TRUSTS AND THE 2% FLOOR

McGUIREWOODS
Relationships That Drive Results

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Table of Contents

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I. INTRODUCTION

1. On January 16, 2008, the Supreme Court decided *Michael J. Knight, Trustee v. Commissioner*, 552 U.S. ___, 128 S. Ct. 782 (No. 06-1286, Jan. 16, 2008). In a unanimous opinion by Chief Justice Roberts, the Court affirmed the Second Circuit and held that for federal income tax purposes trust investment advisory fees are subject to the 2% floor of section 67(a).

2. While *Knight* was pending, the Internal Revenue Service had released proposed regulations under section 67(e), dealing comprehensively and harshly with the application of the 2% floor to trusts and estates. [This outline will generally address the issues in terms of trusts, but executors of decedents' estates face many of the same issues.]

3. These developments will have far-reaching significance for all fiduciaries and their advisors, accented by new and intimidating standards for tax return preparers under section 6694.

II. ENACTMENT OF THE "2% FLOOR"

A. Section 67

1. At the heart of the controversy is section 67 of the Internal Revenue Code, which allows a deduction for "miscellaneous itemized deductions" only to the extent they exceed 2 percent of adjusted gross income (hence, the "2% floor"), with an exception in section 67(e)(1) in the case of an estate or trust 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."

2. Section 67 was added to the Code by the section 132 of the Tax Reform Act of 1986 (Public Law No. 99-514), the sweeping legislation under the flags of "fairness, simplicity, and economic growth" that crowned the tax-cutting agenda of President Reagan's second term (reducing the top rate from 50% to 28%), all in the context of aggressive reductions of income tax rates accompanied by targeted "base broadening."

B. Background in Administration Recommendations

1. Treatment of Miscellaneous Itemized Deductions

a. "Tax Reform for Fairness, Simplicity, and Economic Growth" (popularly called "Treasury I") was published by Treasury on November 27, 1984, just weeks after President Reagan's landslide reelection. It included a proposal that would subject miscellaneous itemized deductions (along with unreimbursed employee expenses and state and local taxes other than income taxes) to a floor equal to 1% of adjusted gross income. At pages 115-116 of volume 2, Treasury justified this proposal as follows:

> <u>Reasons for Change</u>
>
> Allowance of the various employee business expense deductions and the miscellaneous itemized deductions complicates recordkeeping for many taxpayers. Moreover, the small amounts that are typically involved present significant administrative and enforcement problems for the Internal Revenue Service. These deductions are also a source of numerous taxpayer errors concerning what amounts and what items are properly deductible.
>
> ….
>
> <u>Analysis</u>
>
> Disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses.
>
> In 1982, one-half of all itemizers claimed miscellaneous deductions of less than one-half of one percent of their AGI. Fifty-eight percent claimed deductions of less than one percent of their AGI, and 93 percent claimed deductions of less than five percent of their AGI. Thus, introduction of a "floor" or "threshold" of one percent of AGI would substantially reduce the number of returns claiming this deduction. The proposed extension of the miscellaneous deduction to nonitemizers would partially offset the revenue gain from introduction of the floor.

> The proposal would broaden the tax base and, thus, contribute to the reduction in marginal tax rates. Any increase in tax liability resulting from this proposal should be more than offset by the reduced marginal rates and the increase in the zero bracket amount and the personal exemption.

b. "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (often called "Treasury II") was published by the White House on May 29, 1985, to communicate the President's recommendations to Congress. Treasury II included the proposed 1% floor on miscellaneous itemized deductions from Treasury I. On pages 104-105, Treasury II reproduced the same justification quoted above, except that the last paragraph (referring to broadening the tax base) was omitted.

2. Changes in the Income Taxation of Trusts

a. Under the heading of "Tax Abuses—Income Shifting," Treasury I and Treasury II also proposed the taxation of the unearned income of children under 14 at the marginal tax rate of their parents, outlined sweeping changes in the income taxation of trusts, and suggested the continuation of a decedent's taxable year without starting a new taxable year upon death.

b. The proposal for changing the income taxation of trusts would eliminate the separate rate schedule for trusts (based on the rate schedule applicable to married individuals filing separate returns). At page 105 of volume 2, Treasury I summarized the proposal as follows:

> Because all trust income would be taxed to the grantor, taxed to trust beneficiaries, taxed to the trust at the grantor's marginal rate (during the grantor's lifetime), or taxed to the trust at the highest individual rate (after the grantor's death), the proposal would eliminate the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

C. Action in the House of Representatives

1. The original House bill that became the Tax Reform Act of 1986 (H.R. 3838, introduced December 5, 1985, and reported by the Ways and Means Committee December 7, 1985) proposed a new section 67 of the Internal Revenue Code, subjecting "miscellaneous itemized deductions" to a floor equal to 1% of adjusted gross income.

2. In explaining this proposal, the House Ways and Means Committee stated:

> The committee believes that the present-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fosters significant complexity. For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the Internal Revenue Service. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what type of expenditures are properly allowable as miscellaneous itemized deductions.

H.R. REP. NO. 99-426, 99TH CONG., 1ST SESS. 109 (1985).

3. The House bill included the following new section 67(c):

> (c) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—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 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.

D. Action in the Senate

1. The Senate Finance Committee's version of the 1986 bill proposed disallowing altogether a deduction for miscellaneous itemized deductions and proposed a new section 280I of the Internal Revenue Code, subjecting certain employee expenses to a 1% floor.

2. The Finance Committee's explanation of this proposal resembled the Ways and Means Committee's explanation. The Finance Committee began its discussion of "Reasons for Change" with the following:

> The committee believes that, as part of the approach of its bill to reduce tax rates through base-broadening, it is appropriate to repeal the miscellaneous itemized deductions and to limit deductions for certain employee expenses. The committee also concluded that allowance of these deductions under present law fosters significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures.

S. REP. NO. 99-313, 99TH CONG., 2D SESS. 78 (1986).

3. The Senate bill included the following new subsection (b) to section 62 (the definition of "adjusted gross income"):

> (b) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of this subtitle, 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.

E. The House-Senate Conference

1. The House-Senate conference refused to go as far as the Senate's repeal, but it increased the 1% floor of the House bill to the 2% floor now imposed by section 67.

2. It was the House-Senate conferees who added to section 67(e) the words "and would not have been incurred if the property were not held in such trust or estate."[1]

3. It was the conference report that first mentioned trusts in committee report language:

> Pursuant to Treasury regulations, the floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs [the rule contained in section 67(c)]. The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of present-law grantor trust and pass-through rules. In the case of an estate or trust [*i.e.*, other than a grantor 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 or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor [the rule contained in section 67(e)]. 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.

[1] The Technical and Miscellaneous Revenue Act of 1988 (Public Law No. 100-647) redesignated this statutory provision as section 67(e)(1), added the second use of the word "which" in section 67(e)(1), and added a new section 67(e)(2) to clarify that the personal exemption and the distribution deduction are exempt from the 2% floor.

H.R. REP. NO. 99-841, 99TH CONG., 2D SESS. II-34 (1986) (conference report).

4. Thus, the single sentence of the legislative history that specifically addresses section 67(e) adds nothing to the statutory language. But it has been argued in the ensuing litigation that the context suggests a congressional concern only with other kinds of entities, and that the sole purpose of section 67(e) was to relieve estates and non-grantor trusts from the application of the 2% floor.

F. No Structural Changes in the Taxation of Trusts

1. Congress did not accept the proposals of the Administration to make sweeping structural changes to the income taxation of trusts and estates.

2. Instead, the ’86 Act simply compressed the rate brackets applicable to trusts, so that the top rate (28%) would be reached at the level of a taxable income of $5,000 (indexed for inflation), rather than $79,500 (indexed for inflation) as under pre-1986 law.

3. Section 1411 of the ’86 Act did follow through on the Administration proposal regarding the unearned income of children, by enacting the “kiddie tax” now found in section 1(g).

G. Summary of the Legislative History

1. Thus, Congress’s stated purposes in subjecting certain deductions to the “2% floor” were simplification (by reducing recordkeeping) and fairness (by removing the opportunity to mix personal expenditures with legitimately deductible expenses).

2. Nevertheless, it would not be unduly cynical to observe that a significant result of the 2% floor and similar computational rules (including phase-ins and phase-outs) was *to increase the bottom line of federal revenue without the political cost of raising tax rates*. This view would find support in the references to “base-broadening,” including the last paragraph of the Treasury I justification quoted above (but omitted from Treasury II).[2]

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[2] Admittedly, there are many ways of looking at “legislative intent.” The following is a sampling:

- What Congress **“must have” intended**, given the mood of the times and the personalities involved.
- What Congress **“actually” intended**, which is usually “known” only by “insiders” of the day (and since Congress has 535 Members, such “knowledge” is necessarily suspect).
- What Congress **said**, typically in committee reports.
- What the purpose of any given provision **should be understood to be**, given the provision’s terms and effect and the law-school notion of asking the “reason for the rule” when application to a given set of facts is unclear.

3. In any event, anyone who has ever administered a trust knows that the trustee's fiduciary duties to beneficiaries (and sometimes accountability to a court) require careful recordkeeping and identification of the character of expenditures, without regard to tax rules. Thus, there should be no disagreement that Congress, judging by its stated purposes, did not aim section 67 at trusts. Nevertheless, there has been disagreement.

III. LITIGATION OVER THE 2% FLOOR AS APPLIED TO EXPENSES FOR INVESTMENT ADVICE

A. The Sixth Circuit: *O'Neill*

1. In *William J. O'Neill, Jr. Irrevocable Trust v. Commissioner,* 98 T.C. 227 (1992), a case arising from a fiduciary income tax return for 1987, the first year the 2% floor was in effect, the Tax Court agreed with the Internal Revenue Service that the costs for investment advice incurred by trustees of a multi-generation trust were not "unique" to the administration of a trust, because they were routinely incurred by individual investors, and therefore those costs were subject to the 2% floor.

2. The Court of Appeals for the Sixth Circuit reversed, concluding that "the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees." *William J. O'Neill, Jr. Irrevocable Trust v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993).

3. Although the Sixth Circuit did not rigorously wrestle with either the language of the statute or the meaning of "uniqueness" in a world in which individuals pay for investment advice too, the fiduciary and estate planning communities universally viewed the Sixth Circuit opinion as a common sense analysis that respected congressional intent and reached the right result.

B. The Federal Circuit: *Mellon Bank*

1. The repose ushered in by the Sixth Circuit's *O'Neill* decision was shattered in 2000, when the Court of Federal Claims agreed with the Sixth Circuit that a trustee had unique legal obligations but did not view the fee paid for investment advice as sufficiently different from such fees paid by individuals to justify an exception from the 2% floor. *Mellon Bank, N.A. v. United States*, 47 Fed. Cl. 186 (2000).

This outline relies on what Congress **said** with immediate reference to the provision in question – hence the reference to Congress's "stated" purposes – and, in identifying relevant considerations in finalizing the Treasury's proposed regulations in part VIII.C on page 19 below, takes a "reason for the rule" approach. All such exercises necessarily have a significant subjective component. For a different view of the legislative history, offered by Government counsel in *Knight*, see part V.A on page 11 below.

2. The Court of Appeals for the Federal Circuit affirmed, stating that section 67(e)(1) "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001). Nevertheless, despite the use of the word "unique," the court rested its conclusion merely on the observation that "[i]nvestment advice and management fees are commonly incurred outside of trusts." *Id.*

C. The Fourth Circuit: *Scott*

1. Next, in *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), a case handled by this writer, the Court of Appeals for the Fourth Circuit reached the same unwelcome result as the Federal Circuit had reached in *Mellon Bank*.

2. The Fourth Circuit's opinion, like its treatment of the issues in oral argument, was thoughtful and respectful of the taxpayers' arguments, but it simply could not overcome the clumsiness of the statutory language.

3. The Fourth Circuit quoted the reference to "unique" expenses in *Mellon Bank*, but immediately added that "[p]ut simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers." *Id.* at 140.

4. The court concluded that the statute "asks whether costs are commonly incurred outside the administration of trusts. As the Federal Circuit decided in *Mellon Bank*, investment-advice fees are commonly incurred outside the administration of trusts, and they are therefore subject to the 2% floor established by § 67(a)." *Id.*

D. The Second Circuit: *Rudkin*

1. Then, in *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149, 156 (2d Cir. 2006), the Court of Appeals for the Second Circuit found that "the statute demands not a subjective and hypothetical inquiry, but rather an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are incapable of incurring."

2. In subjecting investment advice expenses to the 2% floor, the Second Circuit stated (emphasis added):

> While the Federal and Fourth Circuits' approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of § 67(e) requires that we

> determine with certainty that costs **could not have been incurred** if the property were held by an individual. We therefore hold 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.

3. To the fiduciary and estate planning communities, the Second Circuit's "individuals are incapable of incurring" and "could not have been incurred" test was alarmingly harsher than even the unwelcome "customarily" or "commonly" incurred tests of the Federal and Fourth Circuits.

4. As a result, many observers were hopeful when the U.S. Supreme Court granted certiorari on June 25, 2007, under the name of *Michael J. Knight, Trustee v. Commissioner*.

IV. THE INTERNAL REVENUE SERVICE PROPOSES TOUGH REGULATIONS

A. Background of the Proposed Regulations

1. The 2006-2007 Treasury-IRS Priority Guidance Plan, indicating the intended commitment of guidance resources from July 2006 through June 2007, was released on August 15, 2006. The first of eight items under the heading of "Gifts, Estates and Trusts" was "Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate."

2. Accordingly, on July 26, 2007, just one month after the Supreme Court granted certiorari in *Knight*, the Internal Revenue Service released proposed regulations under section 67(e). Proposed Reg. § 1.67-4, REG-128224-06. Because the *Knight* case was pending in the Supreme Court, this move surprised many.

3. As proposed, these new regulations would go much further than any of the court cases. Not being restricted by any particular facts, as court cases are, the Service proposed an approach that many regarded as the harshest approach possible.

B. Full Deduction Limited to "Unique" Costs

1. The proposed regulations adopt the view that only costs that are "unique" to a trust escape the 2% floor and, in an articulation reminiscent of the Second Circuit's test, state that "a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant."

2. As "unique" fiduciary activities, the cost of which is fully deductible, the proposed regulations cite fiduciary accountings, required judicial filings, fiduciary income tax returns, estate tax returns, distributions and communications to beneficiaries, will or trust contests or constructions, and fiduciary bonds.

3. As examples of services that are **not** "unique" to a trust or estate, the costs of which are subject to the 2% floor, the proposed regulations cite the custody and management of property, "advice on investing for total return," preparation of gift tax returns, defense of claims by creditors of the grantor or decedent, and the purchase, sale, maintenance, repair, insurance, or management of property not used in a trade or business.

C. "Unbundling" Fiduciary Fees

1. Most fiduciaries do not charge separately for their activities. For example, most trustees' bundle their services and charge a fee based on a percentage of the value of the trust assets. This bundled fee represents compensation for all fiduciary services, including acting as a custodian for the trust assets, investing the trust assets, filing income tax returns, communicating with beneficiaries, and handling any necessary court filings.

2. The proposed regulations require the "unbundling" of such fiduciary fees or commissions, so as to identify the portions attributable to activities and services that are not "unique" and are therefore subject to the 2% floor.

3. For example, under this proposed approach, if 30% of a trustee's fee is allocable to fiduciary bonds and accountings, fiduciary income tax returns, and distributions and communications to beneficiaries, while 70% of the fee is allocable to custody, management, and investment advice, then only 30% of the fee will be fully deductible as an "above-the-line" expense, and the other 70% will be deductible only to the extent it exceeds 2% of the trust's equivalent of "adjusted gross income."

D. Posture of the Proposed Regulations

1. As proposed, the regulations would apply to "payments made after the date final regulations are published in the Federal Register." Proposed Reg. § 1.67-4(d).

2. The Service received written comments about the proposed regulations and held a public hearing on November 14, 2007.

V. ARGUMENTS IN THE SUPREME COURT

A. The Approach to Legislative History in the Government's Brief

1. On page 34 of the Government's Supreme Court brief, Government counsel cited the Senate Finance Committee's 1986 references to "complexity" and "voluntary personal expenditures" in S. REP. NO. 99-313, 99TH CONG., 2D SESS. 78-79 (1986) (quoted from in Part II.D.2 on page 4 above).

2. In the next paragraph, on the same page, of the Government's brief, counsel added the following:

> Congress also recognized that "[t]he present rules relating to the taxation of trusts and estates permit the reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or grantors of the trust or estate." *1986 Senate Rep. 867*.

3. Conspicuously, pages 78-79 and page 867 of the Finance Committee report are 788 pages apart. In fact, the Finance Committee's "reduction of taxation" comment was made in the context of explaining the "compression" of the income tax rates in section 1(e) applicable to estates and trusts (described above in Part II.F.2 on page 6). The Finance Committee, just two paragraphs later, went on to add:

> *On the other hand, the committee believes that significant changes in the taxation of trusts and estates are unnecessary to accomplish this result.* Accordingly, the bill attempts to reduce the benefits arising from the use of trusts and estates by revising the rate schedule applicable to trusts and estates so that retained income of the trust or estate will not benefit significantly from a progressive tax rate schedule that might otherwise apply. This is accomplished by reducing the amount of income that must be accumulated by a trust or estate before that income is taxed at the top marginal rate. The committee believes that these changes will significantly reduce the tax benefits inherent in the present law rules of taxing trusts and estates while still retaining the existing structure of taxing these entities.

   S. REP. NO. 99-313, 99TH CONG., 2D SESS. 868 (1986) (emphasis added).

4. Thus, the Finance Committee arguably disclaimed any disposition to implement its "reduction of taxation" objective through any changes to the rules (other than rates) governing the taxation of trusts and estates and in any event gave no indication that it had directed its "reduction of taxation"

comment to the treatment of miscellaneous itemized deductions it addressed 867 pages earlier.[3]

B. Oral Argument in the Supreme Court

1. The Supreme Court held oral argument in the *Knight* case on November 27, 2007.

2. Eight of the Justices asked questions and engaged counsel in dialogue. In the main, their questions reflected thorough preparation, a good grasp of the issues, and a commitment to figuring out the statutory language in a thoughtful way.

C. Justices' Comments That Encouraged Taxpayers

1. If applause were allowed in the courtroom, Justice Scalia might have received applause from the tax and estate planning practitioners in attendance when he challenged Government counsel with the observation that "it seems to me that no individual would get trust investment advice. Only a trust can get trust investment advice." But Justice Scalia was tough on the trustee's counsel too.

2. In the midst of Government counsel's explanation of why the cost of preparing a "fiduciary income tax return" escapes the 2% floor, Justice Souter expressed exasperation that the Government would not recognize the same distinction in the cost of obtaining "fiduciary investment advice."

D. Questions Acknowledging the Proposed Regulations

1. Many questions, especially from Justices Alito, Ginsburg, and Scalia, dealt with the proposed regulations.

    a. This is remarkable, because the proposed regulations are not in effect even now, much less in the year at issue in *Knight*.

    b. But the regulations *were* discussed extensively in the parties' briefs, and the Justices' questions seemed to imply a disposition to write an opinion with a view to principles of general application beyond the specific outcome of the *Knight* case.

[3] For a discussion of ways of looking at legislative intent, see footnote 2.

2. Justice Ginsburg, in particular, asked why the example of investment advice subject to the 2% floor in the proposed regulations was "limited" to "investing for total return."

   a. Government counsel pointed out that "the proposed regulation does not identify any kind of advice that is unique to trusts."

   b. In response to further questioning – including Justice Scalia's suggestion that asking an investment advisor to itemize advice between "total return and … this other thing" is "a crazy way to run a tax system" – Government counsel went on to suggest that "the best reading of the proposed regulation, and perhaps the Service may well clarify this during the rule-making process, is that all advice is not unique to trusts because there's no type of advice that a trustee could seek that an individual could not."

E. Other Colloquies

1. Responding to a question from Justice Stevens about the need for a case-by-case analysis, taxpayer's counsel advocated "a categorical test." Justice Stevens opined that "the most normal reading of the language [is] a case-by-case test. It seems to me … probably the most unwise reading, also."

2. In an exchange with Justice Scalia about the meaning of the word "would," Government counsel responded that "when you have the word 'would,' as we have in this statute, that's not qualified in any way, it's ambiguous."

3. Finally, although Justice Scalia could not garner any applause, he did produce subdued snickers in the courtroom when he said "I don't care about legislative history but some of my colleagues do" and then asked if there was "any indication" of Congress's thoughts about investment advice.

   a. While the taxpayer's argument in the Second Circuit had drawn heavily from legislative history, Government counsel's response to Justice Scalia was that "the legislative history is silent on specifically what Congress's objective was in section 67(e)."

   b. Justice Scalia's immediate come-back to Government counsel was that "the dog didn't bark."

   c. In the four minutes taxpayer's counsel had reserved for rebuttal, he did not challenge Government counsel's answer.

VI. A DIFFICULT OPINION PARSES A DIFFICULT STATUTE

A. The Court's Decision

1. On January 16, 2008, the Supreme Court affirmed the Second Circuit. *Michael J. Knight, Trustee v. Commissioner*, 552 U.S. ___, 128 S. Ct. 782 (No. 06-1286, Jan. 16, 2008).

2. A unanimous opinion by Chief Justice Roberts held that a trustee's investment advisory fees are subject to the 2% floor.

B. The Court's Struggles with Words and Phrases

1. The Court refused to give the "would not have been incurred" language of the statute the "straightforward causation" significance the trustee advocated, because "all (or nearly all) of a trust's expenses are incurred because the trustee has a duty to incur them" and therefore a simple causation application would render the "paid or incurred in connection with" language of the statute "superfluous."

2. Of course, in support of this very argument the Court cites BOGERT ON TRUSTS for the proposition that all trust expenses "must be reasonably necessary to facilitate administration of the trust," which sure looks like it makes the "paid or incurred in connection with" language superfluous anyway. G. BOGERT & G. BOGERT, LAW OF TRUSTS AND TRUSTEES § 801 at 134 (2d rev. ed. 1981).

3. But this point has not impressed other courts that have considered this statute, and Government lawyers, who have championed the so-called two-prong analysis, have never been fazed by it either.

C. The Court's Methodology of Hypothetical Prediction

1. Rejecting the notion (apparently entertained by the Second Circuit) that "would not" means "could not," (128 S. Ct. at 787), the Court seemed more inclined to the tests employed by the Federal Circuit in *Mellon Bank* and the Fourth Circuit in *Scott*.

2. The Court quoted the statement in *Mellon Bank* that section 67(e)(1) "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts" and said "[w]e agree with this approach." *Id.* at 789. Nevertheless, like the Federal and Fourth Circuits, the Supreme Court did not rest its decision on the concept of "uniqueness."

3. The Court reduced the operation of the statute to a simple question: "whether a particular cost would have been incurred if the property were held by an individual instead of a trust." *Id.* at 787. (The Code has the

word "not" in it, by the way, but the Justices chose to look at the issue through the other end of the microscope. The Court's tacit recognition that this statute is so hopelessly clumsy it has to be turned upside down to be read is at least an intellectual victory for the trustee.)

4. It looks as if the Court's approach (encouraged by the Government's brief) is to imagine, hypothetically, that the property in question were not held in trust and then ask if the expense in question "would" (or "not"?) have been incurred by the individual owning it.

    a. This requires a "prediction" – the Court's word.

    b. Investment advice, the Court continues, is not "unusual" (as in weird?) for an individual to incur.

    c. Therefore – this the Court doesn't explicitly say but necessarily assumes – such a choice by an individual must be most likely or most probable.[4]

    d. Most observers missed the part of the record that supported such behavioral analysis – but not to worry, it is now settled as a matter of law.

D. The Court's Unsettling Summary

1. Noting that Mr. Knight himself had cited the "prudent investor" rule to justify his decision as trustee to seek investment advice, the Court concluded:

> [W]e have no reason to doubt the Trustee's claim that a hypothetical prudent investor in his position would have solicited investment advice, just as he did. Having accepted all this, it is quite difficult to say that investment advisory fees "would not have been incurred"–that is, that it would be unusual or uncommon for such fees to have been incurred–if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs.

Id. at 790-91.

[4] The *Mellon Bank* court similarly found that "[a]n individual taxpayer, not bound by fiduciary duty, is likely to incur these [investment advice] expenses when managing a large sum of money." 265 F.3d at 1281.

2. There are at least two unsettling elements of the Chief Justice's invocation of the prudent investor rule in this way.

   a. First, at oral argument, in the view of many observers, the Chief Justice himself had exhibited a naive view of the fiduciary obligations of a trustee undertakes with respect to investments.

      i. The Chief Justice posed the following to taxpayer's counsel:

         > Let's say … the trustee understands perfectly his obligations under the law. Let's just say he is supposed to preserve capital and invest conservatively, but he wants advice on which is the best conservative investment.
         >
         > You know, is it railroads or is it utilities? And that's the investment advice he seeks – just that. He says: I know I'm supposed to invest as a fiduciary, but there are options in there, and I just want advice on the options.

      ii. In fact, the prudent investor rule is all about the tradeoff between risk and return and looks at the portfolio as a whole and not investment-by-investment. Although it is impossible to say that a given fiduciary's risk and return objectives could never be summarized as "preserve capital and invest conservatively," or that implementation of a given fiduciary's investment strategy would never present a choice between a railroad and a utility, it is hard to be comfortable with the Chief Justice's simplistic approach, even for the sake of asking a question.

      iii. Counsel's reply that "I think that is actually quite a typical situation" did not help much either.

   b. Second, what the Chief Justice seems to have in mind in the opinion as the model is a "hypothetical prudent investor in his position" (that is, in the position of Mr. Knight as trustee) and "an individual with the same objectives as the Trust." **But that is largely what the cases have been about – the proposition that individuals aren't in the "position" of a fiduciary and typically don't have the same "objectives" as a fiduciary!**

      i. If so, then it would seem that the Court's opinion is nothing more than a round trip back to where we all started, except that now our analysis must use the words "position" and "objectives."

ii. But the Justices are not pranksters, and that couldn't (wouldn't?) be the answer. The *Knight* decision means that fiduciary investment advisory fees paid to outside advisors are subject to the 2% floor.

VII. DOORS LEFT OPEN BY THE COURT

A. An Opportunity for Fiduciaries to Argue Special Circumstances

1. In a curious twist, however, the Court added this paragraph to the end of its opinion:

> As the Solicitor General concedes, some trust-related investment advisory fees may be fully deductible "if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts." There is nothing in the record, however, to suggest that [the investment advisor] charged the Trustee anything extra, or treated the Trust any differently than it would have treated an individual with similar objectives, because of the Trustee's fiduciary obligations. It is conceivable, moreover, that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper. In such a case, *the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor*. Here, however, the Trust has not asserted that its investment objective or its requisite balancing of competing interests was distinctive. Accordingly, we conclude that the investment advisory fees incurred by the Trust are subject to the 2% floor.

Id. at 791 (emphasis added, citations to briefs omitted).

2. Of course, the "balancing of the interests of various parties" is a major defining characteristic of the role of most trustees, distinguishing them from individuals. Leaving that aside, however, the suggestion that some "incremental" costs of fiduciary investment advice might escape the 2% floor even under the Court's approach is fascinating. While the resulting complexity resembles the case-by-case test Justice Stevens seemed to deplore at oral argument, it is now apparently possible that trustees can employ a bit of self-help "reverse unbundling" to identify such fully-deductible "incremental" costs.

B. An Opportunity for Treasury to Issue Workable Regulations

1. The Court supported its view of section 67(e)(1) by quoting the statement in its 1989 opinion in *Commissioner v. Clark*, 489 U. S. 726, 739 (1989)

(a case involving the treatment of "boot" received in a "triangular merger" as a dividend rather than capital gain under the exception in section 356(a)(2)) that "[g]iven that Congress has enacted a general rule …, we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception." After embracing an "unusual or uncommon" standard for applying section 67(e)(1), the Court said that "[w]e appreciate that the inquiry into what is common may not be as easy in other cases, particularly given the absence of regulatory guidance. … Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, but that is no excuse for judicial amendment of the statute."

2. These references to "a somewhat ambiguous exception," "uncertainty," and "the absence of regulatory guidance" leave the door open for Treasury to provide definitive practical guidance. *See Chevron USA Inc. v. NRDC*, 467 U.S. 837 (1984). This is consistent with Government counsel's reference to the statute in oral argument as "ambiguous." See Part V.E.2 on page 13 above.

3. It will be tempting for tax administrators to see the Government's 9-0 victory as a warrant for a sweeping crackdown on trusts. But it is hard to believe that revenue agents in the field would view the sifting of a trustee's admittedly legitimate expenses, coordination with distributable net income, allocation among beneficiaries, flow-through to K-1s, and integration with the beneficiaries' own 2% floors and alternative minimum tax profiles, often in the context of small numbers, as an efficient use of resources.

VIII. BACK TO THE PROPOSED REGULATIONS

A. Treasury's Follow-up of Its Counsel's "Total Return" Remark

1. In considering how to proceed with their proposed regulations in light of the Supreme Court's decision, the first thing that Treasury and the Service may have to deal with is their lawyer's response, provoked if not encouraged by Justices Ginsburg and Scalia, repudiating any inference that the cost of some kinds of fiduciary investment advice, not directed at "total return," might escape the 2% floor.

2. The "total return" distinction in the proposed regulations has always been troublesome in any event. If it is read as an acknowledgment that advice on investing not just to get richer ("total return") but to help a fiduciary balance successive interests (often expressed as interests in "income" and "principal") really is different – maybe even "unique" – then an effort to create a modern, flexible trust that minimizes the role of outdated concepts of "income" and "principal" might be penalized with higher income taxes.

3. That would be a significant step back from the recent progress made by both the Uniform Prudent Investor Act and the Revised Uniform Principal and Income Act – progress acknowledged and accommodated by amendments to the regulations on the definition of "income" under section 643(b) adopted in 2003. Reg. § 1.643(b)-1, amended by T.D. 9102 (Dec. 30, 2003).

B. Treasury's Opportunity for a Statesmanlike Approach

1. Given the Court's treatment of the statute as ambiguous, affirming Treasury's discretion in addressing the issue, the next step for Treasury and the Service might be to ask whether an approach based on dissecting words like "would" and "unique" really makes any sense after all.

2. Like Justices Stevens and Scalia, Treasury and the Service might conclude that any approach that depends on a case-by-case "what if" inquiry would be intolerable, but any other approach would simply be unfair.

3. Thus, Treasury and the Service might even realize that they have an opportunity to step back and clarify the application of the statute in a bold and statesmanlike manner respectful of general principles of tax policy and tax administration and consistent with Congress's initial stated purposes, rather than merely codifying arguments that their lawyers have found successful in collecting a few marginal dollars of revenue under a statute that is unclear.

C. Considerations That Should Inform the Final Regulations

1. As described above, the stated purposes of section 67 (alleviating a recordkeeping burden and removing the temptation to deduct personal expenses) generally do not apply to fiduciaries.

2. The "which would not have been incurred if the property were not held in such trust or estate" clause in section 67(e)(1) has been overstated by parties and courts as a "second prong" of the statutory test. In the acknowledged absence of any authoritative *articulation* of congressional intent, there is no reason to view it as anything more than a completion of the overall thought of a relationship to estate or trust administration.

3. To the extent that the test of section 67(e)(1) nevertheless suggests elements of both context ("in connection with") and motivation or occasion ("would not have been incurred"), the interests of tax administration demand **the simplifying objective assumption** that a fiduciary's actions (and requests of an investment advisor) **are always informed by the unique standard of fiduciary duty**.

4. Even if it is thought necessary to give greater independent effect to the "would not have been incurred" "second prong" of the section 67(e)(1) test, then that effect should reflect the reference in the statute to "property," suggesting that it is the nature of the property that is critical, not the circumstances of the holder, and that therefore an appropriate carve-out would be limited to incremental "in rem" expenses that run with the property.

5. Administration of a test such as that reflected in the proposed regulations would require disproportionate expenditure of compliance and audit resources and would inevitably lead to widely divergent results, especially in the complex task of reflecting an overall correct approach in the fiduciary's K-1s and the beneficiaries' individual returns – just the opposite of the simplification that was Congress's stated purposes.

6. Unitary or "bundled" fees are welcomed by most grantors and beneficiaries and reflect not only à la carte services but also the fiduciary's availability, reputation, big-picture judgment, and assumption of risk. While "unbundling" fees may be a superficially appropriate way to encourage similar treatment of similar taxpayers, it would operate imperfectly in the marketplace of negotiated fee structures (which could include negotiated unbundling methods), and it would represent one more administrative burden in conflict with Congress's stated purposes.

7. All these considerations suggest that, as a matter of sound tax policy and old-fashioned self-restraint, the regulations should affirm that most fiduciary expenses, including the costs of investment advice in trusts with more than one beneficiary, will not be subject to the 2% floor.

IX. INTERIM GUIDANCE FROM THE IRS AND TREASURY

A. Notice 2008-32

On February 27, 2008, the Service issued Notice 2008-32, 2008-11 I.R.B. 1, stating:

> This notice provides interim guidance on the treatment under § 67 of the Internal Revenue Code of investment advisory costs and other costs subject to the 2-percent floor under § 67(a) that are bundled as part of one commission or fee paid to the trustee or executor ("Bundled Fiduciary Fee") and are incurred by a trust other than a grantor trust (nongrantor trust) or an estate.
>
> BACKGROUND
>
> On January 16, 2008, the Supreme Court of the United States issued its decision in Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. ___, 128 S. Ct. 782

(2008), holding that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the 2-percent floor for miscellaneous itemized deductions under § 67(a). The IRS and the Treasury Department expect to issue final regulations under § 1.67-4 of the Income Tax Regulations consistent with the Supreme Court's holding in Knight. The final regulations also will address the issue raised when a nongrantor trust or estate pays a Bundled Fiduciary Fee for costs incurred in-house by the fiduciary, some of which are subject to the 2-percent floor and some of which are fully deductible without regard to the 2-percent floor. The final regulations, however, will not be issued prior to the due date for filing 2007 income tax returns (determined without regard to extensions), and will apply only prospectively. Accordingly, in light of the Supreme Court's decision in Knight, the IRS and the Treasury Department are providing interim guidance that specifically addresses the treatment of a Bundled Fiduciary Fee.

INTERIM GUIDANCE

Taxpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2-percent floor under § 67 for any taxable year beginning before January 1, 2008. Instead, for each such taxable year, taxpayers may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2-percent floor. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee.

The IRS and the Treasury Department anticipate that final regulations under § 1.67-4 will be published without delay after the extended comment period granted in this Notice. The final regulations may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not. Any safe harbors in the final regulations for determining the allocation of a bundled fiduciary fee between costs subject to the 2-percent floor and those not subject to the 2-percent floor may be available for taxpayers to use for taxable years beginning on or after January 1, 2008.

REQUESTS FOR COMMENTS

Interested parties are invited to submit comments on this notice and § 1.67-4 of the proposed regulations … by May 27, 2008.

The IRS and the Treasury Department are considering various modifications to § 1.67-4 of the proposed regulations that may include safe harbors for determining the allocation of a Bundled Fiduciary Fee between costs subject to the 2-percent floor and those that are not. The IRS and the Treasury Department request comments on whether safe harbors would be helpful and request suggestions on how the safe harbors may be formulated. Comments are specifically requested on reasonable estimates of the percentage(s) of the total costs of

> administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor including, but not limited to, costs for investment management and advice. Comments are also requested on whether the safe harbors should reflect the nature or value of the assets in the nongrantor trust or estate, and/or the number of beneficiaries of the nongrantor trust or estate.

B. Critique of Notice 2008-32

1. It is good that the Notice has clarified that "unbundling" of unitary fiduciary fees will not be required on 2007 returns.

    a. Unless and until the proposed regulations are finalized, there is nothing in the law that requires unbundling anyway.

    b. Indeed, in *Mellon Bank* the Court of Federal Claims explicitly considered an argument referring to unbundling and appears to have assumed that unbundling would be the law, if at all, only "if ultimately required by the IRS … in adopting procedures and regulations for enforcement of I.R.C. section 67(e)(1)." 47 Fed. Cl. at 195.

        i. Against that background of discussion of unbundling in the record before it, the Court of Appeals for the Federal Circuit stated that "[i]t is undisputed that trustee fees are fully deductible." 265 F.3d at 1279.

        ii. Similarly, the Court of Appeals for the Fourth Circuit agreed that "fees paid to trustees … would be fully deductible under the exception created by §67(e)." 328 F.3d at 140.

    c. The Supreme Court, in *Knight*, did not mention unbundling or say anything that could be construed as requiring unbundling.

    d. Nevertheless, it is good to have the reassurance of the Notice, especially in light of the significant changes to tax return preparer penalties Congress enacted in the Small Business and Work Opportunity Act of 2007. *See* Janes, "Between Monsters—The Section 67(e) Prop. Regs. And Section 6694," 35 ESTATE PLANNING 19 (Jan. 2008).

2. It is also good that the Notice has extended the period for public comment on the proposed regulations until May 27, 2008. Many commentators and would-be commentators last fall believed that the opportunity to meaningfully comment was constrained by the uncertainty about what the Supreme Court would do, and many asked that the comment period be

extended until after the Court had spoken. (The Notice does not say that a second public hearing will be held.)

3. It is ominous and could be discouraging that the Notice anticipates final regulations "consistent with the Supreme Court's holding in Knight."

   a. But it would be odd for Treasury to contemplate final regulations that are *inconsistent* with a Supreme Court decision, and, as discussed above, the Court's view of section 67(e) as "ambiguous" opens the door to any reasonable interpretation by regulations, which would then be "consistent" with the Court's view.

   b. Similarly, the suggestions in the Notice that the final regulations "will address" unbundling and "may contain one or more safe harbors" for unbundling should be assumed to reflect nothing more than a reasonable desire to keep all options open and seek public input about those options that can be useful in making final policy judgments. So long as the options that are thereby kept open include the statesmanlike option of limiting the 2% floor to fiduciary cases where "the reason for the rule" justifies it, no one should view the Notice as a threat or as a sign of closed-mindedness.

C. The Problem with Safe Harbors

1. To the extent that the 2% floor applies to fiduciaries under the final regulations, safe harbors may be a controversial subject.

2. Some thoughtful observers have advocated safe harbors as a simplification.

3. Others have viewed safe harbors with suspicion. first as an unsettling sign that Treasury and the Service are not open to more bold, comprehensive, and simplifying exceptions for fiduciaries that would make safe harbors unnecessary, and second as a complication for fiduciaries, who – as with many elections under the tax law – would be compelled by fiduciary duty to calculate the outcome both under the safe harbor and under a more customized "reasonable method" that might be more favorable to the beneficiaries.

4. To the extent that safe harbors only provide "reasonable estimates of the percentage(s) of the total costs of administering a nongrantor trust or estate that is attributable to costs subject to the 2-percent floor," the suspicions of the detractors seem justified.

5. On the other hand, "safe harbors [that] reflect the nature or value of the assets" could be written to limit the 2% floor to "in rem" expenses, and

"safe harbors [that] reflect … the number of beneficiaries" could be written to limit the 2% floor to single-beneficiary trusts that are the equivalent of outright individual ownership – both views that are advocated in this outline.

X. INTERIM SUGGESTIONS FOR FIDUCIARIES

A. Preparing for Final Regulations

1. Such a sound and practical resolution, however, cannot be guaranteed, in part because the ultimate outcome may also depend on political, anecdotal, and other considerations (including private "legislative history" – see footnote 2) that are difficult for citizens to evaluate or even know about.

2. Thus, fiduciaries should begin to think about how to allocate services and expenses among categories they might not be accustomed to using. Although the proposed regulations can provide some guidance in this effort, the final regulations might be different, so it is important to anticipate compliance with the regulations in strategic and general terms and not waste effort in devising a detailed response to rules that are only proposed and not yet effective.

3. The same is true of any unbundling of unitary fees that might be mandated to emulate or reflect the required allocations.

4. Even though a trust-by-trust review solely for the purpose of analyzing categories the regulations have not yet finalized may be wasteful, if there are other natural occasions for surveying and categorizing trusts the potential impact of any new regulations should be kept in mind.

    a. For example, as new fiduciary accounts are opened, intake information might be tailored to accommodate application of rules distinguishing various types of investment advice.

    b. Similarly, where periodic reviews are already in place for other management reasons, information that might prove useful can be updated.

    c. The periodic review and updating of investment policies and instructions to investment advisors is a good idea for many reasons, and that kind of review can also be used to identify types of trusts or even strengthen the ability of a trust to invoke any provisions of the regulations that might be desirable.

5. Generalizing from the "total return" marker in the proposed regulations, the most important question to ask about a trust may be whether the administration of the trust is governed by a strict dichotomy between

income and principal, including whether the trustee has discretion to invade principal for income beneficiaries, to accumulate income, or to make equitable allocations between principal and income. Similarly, it might be appropriate to identify any explicit references to "total return" in investment files, and, where those references are legitimately outdated or otherwise potentially misleading, they might, as appropriate, be revised.

6. Another question is whether there is anything at all about a trust that justifies special instructions or requests to the investment professionals involved or special efforts by those professionals that would produce, in the language of the Supreme Court, a "special" or "unusual" "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer."

7. In addition, the final regulations might make or permit distinctions among trusts based on the characteristics of a trust.

   a. As clues, Notice 2008-32 suggests "the nature or value of the assets … and/or the number of beneficiaries."

   b. For example, a trust for a single beneficiary (such as a "2503(c) trust") might be treated the same as an individual, on the theory that the trustee does not have to balance the interests of multiple beneficiaries.

   c. Other categories that might be given significance are trusts for a single generation of beneficiaries, trusts that have run for several generations, and trusts that have more than one generation yet to serve.

8. In all events, consideration should be given to advising beneficiaries of the new challenges fiduciary income tax returns might bring.

   a. It is usually a good idea to prevent surprise, although this needs to be balanced with the reluctance to alarm beneficiaries over something that might not come to pass.

   b. In many cases, though, a communication that advises beneficiaries of the pending developments will provide an opportunity to demonstrate the fiduciary's awareness of the tax climate in a proactive context that can appropriately remind beneficiaries of the many advantages of professional trust management.

B. Preparing 2007 Returns

1. In preparing 2007 fiduciary tax returns and beneficiaries’ K-1s, it must be acknowledged that *Knight* is the law of the land, without prospective application as a regulation might have.

2. This will focus intense scrutiny on the last paragraph of the Court’s opinion (quoted in part VII.A on page 17 above) as fiduciaries seek legitimate opportunities to “reverse unbundle” by identifying “the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer.”