(e), too, reveals a purpose to address expenses with a personal aspect, subjecting to the floor costs that would "have been incurred if the property not been held in such trust or estate." *Cf.* Blue Book at 79 ("The use of a deduction floor . . . 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.")

Applying the two-percent floor to distinct costs that are incurred to satisfy the fiduciary requirements imposed on the trustee would not serve the purpose for which § 67(a) and (e) were designed. These trust expenses do not have a voluntary or personal aspect. Investment fees incurred by trusts are properly treated categorically as a legitimate business expense of discharging the fiduciary duty to prudently invest trust assets. They are mandated by the existence of the trust fiduciary relationship, and serve only the fiduciary purpose of the trust. See *supra* at 5-10. A limitation on their deductibility would thus be beyond the scope of Congress's purpose in enacting § 67.

2. The Text and Structure of the 1986 Act and the Code More Broadly Demonstrate a Purpose to Retain the Type of Deduction at Issue Here, Not to Restrict It.

Consistent with this, the text and structure of the 1986 Act and the Code more broadly demonstrate a purpose to retain the deductibility of fees like those at issue here, not to limit it.

a. Other taxable entities, for example taxable corporations, Real Estate Investment Trusts (REITs), and so on, are permitted to deduct for income tax purposes similar investment management fees.[25] This is consistent with the basic policy of taxing net income. Congress has recognized that trusts and estates, like these others, are meaningful entities with substantial economic and societal purposes, and so it makes sense that the deductibility of trust and estate investment advice fees should have been preserved by § 67(e), not limited by it.

Trusts and estates are created by the transfer of assets to a third-party trustee who holds, manages and controls the trust property for the benefit of others, the beneficiaries. Individuals create trusts (and estates) to provide for others and to give them protection. The beneficiaries may, as in this case, include a large number of distinct individuals as well as individuals who are not even yet born.

Trusts and estates thus have substantial economic and societal purposes, including the independent management of

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[25] Taxable corporations and REITs, for example, may deduct such fees as ordinary and necessary trade or business expenses under 26 U.S.C. § 162.

trust assets in the interests of the beneficiaries. Trusts' ability to earn income serves their legitimate societal purposes. Consequently, as this Court explained long ago, the Code "treats the trust as an entity for producing income comparable to a business enterprise . . . and permits deductions of management expenses of the trust. . ." *Bingham's Trust v. Commissioner*, 325 U.S. 365, 374 (1945). The Code has set up a unique system for trust and estate income taxation in their own right that differs from that applicable to individuals. See 26 U.S.C. §§ 641, *et seq*. (Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code).

b. The Commissioner does not deny this, nor does he suggest there is any reason Congress would have wanted to impose a two-percent floor on deductibility of trust and estate investment advice fees for its own sake. The Commissioner argues, rather, that Congress imposed this new restriction in 1986 to prevent individuals from abusing trusts and estates by shifting income, placing assets and expenses into trusts and estates to circumvent the two-percent floor that would be applicable to them as individuals. Brief of Respondent in Opposition ("Opp.") at 12.

This argument is based on a misunderstanding of the nature of trusts and estates, of their vulnerability to abuse, and of the design of the Code. The text and structure of the Code and the 1986 Act make clear that § 67(e) should be read as a provision *preserving* the ability of trusts and estates to deduct in full most of the costs incurred in connection with their administration, not as a provision *preventing* the full deduction of what is perhaps the largest single such cost.

There are substantial costs and serious consequences to creating and administering an estate or nongrantor trust (the only kind to which § 67(e) applies) that prevent the creation of a trust (or estate) in order to avoid income taxation in the way the Commissioner posits. Congress has repeatedly recognized these consequences. They militate against the Commissioner's reading of § 67(e).

First, there is a tax cost: The grantor, the person who creates the trust, will ordinarily have to pay a significant transfer tax that diminishes the assets. 26 U.S.C. §§ 2501-2502. Second, the grantor loses ownership of and control over assets placed in the trust; the transfer of assets to a nongrantor trust is irrevocable. Management of the assets is committed to the trustee, not the grantor or beneficiaries, and the trustee is not permitted to manage the property as the grantor would. See *supra* 7-10. In addition, a trust or estate has greater costs for recordkeeping, judicial accountings, and the like.

The costs of creating an estate are even greater: One must also die in order to do so. While they are lumped together in the popular imagination, we are confident no one yet has chosen death over taxes. Yet § 67 applies not only to trusts, but to estates. Given the attendant costs, it is implausible that one would create a trust (or estate) in order to obtain a reduction of adjusted gross income (not a direct reduction of taxes), equal to, at most, two percent of AGI. That tail simply cannot wag the massive dog of nongrantor trust or estate creation.

c. More significantly, several other provisions in the Code and, indeed, in the 1986 Act itself, demonstrate that Congress was not concerned with income shifting through the use of nongrantor trusts and estates.

In the 1986 Act, Congress actually included a different provision – § 67(c) – to prevent the kind of income-shifting abuse the Commissioner claims § 67(e) targets. Congress identified the entities that it determined were subject to such abuse, and it *expressly excluded trusts and estates from that list*. There is a category of entities known as "pass-through" entities, common examples of which are partnerships and S corporations. Such entities are not distinct taxpayers; they do not pay tax on their income, but pass their own income through to their owners who pay income tax upon it. See, *e.g.*, 26 U.S.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.") Each owner's share of the entity's income is reported on a Schedule (ordinarily, a "Schedule K-1") that the entity provides to the owner.

If a pass-through entity could deduct something from its income that an individual could not deduct, and then pass its new, reduced net income figure through to its owner, and if it were relatively cost-free to create such an entity, individuals could avoid some of their individual income tax by placing their assets in such pass-through entities. An owner might deliberately shift income and expenses to the entity in this way in order to reduce resulting net income by a deduction to which the owner, *qua* individual, is not entitled.

In § 67, Congress in the 1986 Act prevented this kind of income shifting to pass-through entities that it determined were subject to such abuse, and it explicitly excluded trusts, estates, and certain other entities. Congress did so even though some of the excluded entities may, like pass-through entities, at times distribute net income to beneficiaries who must report it on their own income tax returns. As adopted in the 1986 Act, § 67(c) provided:

> The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection. The preceding sentence shall not apply with respect to *estates, trusts,* cooperatives, and real estate investment trusts.

100 Stat. at 2114, Pet. Br. App. 6a (emphasis added).[26]

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[26] See also 26 CFR 1.67-2T(g) (defining "pass-thru entity"). We note that the variant of trusts known as "grantor trusts" described *supra* at n.1 are treated as pass-through entities as permitted by a 1988 technical amendment to §67(c). See *id*; see also 26 U.S.C. § 67(c).

This provision confirms that § 67(e) should be read as preserving the full deductibility of most trust and estate costs incurred in connection with their administration, not as preventing the deduction of what is perhaps the largest single such cost trusts and estates incur.[27]

And indeed, in other provisions of the Code beyond § 67(e) Congress consistently has permitted expenses incurred in connection with the administration of trusts and estates, including trust investment advice fees, to be deducted from trust and estate income even when similar expenses can not be deducted by individuals. As described above, for example, prior to the enactment of the 1986 Act, § 57(b)(2) allowed deduction of costs incurred in connection with the administration of a trust or estate even when similar costs could not be deducted by individuals. See *supra* at 12. Even more dramatically, § 68 provides that once an individual's adjusted gross income exceeds a certain threshold amount, currently $156,400, most of his or her itemized deductions will be reduced by the lesser of eighty percent of their total

[27] The structure of § 67(e) confirms that it was not designed to address the risk of abuse through income-shifting. Where Congress did address abuse-prone entities it did so not by imposing a deductibility floor at the entity level, but by requiring the individuals who ultimately received the income to treat their share of the entity's miscellaneous itemized deductions as subject to the two-percent floor on their own individual returns. See 26 U.S.C. § 67(c)(1) (addressing pass-through entities). This makes perfect sense. For to impose the two-percent floor on expenses at the entity level, as the Commissioner would here, could actually result in a disadvantage for those taxpayers who receive income from trusts and estates. This could happen when an individual's aggregate miscellaneous itemized deductions have already met the two-percent floor – so that if the trust investment advice expenses were passed out to the individual separately, he or she could fully deduct them, as the individual would if they were his or her own investment advice expenses. On the Commissioner's reading, if the trust had not met its two-percent floor, these costs could not be deducted at the entity level by the trust, nor could they be deducted by the individual receiving the trust income, since that individual would not be entitled to claim the trust's miscellaneous itemized deductions as his or her own.

or three percent of the amount by which the adjusted gross income exceeds that threshold. 26 U.S.C. § 68; see also Rev. Proc. 2006-53, 2006-48 I.R.B. 996, *as modified by* Rev. Proc. 2007-36, 2007-22 I.R.B. 1335 (adjusting threshold amount for inflation). This is a parallel provision to § 67, and it, like § 67, reduces the extent to which individuals are able to deduct certain of the itemized deductions. See 26 U.S.C. § 68(a), (c). Yet 26 U.S.C. § 68(e) provides that "[t]his section shall not apply to any estate or trust."

In light of all this, it cannot sensibly be maintained that Congress intended in § 67(e) to eliminate the full deductibility of trust and estate investment management fees because of concern about abuse hypothesized if trusts and estates were allowed to deduct such fees from their income. The text and structure of the statute thus indicate that § 67(e) should be read to preserve the deductibility in full of trust investment advice fees, not to prevent it.

II. IF THERE WERE AMBIGUITY IN § 67(e), THE TOOLS APPROPRIATELY USED TO RESOLVE IT WOULD ALL SUPPORT PETITIONER'S READING

The statute has a "plain meaning," despite the confusion about its construction among the courts of appeals. And, indeed, as we will demonstrate below, none of the other proposed constructions of the statute are even textually supportable. See *infra* at 44-48. There is thus ultimately no ambiguity in the statute requiring inquiry beyond its text and structure. If this Court were nonetheless to find the statute ambiguous, the tools appropriately used to resolve statutory ambiguity, both the legislative history and the canons of construction, support the construction of the language we have put forward.

A. Legislative History.

Most significantly, the legislative history of § 67 confirms that Congress did not intend the two-percent floor to apply as the Commissioner urges. It makes clear that the primary purpose of the second prong of § 67(e) was to prevent the deduction of administrative expenses incurred by pass-through entities in which trusts or estates happened to have an interest. See H.R. Conf. Rep. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122. These and similar costs that have nothing to do with the fiduciary's unique obligations are the only ones subjected to a two-percent floor by the statute.

1. In both the original House and Senate versions of the bill, what became § 67(e) did not contain a second prong. In both versions, it read simply "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 paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income." See H.R. 3838, 99th Cong., 1st Sess., § 132 (as passed by the House, Dec. 17, 1985); H.R. 3838, 99th Cong., 2d Sess., § 133 (as passed by the Senate, June 24, 1986), *reprinted at* 132 Cong. Rec. 16,061, 16,070 (June 26, 1986). Congress thus clearly intended as an initial matter to continue its policy of allowing trusts and estates this deduction in full "above-the-line" for the costs incurred in connection with their administration.

2. Further, the legislative history of § 67(a) indicates what has already been discussed: the two-percent floor was adopted out of a concern that taxpayers were frequently deducting expenses with some "personal" aspect, erroneously claiming deductions or deducting expenses that would have been incurred even if they did not contribute to the taxpayer's income-producing activities. See S. Rep. 99-313, at 78-79 (1986). The two-percent floor was intended to address both such deductions and the burden upon the IRS and the taxpayer imposed by recordkeeping requirements for determining and verifying that certain miscellaneous itemized deductions were properly claimed. See H.R. Rep. 99-426, at 109-110 (1985); S. Rep. 99-313, at 78-79. As described above, the two-percent floor on deductions served as "rough justice" for disallowing that part of miscellaneous itemized deductions assumed to be "personal."

Permitting the deduction in full of most administrative expenses incurred by trusts by reason of the trust's existence was an implicit recognition that these expenses do not contain a personal aspect. It also reflected the policy determination that ordinary trust operations do not present the potential for abuse that was addressed by the two-percent floor, a policy determination prominent in the statute as it was adopted. See 26 U.S.C. § 67(c) (1986), Pet. Br. App. 6a.

3. The second prong of § 67(e) – the limitation on the deduction allowed by the provision – was added only in the Conference Committee. The history of its adoption makes clear that it was intended primarily to address the problem of trust and estate treatment of administrative costs passed through to the trusts or estates by pass-through entities in which they happened to have an ownership interest.

As described above, the 1986 Act included a provision to restrict the ability of individuals indirectly to deduct costs of pass-through entities in which they had an ownership interest when those costs would not have been deductible in full had the individuals incurred them themselves. 26 U.S.C. § 67(c). One of the effects of the second prong of § 67(e), indeed, the one about which the enacting Congress was specifically concerned, was to impose a parallel restriction on pass-through entity expenses when those entities happened to be owned by trusts and estates. If a trust is a partner or shareholder in a pass-through entity, that entity can incur expenses in its administration, and pass them through to the trust, reporting them on the schedule sent to the trust. The trust can then record those costs as administrative expenses on its own tax return. Section 67(e) ensures that, when a trust owns an interest in a pass-through entity, these costs are subject to the two-percent floor.

The Conference Committee action with respect to § 67 was focused on pass-through entities. Neither the version of the Act passed by the House nor that reported out of the Senate Finance Committee included any language limiting the use of pass-through entities to avoid limitations on individual deductions, though both exempted all costs incurred in connection with the administration of trusts and estates from the limits on deductibility imposed on individuals. On the very day the Senate passed its version of the Act, it first passed a floor amendment introduced by Sen. Packwood that read

> The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual.

132 Cong. Rec. 15,156 (June 24, 1986). This was the first time pass-through entity costs were addressed in the context of limiting individual use of itemized deductions.

The Conference Committee adopted this language from the final Senate bill, but it had to harmonize it with, among other things, the provision allowing deductions for trust and estate costs incurred in connection with their administration. It did so first by adding to the pass-through restriction that became § 67(c) the language expressly *exempting* trusts and estates from being themselves treated as pass-through entities: "The preceding sentence shall not apply with respect to estates, trusts, cooperatives, and real estate investment trusts." 100 Stat. at 2114, Pet. Br. App. 6a. This preserved the benefit of the special rule allowing trusts and estates to deduct costs incurred in connection with their administration. Second, though, the Senate pass-through provision adopted by the Conference Committee also applied only to "individual[s]" deducting the costs of pass-through entities. See *supra* this page. So, to ensure that the pass-through entity's costs were no more deductible when passed through to trusts and estates than they were when passed through to individuals, the Committee added the second prong to § 67(e) providing that a trust or estate could not deduct costs incurred in connection with administration if the cost would "have been incurred if the property were not held in such trust or estate."

And indeed, the legislative history of the second prong of § 67(e), which lies solely in the Conference Report, makes clear that this was Congress's purpose:

> Pursuant to Treasury regulations, the [two-percent] floor is to apply with respect to indirect deductions through pass-through entities. . . . In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid and 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 trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. *The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.*

H.R. Conf. Rep. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122 (emphasis added).

This language – the only congressional explanation ever given for the second prong of § 67(e), and the most authoritative legislative history there could be[28] – makes clear that the second prong was designed to prevent trusts from deducting in full the administrative expenses incurred by pass-through entities in which they held an ownership interest that would have been incurred whether or not the pass-through interest was held in the trust. Section 67(e) means that when a trust owns an interest in a pass-through entity, such costs of

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[28] See, *e.g.*, *Railway Labor Executives Ass'n v. ICC*, 735 F.2d 691, 701 (CA2 1984) (Friendly, J.) (citation omitted) ("Because the conference report represents the final statement of terms agreed to by both houses, next to the statute itself it is the most persuasive evidence of congressional intent.").

pass-through entities they own are subject to the two-percent floor. That is why, as the legislative history explains, its effectuation required the Secretary to take account of § 67(e) in reporting requirements relating to application of the floor to expenses of pass-through entities. The reporting requirements issued by the Treasury to implement the statutory command that pass-through entity costs were to be subjected to the two percent floor by their owners who were individuals would have to be crafted to address the rule enacted in § 67(e) under which pass-through entity costs would also be subjected to the two-percent floor limitation when the pass-through entity was owned by a trust or estate.

The legislative history thus confirms our reading of the statute. Section 67(e) was enacted to impose the two-percent floor on costs incurred in connection with the administration of trusts and estates that were not caused by the property being held in the trust or estate, but that would have been incurred regardless of the property's ownership, archetypally the administrative costs of pass-through entities. There is no indication at all in the legislative history that the Conference Committee intended instead to depart from the position already taken by both Houses of Congress in the versions of the bill they had passed: That the pre-existing tax treatment of trusts and estates would be continued by permitting an above-the-line deduction for most costs incurred in connection with trust and estate administration. The legislative history makes clear that Congress simply did not intend the significant change in the taxation of trusts and estates that would have been wrought by a restriction on the deduction of what is perhaps the largest single such expense, fees for trust and estate investment advice.

4. By contrast, the legislative history long relied upon by the Commissioner is irrelevant to the provision before the Court. The Commissioner says

> Congress . . . sought to reduce the tax benefit of placing assets in trust in order to split income between the

> trust and its beneficiaries, primarily by setting the tax rates for trusts so that little income could be sheltered at the lower rates. See 26 U.S.C. 1(e); S. Rep. No. 313, *supra*, at 867-868. Making the 2% floor for miscellaneous itemized deductions applicable to trusts (with an exception for trust-related administrative expenses that would not have been incurred if the property were not held in a trust) also serves that goal by preventing trusts from fully deducting the same expenses that individuals cannot fully deduct.

Opp. at 12.

No one would deny that Congress set the tax rates for trusts in 26 U.S.C. § 1(e) in such a way as to discourage splitting income. Under that provision trusts and estates currently reach the top 35% tax bracket with undistributed taxable income of more than $10,050, while individuals need to have more than $349,700 of taxable income to be taxed at the highest rate. See 26 U.S.C. § 1(a)-(e); Rev. Proc. 2006-53 § 3.01, 2006-48 I.R.B. 996, *as modified by* Rev. Proc. 2007-36, 2007-22 I.R.B. 1335. But that (and the inapposite Senate Report describing it cited by the Commissioner) has nothing to do with the two-percent floor, or the meaning of the second prong of § 67(e). Indeed, the Senate Report the Commissioner cites states that the Committee "believe[d] that significant changes in the taxation of trusts or estates" beyond the new rate schedule were "unnecessary" to address "the tax benefits which result from the ability to split income between a trust or estate and its beneficiaries." S. Rep. 99-313 at 868 (1986). Section 67(e) is designed precisely to allow some miscellaneous itemized deductions to be deductible in full by trusts and estates, even though for an individual all such deductions are subject to the two-percent floor. The only question of legislative purpose actually implicated here is why the Congress added the second clause to § 67(e). And that is answered by the legislative history described above.

B. Canons of Construction

Canons of statutory construction applicable to the interpretation of ambiguous statutes also favor the position taken by Petitioner.

This is a tax statute. There is of course a longstanding and "traditional canon that construes revenue-raising laws against their drafter." *United Dominion Indus. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring). As this Court has explained, in construing a revenue statute, "[i]f the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer." *United States v. Merriam,* 263 U.S. 179, 188 (1923).

The Commissioner has argued, citing *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992), that "[b]ecause deductions are matters of legislative grace, they are strictly construed, and any vagueness in a Code section authorizing a deduction must be resolved in favor of the Government." Gov't CA2 Br. 18.

Even if that were a viable, broadly applicable rule of construction it would not apply here. There is no question that the fees at issue here qualify as "miscellaneous itemized deductions." The only question is whether they are allowable in full or subject to the two-percent floor. Further, the dispute is over the applicability *vel non* of an *exclusion* from a rule of full deductibility. Thus, this case does not involve a determination of the scope of a deduction in light of a background rule that the income in question is to be taxed. It involves the determination of the scope of an exception in light of a background rule that costs of this type are fully deductible.

In any event, as this discussion may suggest, the rule described in *INDOPCO* is not a viable, broadly applicable canon of construction. In *INDOPCO*, the Court applied the canon of resolving doubt against deductibility only in the context of determining whether a particular expense was deductible or was instead a capital expenditure to be amortized and depreciated, and it did so only after examining the statute to find a "norm of capitalization." 503 U.S. at 84. The Court acknowledged that it was "*[i]n exploring the relationship between deductions and capital expenditures*" that it had "noted the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" Id. (emphasis added). Thus, the Court said that in that one context "deductions are strictly construed and allowed only 'as there is a clear provision therefor.'" Id. (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940)).

By contrast, the cases *INDOPCO* quoted and cited are all over sixty years old. Outside of this narrow context, this Court appears not to have relied upon the canon based upon deductions being a matter of "legislative grace" since *Equitable Life Assurance Society v. Commissioner*, 321 U.S. 560 (1944). Before *INDOPCO* it was last *cited* by this Court over thirty years ago. See *Commissioner v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 148 (1974). Indeed, this Court has viewed this alleged rule of construction of deductions with skepticism since at least 1952, when it pointedly declined to rely upon it in *Lykes v. United States*, 343 U.S. 118, 120 n.4 (1952) (citing Griswold, *An Argument against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142 (1943)).

Of course, as Justice Thomas's concurrence in *United Dominion Industries* suggests, the idea that deductions must be construed *against* the taxpayer is at most a vestige of another era, when it was thought that *not* taxing someone's income was an act of "legislative grace." Whether done through narrow interpretations of deductions or through broad interpretations of a tax, the employment of an ambiguous statute to impose tax upon an individual is an assertion of power by the State to make a claim upon some of his or her income without a clear expression of congressional intent. The canon that revenue laws must be construed against the government has equal force in both circumstances. See 522 U.S. at 839 (Thomas, J., concurring). The canons of construction applicable in cases of statutory ambiguity thus favor Petitioner's reading of the statute.

III. AN ALTERNATIVE CONSTRUCTION WOULD WORK SUBSTANTIAL DETRIMENT TO BENEFICIARIES AND THE FINANCIAL SERVICES INDUSTRY.

Any construction of the statute that forbids full deduction for trust investment fees would have serious consequences that Congress could not have intended for beneficiaries and the financial services industry.

Of course, the imposition of this tax would consistently erode trust corpus, and thus the earnings thereon, not just once, but in cumulative fashion, year after year. That would be a direct harm to the beneficiaries that trusts and estates exist to protect. Further, though, if fees for investment advice were no longer fully deductible, trustees would have an incentive to attempt to fulfill their fiduciary responsibilities of prudent investment without incurring investment management and advice fees subject to the two-percent floor. This would be harmful both to beneficiaries and to the financial services industry.

Some, particularly smaller trusts, may take their assets out of management and attempt to invest them in mutual funds, the costs of which are always deductible under 26 U.S.C. § 67(c)(2). Indeed, commentators have urged this approach since the decision below was handed down. See Cohen, *A Tense Time for Trust Administration*, 146 Trusts and Estates 28, 29 (2007). Others may try to use brokers, who typically charge only commissions for purchases and sales. These commissions are included in the cost basis for securities and deducted from the gain upon sale so that they are, effectively, excluded from taxable income. See 26 CFR 1.263(a)-2(e). Many will also likely seek trustees who are themselves skilled in investment, so that no separate investment advice and management fee need be incurred, but the fee will be built into deductible "trustee fees." This is an approach that has been described repeatedly in the literature.[29]

A trustee must always fulfill his or her fiduciary obligations, but it would make little sense for Congress to have created an incentive for one method of trust and estate investment over another. An affirmance of the decision below would be harmful both to the beneficiaries for whom the trusts were created in the first place, and to the financial services industry whose professionals may be best able to assist with fulfillment of fiduciary obligations and to ensure that trusts and estates are managed appropriately in light of their purposes. *Cf.* Brief *Amici Curiae* of the American Bankers Association, *et al.*, in Support of Petition for Certiorari 6.

IV. ONLY PETITIONER'S CONSTRUCTION OFFERS A COHERENT APPROACH TO THE INTERNAL REVENUE SERVICE'S LONGSTANDING TREATMENT OF COSTS INCURRED IN CONNECTION WITH THE ADMINISTRATION OF TRUSTS AND ESTATES.

Only the principle of full allowability for costs caused by the fact that the property is held in the trust or estate can adequately explain the Commissioner's own longstanding position with respect to a wide range of costs incurred in connection with the administration of trusts and estates. Indeed, the principle we advocate here is the same one that

[29] See, *e.g.*, Satchit, *Estates, Trusts & Gifts: Trusts, Investment Advisory Fees and the 2% Floor*, Tax Adviser, Feb. 2004 at 87, 88; Hohos, *Fees Paid By Trustees For Investment Strategy Advice and Management Services are not Deductible Under Section 67(e)(1):* Mellon Bank, N.A. v. United States, 54 Tax Law. 693, 699 (2001). It has been the Commissioner's longstanding position that "trustee fees" are deductible, see, *e.g.*, Opp. at 11, even though these are fees that are paid by the trust to the trustee himself or herself primarily for managing the trust assets. The Commissioner's new proposed regulation does not directly address trustee fees. See *infra* n.32.

animates the Commissioner's treatment of all such expenses except for those at issue here, expenses for trust and estate investment advice.

Thus, the Commissioner's position consistently has been that fees for income tax preparation incurred by trustees are fully deductible, even though income tax preparation fees are routinely incurred by individuals and are subject to the two-percent floor. See Opp. 11; Levin, *Limitation on Deductions for Trusts: What Should a Trustee Do?*, 111 Tax Notes 445, 453 (Apr. 24, 2006) ("Income tax return preparation fees . . . are not unique to trusts or estates."). This position is reiterated in the Commissioner's proposed regulation. See Pet. Br. App. 14a. Similarly, the Commissioner has long taken the position that legal fees and accounting fees incurred by trusts are fully deductible, even though the same types of fees are commonly incurred by individuals, for whom they are subject to the two-percent floor. See id. Indeed, there is a line on the Form 1041 for the full deduction of "attorney, accountant and return preparer fees" under § 67(e). See J.A. 12 (line 14).

The Commissioner's attempts to distinguish these expenses and to explain the meandering line he has drawn in practice rest upon the inappropriately broad level of generality in his description of trust investment advisory fees. He has thus called the fees at issue in this case "fees for investment advice," Opp. at 10; see also Gov't CA2 Br. 11 (describing this as a cost "of a type that would customarily be incurred outside the context of trusts").[30] Costs that he has historically allowed in full, however, he describes more narrowly. In his proposed regulation, he thus, for example, describes trust legal fees as fees for services rendered in connection with "judicial . . . filings *required as part of the administration of the trust or estate*." Pet. Br. App. 14a (em-

[30] As described above, the Commissioner's latest proposal is that only fees for "advice on investing for total return," are subject to the two-percent floor. Pet. Br. App. 14a.

phasis added), and trust income tax preparation fees as fees for services rendered in connection with "*fiduciary* income tax" returns. Id. (emphasis added).[31] That more particular approach is what the statute, in asking about specific costs, properly requires. The correct way to describe the fees at issue here is "investment advice fees required as part of the administration of the trust or estate," or "trust investment advice fees."

A rule of law must be applied in a principled manner, or it is no rule of law at all. *Cf.* Scalia, *The Rule of Law as a Law of Rules*, 56 U. Chi. L. Rev. 1175 (1989). And this Court has made clear that, where tax law is concerned, substance is what matters, not labels. See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). The costs the Commissioner allows are, indeed, fully deductible – and as his treatment of them suggests, trust investment advice fees are as well. The only principled explanation for construing § 67(e) to permit the Commissioner's preferred deductions-in-full is that those particular expenses are caused by the fact that the property is held in the trust or estate. They purchase services for the trust or estate that differ in character from

[31] The Commissioner has also suggested that preparation of a fiduciary income tax return is an "additional" cost created by the trust because an individual would have to prepare an individual income tax return whether or not he or she held the property that is now held in the trust. Opp. at 11. Contrary to the Commissioner's suggestion, an individual is not required to file an income tax return simply because he or she exists. Individuals, like trusts, are required to file income tax returns – and therefore may incur fees for their preparation – only when they have income above a certain amount. See 26 U.S.C. § 6012(a)(3)-(4) (in general only trusts with gross income above a certain amount or with some "taxable income" need file fiduciary income tax returns); id. § 6012(a)(1) (only individuals with income above a certain amount need file income tax returns). If the trust, with no other assets or income, were to turn the trust property over to a similarly situated individual, that individual would be required to file an individual income tax return – and thus perhaps to incur a fee for the preparation of such a return – only because of his or her ownership of that income-producing property.

similar services purchased by individuals. Those particular costs, therefore would not have been incurred if the property had not been held in the trust in question, though similar costs may, and often are, incurred by individuals. The same principle applies to Petitioner's costs in issue here.[32]

V. THE OTHER PROPOSED READINGS ARE NOT TEXTUALLY PLAUSIBLE.

The statutory language will not support any of the other proposed readings of § 67(e).

A. The Commissioner's New Proposed Interpretation is Textually Unsupportable.

The Commissioner has now abandoned his longstanding position that only expenses commonly or customarily incurred outside trusts may be deducted in full. While this presumably reflects his recognition that the position he has taken in the past and throughout this litigation was wrong, the position he has now adopted and that was taken by the court below is similarly incompatible with the statute's text.

Section 67(e) provides that the trust's administrative expenses are fully deductible so long as they "*would not* have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e) (emphasis added). The Commis-

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[32] The Commissioner has argued that "trustee fees" are deductible, even though they primarily purchase investment management services. See, Opp. at 11. The reason a trust's payment of such fees should, indeed, be fully deductible is that the cost is incurred because a trustee's services are needed to fulfill the fiduciary duties imposed by the trust. A trust purchases a service that individuals do not need: management of the trust in accord with state law and the terms of the trust. The "delegat[ion of] investment and management functions" by the fiduciary, here the Trustees, to an agent, here Warfield, cloaks the agent with the fiduciary's obligations as a matter of law. See Conn. Gen. Stat. § 45a-541i. Perhaps because it is impossible to defend allowing a full deduction for trustee fees while disallowing a full deduction for trust investment fees like those at issue here, the Commissioner's proposed regulation, which categorizes many examples of different costs, does not specifically mention trustee fees at all. See Pet. Br. App. 14a-15a.

sioner's new proposed reading is that a cost is deductible only "if an individual *could not* have incurred that cost in connection with property not held in an estate or trust." Pet. Br. App. 14a (emphasis added); see also Pet. App. 13a (Second Circuit concluding "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.").

This is just wrong. "Would" simply does not mean "could." And a conclusion that a cost "would not" have been incurred in a particular circumstance does not mean that it "could not" have been. This interpretation had its genesis in the Second Circuit, which cut it from whole cloth. This is not a reading the Commissioner urged in that court – presumably because it flatly contradicts the text of the statute.

Further, this new proposed construction would render a portion of § 67(e) superfluous. The clause in question reads "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. 26 U.S.C. § 67(e) (emphasis added). The language italicized in the quotation above, however, would be superfluous under the reading now proposed by the Commissioner.

Costs that "an individual *could not* have incurred . . . in connection with property not held in an estate or trust" within the definition put forward by the Commissioner include only costs "paid or incurred in connection with the administration of the estate or trust," as required by § 67(e)'s first prong. Thus, if the second prong meant what the Commissioner claims, the statute need not have included the first prong at all. In construing statutes, a court of course must "give effect, if possible, to every clause and word of a statute." *Duncan v. Walker,* 533 U.S. 167, 174 (2001) (internal quotation marks and citations omitted). "It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (internal quotation marks and citation omitted).

Finally, the new test proposed by the Commissioner would be utterly, even absurdly, unworkable. One can see this in the line the proposed regulation draws requiring "unbundling" of costs for "advice on investing for total return." Pet. Br. 14a. If a single trust investment advice fee included some portion attributable to such advice and some portion attributable to advice on investing for some other objective, under the Commissioner's reading only the former portion would be subject to the two-percent floor. The rest would presumably be deductible in full. The task of documenting which expenses lie where, or of identifying the portion of fees that are on one side of the line under the newly proposed test and the portion that are on the other, or of auditing those questions, would each be almost insurmountable. Section 67 was enacted to eliminate precisely such burdens, not to create new and even more dramatic ones.

B. The Statute Does Not Ask Whether Costs are of a Type That Are "Customarily" Incurred Outside Trusts and Estates.

The statute also cannot bear the meaning given it by the Fourth and Federal Circuits, that costs of a type customarily or commonly incurred outside of trusts are subject to the two-percent floor. Indeed, the Commissioner essentially has conceded as much in abandoning this, his longstanding interpretation of the statute, in his proposed regulation. Compare Pet. Br. App. 14a with Govt. CA2 Br. 3-4, 22-24; Govt. *Scott* Br. 27, and Govt. *Mellon* Br. 27.

The statute does not ask whether a cost incurred in connection with the administration of a trust is of a type "customarily" or "commonly" incurred outside of trusts. It asks whether the cost would or "would not have been incurred if the property were not held in such trust or estate." 26 U.S.C.

§ 67(e). The statute's plain language, again, will not bear the suggested reading.

The Courts of Appeals that adopted that test did so only because they mistakenly thought any other test would render the second prong of § 67(e) superfluous. See *Mellon Bank*, 265 F.3d at 1280-81 ("under Mellon's construction, the second prerequisite of section 67(e)(1) would be rendered superfluous"); *Scott*, 328 F.3d at 140 ("to give effect to [the second clause of §67(e)] we must hold that the investment advice fees incurred by the trust do not qualify for the exception. . .").

These courts, however, were wrong about this feared superfluity. As described above costs incurred in connection with the administration of the trust or estate that are attendant upon ownership of property and that would be incurred by any owner are subject to the two-percent floor. This includes costs like the costs of maintaining real property that happens to be owned by the trust or estate. It also includes administrative costs that have been passed through to the trust from so-called "pass-through entities" in which the trust has an ownership interest.

In the absence of a superfluity problem, there is literally nothing in the language of the statute to commend, or in fact permit, the Fourth and Federal Circuit's reading. And indeed, this proposed interpretation seems to derive solely from a mistaken use of one of the dictionary definitions of the word "would." The Commissioner began arguing long ago that "if a trust-related administrative expense is also customarily or habitually incurred outside of trusts, then it is subject to the two-percent floor." Govt. *Mellon* Br. 27; see Govt. CA2 Br. 22. That assertion has been based solely on the premise that "the verb 'would' . . . . expresses such concepts as custom, habit, natural disposition or probability." Gov't *Mellon* Br. at 27 (citing two dictionaries); Govt. CA2 Br. at 22 (same).

But that is obviously not the sense in which the word "would" is used here. See, *e.g.*, Merriam-Webster Collegiate Dictionary 1445 (11th ed. 2003) (giving as an example of the use of the word "would" to "express custom or habitual action" the phrase "we would meet often for lunch"); Webster's New International Dictionary of the English Language 2955 (2d ed. 1958) (describing the use of "would" to describe custom or habit as a "special use"); see also *Commissioner v. Soliman*, 506 U.S. 168, 174 (2004) (citation omitted) (stating that "[i]n interpreting the meaning of the words in a revenue Act, we look to the '"ordinary, everyday senses"' of the words," and relying upon a dictionary definition to confirm the statute's meaning). The statute is not asking about what happened in the past customarily or habitually. It is asking concretely with respect to the particular trust or estate whether the cost at issue is one "which would not have been incurred if the property were not held in such trust or estate."

Finally, the test previously urged by the Commissioner and adopted by the Fourth and Federal Circuits would also be unmanageable, and Congress cannot have intended that. If determining whether a cost "would not have been incurred if the property were not held in such trust or estate" requires examining what individuals "commonly" or "customarily" do in like circumstances, the statute could require a trial in virtually every case to determine what individuals customarily do in various particular factual situations. Nor is it at all clear upon what evidence a court could rely in answering the question what costs individuals "customarily" incur in the myriad variable fact patterns that will be presented by different trusts. It is perhaps for this reason that the Commissioner has now abandoned this construction of the statute.[33]

[33] Because the Commissioner's proposed regulation is just that, a proposed regulation, it would of course even in the face of statutory ambiguity not be entitled to deference of any kind. Notice and comment on tax regulations typically stretches into a several-year process. See, *e.g.*, 26 CFR 1.643(b)-1 (notice of proposed rulemaking issued February 15, 2001, final regulation published January 2, 2004). Sometimes it can take

VI. EVEN UNDER THE OTHER PROPOSED READINGS OF THE STATUTE, THE TRUST INVESTMENT FEES HERE WOULD BE FULLY DEDUCTIBLE.

Finally, even if this Court were to adopt the Fourth and Federal Circuit's reading of the statute, or that adopted by the Second Circuit and contained in the Commissioner's proposed regulation, the judgment below would have to be reversed because the fees at issue here would nonetheless be fully deductible.

First, it is not "common" or "customary" for individuals to place their assets under management and to incur percentage-of-assets annual investment advice fees similar to the ones imposed upon the Rudkin Trust here.[34] Indeed, the Commissioner has never produced any evidence suggesting that it is. To the extent individuals have liquid assets and the discipline or propensity to invest (even beyond the most

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as long as fifteen years. See, *e.g.*, 26 CFR 1.401(a)(9)-1 (notice of proposed rulemaking issued July 27, 1987, final and temporary regulations published April 17, 2002). Adoption of the proposed regulation will likely face enormous opposition from the most important relevant elements of the bar, the financial services industry, and the public. See, *e.g.*, Reply Brief on Petition for Certiorari App. 10a (recommendation of the American Bar Association Section on Real Property, Probate and Trust Law); Brief *Amicus Curiae* of the Tax Section of the Florida Bar; Brief *Amicus Curiae* of American Bankers Association, *et al*.

Final regulations issued under the authority of 26 U.S.C. § 7805 that are reasonable are entitled not to *Chevron*, but to the weaker *National Muffler* standard of deference. *Boeing Co. v. United States*, 537 U.S. 437, 448 (2003) (citations omitted); see Salem, *et al.*, *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 Tax Law. 717, 761-763 (2004) (Court adheres to *National Muffler* rather than *Chevron* in cases involving interpretive tax regulations). An agency construction like the one contained in the proposed regulation that is contrary to the text of the statute by definition would not be a "reasonable" one. Whatever ambiguity § 67 might be said to have, it is clear the word "would" in § 67(e) does not mean "could."

[34] Petitioner argued below that management fees were not commonly or customarily incurred by individuals, an argument the court of appeals did not reach because of its adoption of the incorrect standard. Pet. 27.

common investment, real estate), they appear most frequently to invest in mutual funds; others invest in certificates of deposit; some also invest in individual stocks, ordinarily with the assistance of a broker. The costs associated with these transactions are not subject to the two-percent floor. See *supra* at 40. Exceedingly few individuals put their assets under management. Incurring fees for investment advice from a money manager is unusual; it certainly is not "common," nor, *a fortiori*, is it "customary."

Nor would these fees be subject to the two-percent floor under the test articulated by the Commissioner in his proposed regulation and described by the Second Circuit. Trust investment advice fees like those incurred here, compelled by the need for investment of funds consistent with fiduciary obligations, are peculiar to trusts and estates. It is not only the case that they would not have been incurred had the property here not been held in the Rudkin trust. Such fees cannot be incurred by an individual. See *supra* at 5-10. And indeed, in limiting the description in his proposed regulation of investment advice fees subject to the two-percent floor to those for "advice on investing for total return," the Commissioner concedes that under his own proposal only fees for investment advice that is the same as that geared to individual investors is subject to that floor. Since the fees in this case were not for advice so geared, they would be fully deductible even under the principle he has articulated.[35]

CONCLUSION

The judgment of the Second Circuit should be reversed.

[35] Were this Court to adopt one of these standards, therefore, at the very least a remand would be required to permit its proper application by the court of appeals.

Respectfully submitted,

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