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Rudkin Testamentary Trust — A Response to Prof. Cohen

By Douglas A. Kahn

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In the August 3 issue of *Tax Notes*,¹ Prof. Stephen Cohen wrote an article about Justice Sonia Sotomayor's opinions in three tax cases. Of those three cases, only the opinion she wrote in *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (2d Cir. 2006), Doc 2006-21522, 2006 TNT 203-4, is worthy of comment. Although the Second Circuit's decision in that case was affirmed by the Supreme Court under the name *Knight v. Commissioner*,² the construction of the critical statutory language that Justice Sotomayor adopted was rejected and criticized by Chief Justice Roberts, writing for a unanimous court. Cohen concluded that Justice Sotomayor's construction of the statutory language is "at least as valid as, and probably preferable to, the construction adopted by the Supreme Court" and that Chief Justice Roberts's criticism of Justice Sotomayor's rationale is "logically flawed." Cohen also said that Chief Justice Roberts's criticism of Justice Sotomayor's opinion is "unpersuasive and overstated." In my view, the construction adopted by Justice Sotomayor was incorrect, and Chief Justice Roberts's criticism was persuasive and accurately stated. Moreover, based on policy considerations, a plausible case can be made that the courts could have construed the statute differently, resulting in a decision for the taxpayer.

Rudkin involved a trust with a large amount of capital. The trustees employed an investment-management firm to provide advice to the trustees.³ The issue in the case was whether the fees paid to the investment-management firm were fully deductible by the trust or whether their deduction was subject to the limitation imposed by section 67(a), which denies a deduction for some expenses. Those expenses, called miscellaneous itemized deductions, are deductible only to the extent that they total more than 2 percent of the taxpayer's adjusted gross income. The question presented in *Rudkin* was whether the trust's investment-management fees were subject to that restriction.

An individual's AGI is equal to his gross income minus his deductions, not including itemized deductions, standard deductions, and personal exemptions. It is clear that expenses for investment advice are a miscellaneous itemized deduction. Consequently, if the investment counseling expenses had been incurred by an

individual, they would have been subject to the 2 percent of AGI limitation. As we shall see, the issue becomes more complex when the expense is incurred by a trust.

The government contended that the investment fees paid by the trust were subject to the 2 percent of AGI limitation. Section 67(a) states that it applies "in the case of an individual"; a trust is not an individual. While section 67(c) would apply to some expenses of a trust, that provision was not relevant to the case. The application of section 67(a) turned on the construction of section 67(e). Section 67(e) does not expressly make section 67(a) applicable to trusts, but the only reasonable inference from that subsection is that the 2 percent of AGI limitation sometimes applies to trusts. Unless there is a special provision in the code, a trust or estate does not have AGI — that is, ordinarily, that concept does not apply to a trust or estate. Section 67(e) provides how the AGI of an estate or trust should be computed for purposes of section 67. The only possible reason for providing for a determination of AGI of a trust for purposes of that section (the section of the code dealing with the limitation on miscellaneous itemized deductions) is to apply the 2 percent of AGI limitation to trusts. Accordingly, section 67(e) has been construed as applying the miscellaneous itemized deduction limitation to trusts.⁴

Section 67(e) states that for purposes of that section, the AGI of a trust shall be computed in the same manner as that of an individual, with two exceptions. The construction of one of those exceptions, section 67(e)(1), was the central issue in *Rudkin*. Section 67(e)(1) excludes from the miscellaneous itemized deduction category (and thus from the 2 percent of AGI limitation):

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. [Emphasis added.]

The results in *Rudkin* were based on the construction of the italicized portion of that quotation. Clearly, the investment advisory expenses were incurred in connection with the administration of the trust. Therefore, they would not be subject to the 2 percent of AGI limitation unless they were held to fail to be expenses "which would not have been incurred if the property were not held in such trust or estate." The application of that provision had been resolved by three circuits before the issue reached Justice Sotomayor. The Sixth Circuit held that those investment advisory expenses were not subject to the limitation and were fully deductible.⁵ However, the Fourth Circuit⁶ and the Federal Circuit⁷ held that the limitation does apply. In *Rudkin* the Tax Court held that

¹"Judge Sonia Sotomayor's Tax Opinions," *Tax Notes*, Aug. 3, 2009, p. 474, Doc 2009-15953, 2009 TNT 146-12.

²552 U.S. 181 (2008), Doc 2008-948, 2008 TNT 12-6.

³The trustees maintained that they were required by the Connecticut version of the Uniform Prudent Investor Act to employ an investment adviser.

⁴See, e.g., *Knight v. Commissioner*, 522 U.S. 181.

⁵*O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), Doc 93-6321, 93 TNT 118-14.

⁶*Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), Doc 2003-11125, 2003 TNT 86-1.

⁷*Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), Doc 2001-23461, 2001 TNT 176-10.

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the limitation does apply to the investment advisory expenses.⁸ The trust appealed to the Second Circuit.

Justice Sotomayor wrote the opinion for herself and Judge Hall.⁹ She rejected the Sixth Circuit's approach and held that the investment advisory expenses were subject to the limitation, affirming the Tax Court's decision. The Second Circuit agreed with the results reached by the Fourth and Federal circuits and by the Tax Court. However, in her opinion, Justice Sotomayor rejected the construction of the critical statutory language that had been adopted in the other two circuits and by the Tax Court. The question the courts disagreed on was how to determine whether the expense would not have been incurred if the property were not held in trust. The other courts had construed that language as satisfied only when the expense is one that is commonly or customarily incurred by individuals. Rejecting that view, the Second Circuit held that the full deduction applies only to expenses that could not have been incurred by an individual. So, according to the Second Circuit's view, if a trust's expense is one that an individual could incur, regardless of how unlikely and unusual it might be for an individual to incur that type of expense, the expense will be subject to the 2 percent of AGI limitation.

In a unanimous decision, the Supreme Court affirmed the Second Circuit and held for the government. However, in an opinion by Chief Justice Roberts, the Court repudiated Justice Sotomayor's construction of the statutory language and criticized that approach.¹⁰ Instead the Supreme Court adopted the approach of the other two circuits and held that the statute subjected trust expenses that were customarily or commonly incurred by individuals to the 2 percent of AGI limitation. The Court determined that fees for investment advice are commonly incurred by individuals, and so it affirmed the decision. Let us now consider the merits of Justice Sotomayor's and Chief Justice Roberts's opposing constructions.

Justice Sotomayor construed the pertinent statutory language by effectively substituting the word "could" for the word "would." The Second Circuit effectively rewrote the statute to read "and which *could* [would] not have been incurred if the property were not held in such trust or estate." As Chief Justice Roberts noted, the word "would" in the statute requires a prediction whether an expense would have been incurred by individuals who hold that property in their individual status. Because the property is held in trust, and is not held by an individual, the statute leaves open the question of what standard should be used to determine whether the expense is one that an individual holding the property would make. Justice Sotomayor held that no prediction of likely behavior was appropriate. Rather, the test should be one of

impossibility. Only when it is impossible for an individual to incur an expense, will it be found that the expense would not have been incurred outside of the trust.

It is possible, as the Second Circuit did, to read the statute as requiring 100 percent certainty that an expense would not be incurred. Under that construction, only when there is no possibility, however remote, that an expense would be incurred by an individual, will it escape the 2 percent of AGI limitation; but that is a cramped and strained construction of the actual language chosen by Congress. If that is what was intended by Congress, it seems far more likely that they would have used the word "could" instead of "would." While it is possible that Congress was simply careless in its choice of words, the statutory language should be given its more natural meaning unless it contravenes a policy underlying the statute. No such policy was suggested by the court, and none seems applicable.

The other courts, including the Supreme Court, adopted a standard of considering whether some expenses are common and ordinary for individuals to incur. So, if those expenses are rare, unusual, or extraordinary for individuals, the trust can deduct them in full. As Cohen and several other commentators have pointed out, that standard leaves open questions of application and is less predictable than a bright-line standard, such as impossibility. But certainty is only one consideration in adopting tax laws and is often outweighed by other factors. There are numerous examples of when a tidy, bright-line rule has been rejected in favor of a more nuanced but less mechanical and less predictable rule. In *Duberstein*, the Supreme Court rejected the government's proposal for a bright-line definition of gift in favor of the vaguer standard of "detached and disinterested generosity."¹¹ Another example is the standard employed in determining whether the cost of clothes that an employee wears at work can qualify as a deductible uniform. The three-part test adopted by the commissioner and by the courts for deductibility is: the clothing is required as a condition of employment; it is not adaptable to general use; and is not so worn. The second requirement of not adaptable for general use is determined by resorting to community standards rather than to the subjective standards of the individual employee.¹²

Cohen and Justice Sotomayor characterize the standard of customary behavior by individuals that was applied to section 67(e)(2) by the other courts, including the Supreme Court, as a subjective standard. A standard that looks to community practices is based on objective facts, even though they are not as easily determined as most bright-line standards. By way of comparison, the standard adopted by the Fifth Circuit in *Pevsner* (the deduction of clothing case) looked to community behavior, and the court characterized that as an objective standard. A standard does not become subjective merely because it cannot be applied mechanically.

⁸*Rudkin Testamentary Trust v. Commissioner*, 124 T.C. 304 (2d Cir. 2005), Doc 2005-13960, 2005 TNT 123-9.

⁹The third judge recused himself after oral argument was held.

¹⁰A contention of the trust that was rejected by both the Second Circuit and the Supreme Court had little merit and is omitted from this discussion.

¹¹*Commissioner v. Duberstein*, 63 U.S. 278 (1960).

¹²*Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980).

Admittedly, as written, the statute leaves room for construction, which is true of most statutes. Mechanically drawn bright lines have administrative convenience, but also have disadvantages that have to be weighed. Those disadvantages include lack of flexibility, inability to accommodate changing circumstances, and vulnerability to manipulation. The choice between adopting a bright-line or a nuanced standard is one that legislators often face. In some cases in the tax area, Congress has chosen to adopt a bright line, but more frequently, a nuanced approach is adopted. It is a trade-off of convenience for a more judicious application of rules.

Chief Justice Roberts noted that it was likely that Congress would have used the word “could” rather than “would” if it had intended to require impossibility as a standard. When Congress wants a bright-line standard, it knows how to draft the statute to do that. Cohen points out that Congress could have drafted section 67(e)(1) to more clearly accord with the Supreme Court’s construction if it had added the word “customarily” after the words “would not.” So, the statute would have read “would not customarily have been incurred.” That would have avoided any ambiguity. Or, if Congress intended the impossibility standard, it could have added the word “ever” after “would not” so that the language would read “would not ever have been incurred.” Cohen correctly notes that the failure of Congress to add either of those two words no more supports the Supreme Court’s construction than it does Justice Sotomayor’s. But, that is not the point that Chief Justice Roberts made. He did not raise the question of why a word was missing when its addition would have clarified the issue. Rather, he asked why Congress chose the word “would” when the word “could” would have been more precise if that was Congress’s intent, especially because “could” is far from being an obscure term.

A vast number of tax statutes would have been more precise if a word or phrase had been added. In construing those statutes, not much weight can be given to the omission of those words. However, Congress’s choice of one word instead of another highly accessible word that would have given a different meaning to the provision is very significant.

Cohen gives some weight to the fact that after Justice Sotomayor issued her opinion, Treasury promulgated a proposed regulation adopting her view; and the solicitor general argued her view in his brief in the Supreme Court. Cohen considers those adoptions to have “affirmed the validity, and perhaps the superiority, of Justice Sotomayor’s approach.” The significance of Treasury’s temporary adoption of Justice Sotomayor’s view is minimized by the fact that Treasury often takes into consideration, when choosing the position it takes on an issue, which position will increase the amount of revenue collected — that is, it takes the position that favors its interests. Justice Sotomayor’s construction would both increase revenue collection and serve administrative ease of enforcement, and so it is not surprising that Treasury would favor that position. Perhaps that was not the reason that Treasury promulgated its proposed regulation in this case, but that possibility reduces the significance of its adoption. As for the solicitor general’s brief, it is not unusual for an advocate to urge, on review in a

higher court, the position that the lower court took in deciding the case in favor of the advocate’s client. As to both Treasury’s and the solicitor general’s actions, Cohen’s view that the approval of a court’s holding by the winning party demonstrates the validity of that holding is extraordinary to the point of being bizarre.

Chief Justice Roberts makes a strong point in support of his construction of the statute that if the second clause of section 67(e)(1), which is the clause in question, were construed as Justice Sotomayor did, it would render the first clause of that provision meaningless. The first clause requires that the expense in question, to be fully deductible, be incurred in connection with the administration of the trust. If the second clause of that provision is construed to mean that only expenses that cannot be made by individuals are fully deductible, that would swallow the first requirement, rendering it superfluous. No expenses that would be deductible by the trust and that could not be incurred by individuals could fail to be connected with the administration of the trust. Cohen responds to that point by suggesting that the first clause serves to divorce section 67(e)(1) from the second exception in section 67(e)(2). Section 67(e)(2) provides a full deduction for the personal exemptions allowed to a trust or estate and to the deduction for distributions made to beneficiaries. Of course, neither of those deductions should be subject to the 2 percent of AGI limitation. Personal exemptions for individuals are not itemized deductions and so are not subject to the 2 percent of AGI limitation, and neither should be the personal exemptions of a trust or estate. The deduction for distributions to beneficiaries is merely carrying out the conduit element of trusts and estates and should not be limited in amount. However, the first clause of section 67(e)(1) is not needed to divorce that paragraph from the deductions mentioned in section 67(e)(2). If the first clause were eliminated, section 67(e)(1) would read “the deduction for costs which would not have been incurred if the property were not held in such trust or estate.” The costs mentioned in that provision cannot apply to the deductions listed in section 67(e)(2) because none of those deductions involve a cost. The items listed in paragraph (2) are personal exemptions and distributions to beneficiaries, which are not costs in any sense. It would seem that Chief Justice Roberts is correct in saying that the Second Circuit’s construction of the second clause makes the first clause superfluous.

Finally, let us consider a policy consideration that appears to bear on this issue. The statute clearly evidences a policy to allow a full deduction for fees paid to a trustee for performing its fiduciary services. The ultimate question in the instant case was whether the cost of investment advice to a trustee is fully deductible. The final decision about what investments are to be made with the trust’s assets is made by the trustee. If the trustee chooses not to employ an investment adviser, it will act on its own analysis of the market. Even if it obtains advice, the trustee makes the final decision on investment. So, part of the trustee’s fee is received for determining the management and investment of the trust’s funds. Yet, all of the trustee’s fees are fully deductible. Suppose that a trustee were to reduce its fee because it purchased the advice of an investor-management firm. It

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seems incongruous to deny a deduction for the investment counseling fee in that case when it is merely a substitute for a portion of the trustee's fee, which would have been fully deductible. Even if the trustee does not reduce its fee, should the deduction for the investment counseling fee be restricted when the firm is conducting a function that is an essential element of the trustee's fiduciary obligations? It would seem that investment analysis is such an integral part of a trustee's function that whether it is conducted by the trustee personally or by an outside agent, the cost of that function should be fully deductible.

While the language of the statute is not easily reconciled with a construction that would allow a full deduction for expenses incurred for activities that are elements of the basic function of a trustee, it would seem that tax policy is better served by that approach. There are numerous examples in the tax law of statutory constructions that serve tax policies but are contrary to the literal terms of the statute. For example, section 102(c) explicitly prevents exclusion from an employee's gross income of transfers the employee received from his employer. Notwithstanding the literal terms of that statutory provision, prop. reg. section 1.102-1(f)(2) exempts from that statutory provision extraordinary transfers by an employer to an employee who is a natural object of the employer's bounty if the transfer was not made in connection with the employment. While the statute provides no hint of such an exception, the proposed regulation creates one that provides flexibility to otherwise overly broad and strict statutory language.

While those considerations point to allowing a full deduction for the trust's investment fees, the Supreme Court's decision closes that door. Nevertheless, those considerations suggest that the inflexible and narrow approach taken by Justice Sotomayor is inappropriate as well as contrary to a natural reading of the statute. The Supreme Court's construction provides flexibility to allow courts to deal with situations that clearly fall outside of the areas at which the 2 percent of AGI limitation is aimed.