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

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether investment-advice fees incurred by a trust are not costs "which would not have been incurred if the property were not held in such trust," within the meaning of 26 U.S.C. 67(e)(1), and consequently are deductible from gross income under 26 U.S.C. 67(a) only to the extent that they exceed 2% of the trust's adjusted gross income.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 467 F.3d 149. The opinion of the Tax Court (Pet. App. 20a-30a) is reported at 124 T.C. 304.

JURISDICTION

The judgment of the court of appeals was entered on October 18, 2006. A petition for rehearing was denied on January 19, 2007 (Pet. App. 31a-32a). The petition for a writ of certiorari was filed on March 23, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In computing the amount of income subject to tax, both individuals and trusts are entitled to subtract cer-

tain "itemized" deductions from their adjusted gross income. See 26 U.S.C. 63 (2000 & Supp. IV 2004). In the case of individuals, 26 U.S.C. 67(a) defines a subset of itemized deductions called "miscellaneous itemized deductions," which are deductible "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." That limitation is often referred to as the "2% floor." Fees paid for investment advice are deductible, see 26 U.S.C. 212; 26 C.F.R. 1.212-1(g), but are miscellaneous itemized deductions subject to the 2% floor, see 26 C.F.R. 1.67-1T(a)(1)(ii).

The 2% floor also applies to trusts, with limited exceptions. Under 26 U.S.C. 67(e)(1), "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" without regard to the 2% floor.

2. Petitioner is a multi-generational trust that was established in 1967 under the will of Henry A. Rudkin and was funded with proceeds from the sale of the Pepperidge Farm baked-goods company to the Campbell Soup Company. Pet. App. 21a. The beneficiaries are Henry's son, William, and William's descendants. *Id.* at 21a, 35a-36a. The will gave petitioner's fiduciaries broad powers to invest petitioner's assets, and it authorized them to seek outside advice in making those investments. *Id.* at 21a-22a, 38a, 41a.

At the beginning of 2000, petitioner had approximately $2.9 million in assets. Pet. 6. That year, it paid Warfield Associates, Inc., $22,241 for investment-management advice. Pet. App. 22a. On its fiduciary income tax return for 2000, petitioner deducted, in full, the fees that it had paid to Warfield for investment advice. *Ibid.*

After an audit, the Commissioner allowed petitioner to deduct the investment-advice fees only to the extent that they exceeded 2% of petitioner's adjusted gross income, resulting in a tax deficiency of $4448. *Ibid.*

Petitioner sought review of the asserted deficiency in the Tax Court. It relied on *O'Neill* v. *Commissioner*, 994 F.2d 302 (1993), rev'g 98 T.C. 227 (1992), in which the Sixth Circuit held that investment-management fees paid by a trustee are covered by the exception in Section 67(e)(1). The *O'Neill* court reasoned that because a trustee has a fiduciary duty under state law to manage assets prudently, fees for investment advice are necessary to the trust's administration. Although individual investors can incur similar costs, "they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* at 304.

In response, the Commissioner cited *Mellon Bank, N.A.* v. *United States*, 265 F.3d 1275 (2001), in which the Federal Circuit rejected *O'Neill* and held that expenses are fully deductible only if they are "unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1281. Since investment advice and management fees "are commonly incurred outside of trusts," they are not covered by Section 67(e)(1), and they are subject to the 2% floor. *Ibid.* The Fourth Circuit has reached the same conclusion as the Federal Circuit. See *Scott* v. *United States*, 328 F.3d 132, 140 (2003) ("Because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the 2% floor created by [Section] 67(a).").

3. The Tax Court upheld the deficiency. Pet. App. 20a-30a. It concluded that the construction of Section 67(e) that it had set forth in *O'Neill*, 98 T.C. at 230-231,

"remain[ed] sound." Pet. App. 29a. The court rejected the Sixth Circuit's approach and instead agreed with the position of the Commissioner, consistent with its own precedent and with the precedents of the Federal Circuit in *Mellon Bank* and the Fourth Circuit in *Scott*, that Section 67(e)(1) allows full deductibility only for expenses that are not commonly incurred outside of the trust setting. Pet. App. 26a-29a. Because investment-advice fees are commonly incurred by individuals in managing their own investments, the Tax Court held that they are subject to the 2% floor. *Id.* at 27a, 30a.

4. The court of appeals affirmed. Pet. App. 1a-19a. The court rejected the Sixth Circuit's position, and reached the same result as the Fourth and Federal Circuits through a slightly different reading of the statute. Consistent with the reasoning of the Fourth and Federal Circuits, the court of appeals explained that "the statutory language directs the inquiry toward the counterfactual condition of assets held individually instead of in trust," but it "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." *Id.* at 11a. Instead, "the statute sets an objective limit on the availability of a full deduction." *Id.* at 12a. "[A]s the source of that limit," however, the court stated that Section 67(e)(1) "looks to those costs that individual property owners are capable of incurring." *Ibid.* Since investment-advice fees are costs that individuals can incur, they are subject to the 2% floor even when incurred by a trust. The court explained that this analysis differed from that of the Fourth and Federal Circuits because it did not require an inquiry into whether a given cost is "customarily" or "commonly"

incurred by individuals, but only into whether it could have been incurred by an individual. *Ibid.*

ARGUMENT

Petitioner observes (Pet. 14-19) that there is a conflict among the circuits concerning the applicability of 26 U.S.C. 67(e)(1) to investment-advice fees paid by a trust. That conflict, however, does not require resolution by this Court because it is likely to be resolved by new regulations interpreting Section 67(e)(1). The judgment of the court of appeals is correct and does not warrant further review.

1. a. The Internal Revenue Service (IRS) presently intends to issue a regulation resolving the question whether investment-advice fees incurred by a trust or estate are subject to the 2% floor of Section 67(a). As part of its *2006-2007 Priority Guidance Plan* (PGP), the IRS listed the issuance of "[g]uidance under section 67 regarding miscellaneous itemized deductions of a trust or estate" as a goal for the 2006-2007 time period. Office of Tax Policy & Internal Revenue Serv., Department of the Treasury, *2006-2007 Priority Guidance Plan* 15 (last modified Mar. 12, 2007) <http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf>. The PGP is a public announcement that identifies the published guidance that the Department of the Treasury and the IRS intend to issue each year to address significant issues in federal tax law. The 2006-2007 PGP, issued on August 15, 2006, "establish[ed] the guidance that the Treasury Department and the Service intend to issue from July 1, 2006, through June 30, 2007." I.R.S. Notice 2006-36, 2006-15 I.R.B. 756. The PGP's inclusion of guidance resolving the existing uncertainty over the interpretation of Section 67 demonstrates that the IRS and Treasury recognize the importance of the issue to taxpayers and tax

administration and intend to commit resources to resolving it.

In accordance with the PGP, the process of preparing a notice of proposed rulemaking addressing the question at issue in this case is currently underway. The Treasury Department and the IRS are reviewing a draft of the notice of proposed rulemaking and plan to complete a staff-level review this month. By early June, the IRS intends to submit a final draft of the notice of proposed rulemaking for formal clearance through IRS Counsel, the IRS Commissioner's office, and Treasury. Treasury and the IRS anticipate that, barring substantive or policy-level objections, the notice of proposed rulemaking should clear agency review and be ready for publication in the Federal Register by July 2007.

b. A regulation interpreting Section 67(e)(1) would resolve the conflict among the courts of appeals without the need for this Court's intervention. As we explain below, the decision of the court of appeals in this case represents a valid interpretation of the statute. Nevertheless, the opinions of the other courts that have considered the issue demonstrate that the statute is susceptible to different interpretations. Under *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837 (1984), a court would be required to defer to the agency's reasonable interpretation.

In particular, if the IRS were to issue a regulation adopting the interpretation of Section 67(e)(1) embraced by the court of appeals below, that regulation would be controlling even in the Sixth Circuit. As this Court has held, a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 982 (2005). Although the Sixth Circuit in *O'Neill* read Section 67(e)(1) to allow trusts to deduct investment-advice fees without regard to the 2% floor, it nowhere suggested that its reading was compelled by the unambiguous language of the statute. See 994 F.2d at 304. The *O'Neill* decision therefore would not be an obstacle to reconsideration of the issue in light of the agency's contrary views expressed in a regulation issued in the exercise of authority delegated to the agency by Congress.

To be sure, the Fourth and Federal Circuits have adopted a slightly different interpretation from that of the court of appeals below, and both of those courts suggested that the statutory language was unambiguous. See *Scott*, 328 F.3d at 139; *Mellon Bank*, 265 F.3d at 1280. Thus, it is theoretically conceivable that a regulation adopting the view of the court of appeals below might not be accepted by the Fourth and Federal Circuits. But that hypothetical possibility is not a reason to grant review in this case.

As an initial matter, although both the Fourth and Federal Circuits described Section 67(e)(1) as unambiguous, it is not clear that they intended that description to apply to the precise issue on which the court of appeals in this case departed from their analysis. See *Mellon Bank*, 265 F.3d at 1280 ("[S]ection 67(e)(1) unambiguously establishes two requirements for expenditures to qualify for exclusion from the two percent floor."); see also *Scott*, 328 F.3d at 139. In any event, to the extent that there is an abstract difference in the approaches taken by the Fourth and Federal Circuits on the one hand, and the court below on the other, that difference has little or no practical significance. The Fourth and Federal Circuits have held that Section 67(e)(1)'s exception to the 2% floor applies only to expenses "not customarily incurred outside of trusts," *Mellon Bank*, 265 F.3d at 1281; see *Scott*, 328 F.3d at 129, whereas the court of appeals below held that the exception covers only expenses that "could not have been incurred if the property were held by an individual," Pet. App. 12. But all three courts have held categorically that the exception does not include investment-advice fees incurred by a trust, the only context in which the circuit conflict has arisen. See *Scott*, 328 F.3d at 140 ("[I]nvestment-advice fees * * * are subject to the 2% floor."); *Mellon Bank*, 265 F.3d at 1281 ("Investment advice and management fees * * * are *not* exempt under section 67(e)(1)."). Pet. App. 12a ("We thus join the Federal and Fourth Circuits in holding that [Section] 67(e)(1) does not exempt from [Section] 67(a)'s two-percent floor investment-advice fees incurred by trusts."). There is no basis for speculating that there may be some other type of expenses to which these courts might afford different treatment. If such a concrete conflict were to arise, the Court could address it in a future case. At this time, however, there is no need for this Court to address a hypothetical future conflict concerning the validity of a regulation that has not yet been issued.

2. Petitioner asserts (Pet. 23) that "the construction given the statute below is clearly in error." That is incorrect. In fact, the court of appeals reasonably interpreted the statutory language, giving effect to every part of Section 67(e)(1). The initial text of Section 67(e) establishes the general rule that the adjusted gross income of a trust is to be computed in the same manner as

the adjusted gross income of an individual. Under that rule, the miscellaneous itemized deductions of a trust are subject to the 2% floor of 26 U.S.C. 67(a). Section 67(e)(1) then provides an exception to the general rule, allowing the deduction, without regard to the 2% floor, of costs (i) "which are paid or incurred in connection with the administration of" a trust, and (ii) "which would not have been incurred if the property were not held in such trust."

The first clause requires that the costs be "paid or incurred in connection with the administration of the * * * trust." 26 U.S.C. 67(e)(1). That clause employs the indicative mood, and it asks the simple, objective question whether a cost is related to, associated with, or otherwise linked to the administration of a trust. See *Mellon Bank*, 265 F.3d at 1280. The first clause thus separates trust-related administrative expenses from other trust expenses and from similar expenses incurred by individuals. There is no dispute that fees paid for advice in investing trust assets satisfy the first clause. See Pet. App. 6a.

The second clause states that the costs must be costs "which would not have been incurred if the property were not held in such trust." 26 U.S.C. 67(e)(1). In keeping with the canon that statutes should, whenever possible, be interpreted to give effect to all their terms, the second clause is best read as doing something more than merely separating trust-related administrative costs from other trust-related expenses (and from administrative expenses incurred by individuals). See *Duncan* v. *Walker*, 533 U.S. 167, 174 (2001). Instead, it is a "filter" for determining which trust-related administrative costs are exempt from the 2% floor. *Mellon Bank*, 265 F.3d at 1280-1281; see Pet. App. 11a-12a;

Scott, 328 F.3d at 140. The second clause, moreover, is in the subjunctive mood, suggesting that, as the court of appeals observed, it "focuses the inquiry * * * on the hypothetical situation where the assets are in the hands of an individual." Pet. App. 11a; *Scott*, 328 F.3d at 140 (the second clause "asks whether costs are commonly incurred *outside* the administration of trusts").

The courts of appeals that have upheld the application of the 2% floor for investment-advice fees incurred by trusts have construed the verb "would" in the second clause somewhat differently, but, as discussed above, the differences in their approach do not affect the proper categorization of investment-advice fees incurred by trusts. The Fourth and Federal Circuits treat the verb "would" as expressing such concepts as custom, habit, natural disposition, or probability. Under that construction, the second clause makes fully deductible only those trust-related administrative expenses that are not natural, customary, or probable outside of the context of trusts. *Scott*, 328 F.3d at 139-140; *Mellon Bank*, 265 F.3d at 1281. The court below, on the other hand, took a "more restrictive" approach to the meaning of the second clause, limiting full deductibility to costs that individuals are incapable of incurring. Pet. App. 12a. As the court of appeals saw it, a full deduction is permitted "only for those costs that could not have been incurred by an individual property owner." *Id.* at 13a.

Despite their slightly different approaches to the second clause of Section 67(e)(1), the Second, Fourth, and Federal Circuits are in agreement regarding the proper tax treatment of common trust expenses such as fees for investment advice. Because individuals can—and commonly do—pay for professional investment advice, investment-advice fees are subject to the 2% floor when paid by a trust. Pet. App. 12a, 19a; *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281. On the other hand, trustee fees and the costs associated with judicial accountings and the preparation of fiduciary income tax returns are expenses peculiar to trust administration and would escape the floor. Pet. App. 12a; *Scott*, 328 F.3d at 140.

Despite petitioner's assertion to the contrary (Pet. 28), there is no lack of "consisten[cy]" in this regard. Fully deductible costs are those that are either unique to the fiduciary context (such as trustee fees) or that constitute additional sums that would not have been incurred had there not been a fiduciary arrangement (such as the extra cost of preparing a fiduciary income tax return in addition to the cost of preparing individual income tax returns). Unlike the cost of financial advice, which can be—and often is—incurred by individuals, those fiduciary costs are fully deductible because they would not have been incurred if the property were not held in trust.

3. Petitioner relies on legislative history (Pet. 3, 9) in support of its assertion that Congress enacted 26 U.S.C. 67(e) to give preferential tax treatment to trusts. Petitioner is mistaken. In enacting the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, Congress sought to increase the fairness, simplicity, and economic efficiency of the tax system, largely by closing loopholes and reducing marginal rates in order to make economically inefficient tax-avoidance schemes less attractive. H.R. Rep. No. 426, 99th Cong., 1st Sess. 54-61 (1985); see S. Rep. No. 313, 99th Cong., 2d Sess. 3-8 (1986). Those goals are reflected in the 2% floor of 26 U.S.C. 67(a) and in amendments to other Code sections governing the taxation of trusts. Section 67(a), Congress be-

lieved, would relieve taxpayers of the burden of record-keeping unless they anticipated miscellaneous expenditures in excess of the floor. H.R. Rep. No. 426, *supra*, at 109-110; S. Rep. No. 313, *supra*, at 78-79. Congress also 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. See *Scott*, 328 F.3d at 138-140; *Mellon Bank*, 265 F.3d at 1281; see also *Mellon Bank, N.A.* v. *United States*, 47 Fed. Cl. 186, 193-194 (2000). Thus, subjecting investment-advice fees to the 2% floor is consistent with the intent of Congress underlying the 1986 reforms.

Petitioner contends (Pet. 24-25) that Congress's sole focus in enacting the second clause of 26 U.S.C. 67(e)(1) was to prevent trusts from fully deducting expenses passed down to them from pass-through entities, such as partnerships and nonpublic mutual funds. As the court of appeals explained, however, a study of the bills and committee activity leading to the current version of 26 U.S.C. 67(e) does not support petitioner's interpretation of the statute. See Pet. App. 14a-18a. Although Congress was concerned about taxpayers using pass-through entities to avoid the 2% floor, it could have drafted the second clause of Section 67(e) much more narrowly had that been its only concern. For example, as the court of appeals hypothesized, Congress could have limited full deductibility to those administrative costs "which are not pass-through costs restricted under section 67(c)." Pet. App. 18a. Instead, Congress chose the broader clause "which would not have been incurred if the property were not held in such trust or estate." That language subjects the cost of investment advice incurred by trusts and estates to the 2% floor—just as if that cost had been incurred by an individual.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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