Pepperidge Farm Legacy

Beyond goldfish crackers, it's also going to be a Supreme Court ruling deciding if trusts can fully deduct investment fees. Rich folks and financial firms hope the high court's answer will be 'Yes'

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On June 25, 2007, the Supreme Court agreed to hear *Knight v. Commissioner*[1] to decide whether trusts and estates can fully deduct the fees they pay for the investment management and advisory services they receive.[2]

For the last 10 years, a debate has raged over what level of deductibility Internal Revenue Code Section 67(e)(1) permits for trust investment advisory fees (IAFs). Some courts, notably the U.S. Court of Appeals for the Sixth Circuit, have found that IAFs are fully deductible before arriving at a trust's taxable income. Others, including the Second, Federal and Fourth Circuits, maintain that IAFs are just miscellaneous itemized deductions (MIDs) that are deductible only to the extent that they exceed 2 percent of a trust's adjusted gross income (AGI), often referred to as the "2 percent-of-AGI floor."[3]

The stakes are substantial for the wealthy. Having their trusts pay such fees without full deductibility whittles away at the trust *corpus* over time.

For the financial industry, full deductibility means firms will keep more assets under management, reduce administrative costs, have fewer arguments with clients over fees, and generally have simpler accounts and tax planning. This is a big deal for both firm marketing and internal operations.

Meanwhile, for the general public, it's a question of fairness. Should trusts benefiting the wealthy get to totally write off the expense of investing and managing money when mere individuals might not? We predict that the high court will find that the law allows trusts to deduct fees that do, in fact, go beyond what an individual would shoulder and that, because of prudent investor laws, that extra burden does include most investment fees.

Briefs are due at the Supreme Court in August, September and October 2007, with oral arguments scheduled for December 2007. That means a decision is not likely until 2008.

But already the Internal Revenue Service has cast its vote—and beneficiaries of trusts and estates have no reason to like it. On July 27, 2007, the Service released proposed regulations[4] that take the harshest possible approach in interpreting Section 67(e)(1): Any otherwise deductible trust or estate expense that is not unique to such entity would be a MID; and an expense is considered unique only if "an individual could not have incurred that cost in connection with property not held in an estate or trust."[5] These regulations provide several examples of "unique" and "non-unique" costs. Included among the non-unique costs are IAFs.[6] Further, to the extent that an estate or trust incurs a cost that combines costs that are "unique" and "not unique," the regulations require such costs to be "unbundled."[7] Thus, a trustee that charges a single fee for all fiduciary services, including IAFs, would be required to allocate such fee among "unique" and "non-unique" categories. Unquestionably, this hard-line stance will be controversial and generate significant opposition from banks. It certainly ups the ante on the *Knight* decision.

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CASE FACTS

Michael J. Knight[8] served as trustee of the William L. Rudkin Testamentary Trust, a trust established under the will of William's father, Henry A. Rudkin.[9] Initially, the trust was funded primarily with the proceeds from the 1961 sale to Campbell Soup Company of Pepperidge Farm, Inc., a baked goods company founded in 1937 by Margaret Fogarty Rudkin, Henry's wife.[10]

Under the terms of the Rudkin Trust, the trustee was given broad authority to manage the trust assets, including authority "to invest, and reinvest the funds of my estate or of any trust created hereunder in such manner as they deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agent, experts and counsel."[11]

Pursuant to the terms of the Rudkin Trust, Trustee Knight engaged Warfield Associates, Inc., of New York, to provide investment management services for the trust. During the taxable year 2000, the trustee paid $22,241.31 for such services. On its 2000 federal income tax return, the Rudkin Trust fully deducted these fees.[12]

The IRS determined that the IAFs paid to Warfield were not fully deductible, but instead were an MID. It issued to the Rudkin Trust a statutory notice of deficiency in the amount of $4,448.[13]

The Tax Court held (consistent with its earlier decision in *O'Neill I*[14]) that IAFs are MIDs.[15] In doing so, the Tax Court quoted *O'Neill I*, saying that "the thrust of the language of [S]ection 67(e)[(1)] is that only those costs which are *unique* to the administration" of a trust are fully deductible.[16] Because "[i]ndividual investors routinely incur [IAFs] . . . it cannot be argued that such costs are somehow unique to the administration of . . . [a] trust simply because a fiduciary might feel compelled to incur such expenses in order to meet the prudent person standards imposed by State law."[17]

Then, the Tax Court rejected the Sixth Circuit's reasoning in *O'Neill II* that costs—including IAFs—attributable to the trustee's

fiduciary duty, not required outside the administration of the trust are fully deductible.[18] Instead, the Tax Court expressed support for the positions espoused by the Federal Circuit in *Mellon* and the Fourth Circuit in *Scott*, stating that "the second requirement of [Section] 67(e)(1) does not ask whether costs are commonly incurred in the administration of trust. Instead, it asks whether costs are commonly incurred *outside* the administration of trusts. As the Federal Circuit decided in *Mellon Bank,* [IAFs] are commonly incurred outside the administration of trusts, and they are therefore [MIDs]."[19]

The Second Circuit affirmed the Tax Court, but established a highly restrictive interpretation of Section 67(e)(1)'s second requirement,[20] one that could rarely be met.[21] Specifically, the court stated that "the plain text of [Section] 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. Therefore, we 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."[22]

LINES ARE DRAWN

There's no need to wait until December when all briefs are due before the Supreme Court and oral arguments are heard, to know the key arguments that are likely to be made in this battle. The parties already have tipped their hands. We need only look at the taxpayer's petition for *certiorari*, the *amici curiae* brief filed by the American Bankers Association (ABA) and the New York Bankers Association (NYBA), the government's brief and the taxpayer's reply brief.[23]

Knight, as the taxpayer and petitioner, offered four primary reasons why the Supreme Court should hear the case. First, his petition noted that there's an acknowledged, irreconcilable and untenable split among the circuits regarding the deductibility of IAFs by trusts and estates.[24] The irreconcilability is reflected in the various positions espoused by the circuits. Although the Federal Circuit's holding in *Mellon Bank* and the Fourth Circuit's holdings in *Scott* are essentially the same, the Sixth Circuit's holding in *O'Neill II* and the Second Circuit's holding in *Rudkin II* are at odds with each other and with *Mellon Bank* and *Scott.*

> The parties already have tipped their hands as to what their arguments before the Supreme Court will likely be. Just look at what they've said in the petition for *certiorari*, the *amici curiae* brief and the reply brief.

The untenable aspect of the circuit split results from the fact that the Supreme Court "has long recognized the special need for uniform rules with respect to federal taxation."[25] Also, the issue is recurring and fundamentally important to trust beneficiaries and the financial services industry.[26] The impact on beneficiaries stems from industry estimates that IAFs total in the billions of dollars annually. Although trustees pay these fees, beneficiaries suffer the consequences of treating them as MIDs rather than fully deductible. Higher annual taxes for the trust reduces its *corpus* every year and, thereby, its future earnings. Ultimately, this means a smaller amount of funds available for current and future trust beneficiaries.[27]

The negative impact on the financial services industry stems from potential forum shopping and reduced IAFs.[28] To avoid having IAFs treated as MIDs, settlors and beneficiaries in adverse circuits may favor trustees—who're typically chosen to serve as trustees and to provide investment and advisory services—located in non-adverse circuits. Financial services companies in adverse circuits, notably the financial services headquarters of New York, would suffer economically.[29] Also, trustees in adverse circuits may attempt to fulfill their fiduciary duties to invest trust assets prudently, avoiding IAFs by using mutual funds, brokers or investment-savvy trustees who do not charge separately for IAFs.[30]

Knight also argues that the Second Circuit's interpretation of the second requirement of Section 67(e)(1) is clearly erroneous.[31] The court's highly restrictive reading of the statute—that a trust is permitted to take "a full deduction only for those costs that could not have been incurred by an individual property owner"—is inconsistent with the language of the statute that provides that trust administration expenses are fully deductible so long as they "would not have been incurred if the property were not held in such trust or estate." Because the IAFs incurred by the Rudkin Trust would not "have been incurred if the property were not held in such trust," such fees are fully deductible.[32]

Supporting Knight's position that such a reading does not render superfluous the second requirement of Section 67(e)(1), he noted that a

trustee can incur administrative costs that would have been incurred even outside a trust context. He illustrated this point by referring to a trust that was a partner or shareholder in a pass-through entity that incurred administration expenses. Because these expenses in most circumstances "would . . . have been incurred" irrespective of whether the pass-through entity interest was "held in such trust or estate," such expenses would be MIDs. According to Knight, "[T]he legislative history to [the] second [requirement] confirms that this was its primary purpose."[33]

KNIGHT SUPPORTERS

The ABA and NYBA made two arguments in their *amici curiae* brief. First, resolution of the issue is necessary to prevent harm to the financial services industry and resolve the circuit split.[34] In support of this argument, the bankers associations raised points that closely mirrored those made in the taxpayer's petition.[35]

The bankers groups claim *Rudkin II* was incorrectly decided.[36] The Second Circuit failed to recognize that trusts actually are required by law to incur investment fees because, "unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets."[37] Forty-three states have adopted versions of the Uniform Prudent Investor Act (UPIA), which mandates that a trustee "invest and manage trust assets as a *prudent* investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.[38] (Emphasis added.) Older statutes permitted trustees to invest pursuant to a statutorily approved list of investments. But the UPIA greatly complicates the fiduciary duties associated with the investment and management of trust assets. Among other things, it requires that trustees consider the general condition of the economy; the impact of inflation or deflation; the tax consequences of various investments; the role of various investments within the context of an overall portfolio; the anticipated returns from income and capital appreciation; and the beneficiary's other resources and needs.[39] As a result, the bankers groups say, "the legal duty to act as a 'prudent investor' would dictate that a trustee hire one or more investment managers to handle the complexities inherent in modern trust management."[40] In doing so, IAFs incurred by the trustee are usually "peculiar to the particular trust in light of the trust's purpose and other factors outlined by the UPIA."[41] As such, the IAFs should be fully deductible because they "would not have been incurred if the property had not been held in trust."[42]

GOVERNMENT'S BRIEF

Seeking to persuade the high court not to hear *Knight*, the government offered three arguments. First, the government said that the IRS was on the verge of issuing a regulation to resolve the issue of whether IAFs are fully deductible or MIDs.[43] The government claimed to know the IRS would do so because one of the stated goals in the Service's 2006-2007 Priority Guidance Plan (PGP) was to issue "[g]uidance under section 67 regarding miscellaneous itemized deductions of a trust of estate," demonstrating "that the IRS and Treasury recognize the importance of the issue to taxpayers and tax administration."[44] Moreover, the government said, a regulation interpreting Section 67(e)(1) would resolve the split among the circuits by binding all circuits, even the Sixth.[45] As support, the government quoted the Supreme Court's holding in *National Cable & Telecomms Ass'n v. Brand X Internet Servs. (Brand X)*[46] that a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron*[47] 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."[48] Pursuant to *Chevron*, a court is required to give deference to the IRS' reasonable interpretation of a statute.[49]

Also, the government argues, the Second Circuit's construction of the statute was reasonable and not in error.[50] Despite the "slightly different approaches" given to the second clause of Section 67(e)(1), the Second Circuit agreed with the Fourth and Federal Circuits that the appropriate tax treatment for common trust expenses, such as IAFs, is as MIDs, while trustee fees, judicial accounting costs and fiduciary tax return preparation costs are "expenses peculiar to trust administration" and, thus, would be fully deductible.[51]

Third, the government claims that the legislative history underlying Section 67(e)(1) indicates that it was not intended to give trusts preferential tax treatment.[52] Instead, such history suggests that, among other things, Congress "sought to reduce the tax benefit of placing assets in trust in order to split income between the trust and its beneficiaries, primarily by setting the tax rates for trust so that little income could be sheltered at the lower rates."[53] This goal is served by not allowing a trust to fully deduct certain administration expenses—such as IAFs—that individuals cannot fully deduct.[54]

> We predict the high court will come down with a ruling similar to the Second Circuit's *O'Neill II*—but not as favorable. Beneficiaries should not jump for joy.

KNIGHT COUNTERS

In reply, Knight offered two arguments. First, even if the IRS issued regulations interpreting Section 67(e)(1), that would not resolve the need for the Supreme Court to review the case.[55] Such regulations would be interpretive in nature and, thus, subject to the standard of deference established in *National Muffler Dealers Association v. United States*[56]—not the higher standard of deference established in *Chevron*. Pursuant to *Brand X*, "judicial decisions are unaffected by subsequent 'agency interpretations to which *Chevron* is inapplicable.'"[57] Moreover, even if *Chevron* deference were given to a regulatory construction of Section 67(e), the circuit split would remain unresolved. Because the Second, Fourth, and Federal Circuits found the statutory language "unambiguous," under *Brand X*, "[a] precedent holding a statute to be unambiguous forecloses a contrary agency construction."[58] As such, a regulatory interpretation of Section 67(e)(1) could not resolve the circuit split even assuming *Chevron* deference.[59]

Knight also noted that, based on Supreme Court practice, review should not be denied based on the possibility that another branch of government might resolve an issue.[60] To bolster this argument, Knight noted that no regulation or proposed regulation has been promulgated by the Treasury Department in the 21 years since the statute was enacted;[61] a final regulation, if any, is "likely years away;[62] and that it would be inappropriate to deny review on the basis of a speculative regulation.[63] Among the more significant points made, the taxpayer stated that the inclusion of "[g]uidance under [S]ection 67 regarding [MIDs] of a trust or estate" on the PGP list is meaningless. Neither law nor regulations require the completion of projects on that list.[64] Further, such guidance may come in the form of IRS guidance other than a regulation; even if a legislative regulation were entitled to *Chevron* deference, such other forms of IRS guidance would not.[65] Finally, such guidance may be directed at other subsections of Section 67, not Section 67(e)(1), the subsection relevant to the case at hand.

OUR TWO CENTS

Of course, the IRS did indeed issue regulations on Section 67(e) and, ironically, it did so a mere two days after the Supreme Court agreed to hear Knight's case. Still, the high court did the right thing in agreeing to resolve the issue. The arguments made in Knight's petition, the *amici curiae* brief and Knight's reply brief

are powerful while the government's position is weak. Indeed, the IRS' ultra-restrictive interpretation in its regulations only makes it clearer that the high court needs to step in.

How will the Supreme Court ultimately decide? We stand by what we've said before: "If Supreme Court review becomes a reality, at the very least we might get a decision based on more sound rationale than what is set forth in the cases that have denied full deductibility."[66] More specifically, it's our prediction that the court will cut back on the holdings in *Mellon Bank, Scott,* and *Rudkin II.* But beneficiaries should not jump for joy. While the high court likely will come down with a rule that is similar as the Sixth Circuit's ruling in *O'Neill II,* it's not going to be as favorable. One possibility is that the high court will impose a "but for/reasonable person standard:" Would a reasonable individual investor incur the IAFs at the same level as those incurred by the trust (with the burden on the taxpayer to show that such fees would not have been so incurred)?

Whatever the court decides, there finally will be an end to this long-standing controversy over how much of a deduction trusts and estates can take for investment fees. And if there's one thing practitioners like more than anything else, it's certainty. ▮

Endnotes

1. *Knight v. Commissioner,* U.S. No. 06-1286 (2007).
2. *Ibid.*
3. This distinction may be relevant for both regular tax purposes and alternative minimum tax (AMT) purposes. For a discussion of the potential impact for both regular tax and AMT purposes, *see* John M. Janiga and Louis S. Harrison, "Deducting Fees for Investment Advice," *Trusts & Estates,* April 2007, pp. 42-49 and endnotes 5-6.
4. Internal Revenue Service Proposed Regulations Section 1.67-4. The IRS will accept written comments on the proposed regulations through Oct. 25, 2007, and a public hearing on the regulations is scheduled for Nov. 14, 2007. The regulations are proposed to apply to payments made after the date final regulations are published in the Federal Register.
5. *Ibid.*
6. *Ibid.* Examples of costs that are "unique" and, therefore, are fully deductible include "fiduciary accountings, judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or *corpus* to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums, and communication with beneficiaries regarding estate or trust matters." Examples of costs that are "not unique" and, therefore, are miscellaneous itemized deductions (MIDs), include "those rendered in connection

with: custody or management or property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property."

7. *Ibid.*
8. Michael J. Knight is managing partner of Fairfield, Conn.'s Michael J. Knight & Company, Certified Public Accountants.
9. *Rudkin v. Comm'r,* 467 F.3d 149 (2d Cir. 2006) (*Rudkin II*), *aff'g Rudkin v. Comm'r,* 124 T.C. 304 (2005) (*Rudkin I*).
10. Margaret F. Rudkin, the Martha Stewart success story of her time, began baking bread at age 40, because her youngest son, Mark, was diagnosed in 1937 with severe allergies and asthma that were exacerbated by most commercially processed foods. According to *answers.com,* Margaret drew on childhood memories of her Irish grandmother's recipe for whole wheat bread made with old-fashioned ingredients, including stone-ground whole wheat flour, honey, molasses, natural-sugar syrup, whole milk, cream and butter.

    By 1960, the Connecticut-based Pepperidge Farm was producing 1.2 million loaves a week, had a workforce of 1,700, and sold more than 50 products in about 50,000 stores across the country. For the fiscal year ending in April 1960, profits totaled about $1.3 million on revenues of $32 million. The Rudkin family owned more than 80 percent of the stock. Margaret handled production and personnel, while her husband, Henry A., was responsible for the financial side, as well as marketing, sales, shipping and other areas; he also served as the company chairman. Henry had gradually retired from his Wall Street job to work full-time at Pepperidge Farm.

    The Connecticut-based Campbell Soup bought Pepperidge Farm for about $28.2 million worth of Campbell Soup stock in a deal that closed in January 1961. Margaret Rudkin continued to be in charge of Pepperidge Farm, which became a wholly owned subsidiary of Campbell. She also gained a seat on the soup company's board of directors—the first woman to do so. In 1962, her husband retired from the company, Margaret took over the chairmanship and their son William was named president. Margaret died at age 69 in 1967. *See* "Pepperidge Farm, Incorporated" at *www.answers.com/topic/pepperidge-farm-inc?cat=biz-fin.*
11. *Rudkin I, supra* note 9, at pp. 305-306.
12. *Ibid.,* at p. 306.
13. *Ibid.*
14. *O'Neill v. Comm'r,* 994 F.2d 302 (6th Cir. 1993) *(O'Neill II), rev'g O'Neill v. Comm'r,* 98 T.C. 227 (1992) (*O'Neill I*).
15. *Rudkin I, supra* note 9, at p. 304.
16. *Ibid.,* at p. 309 (emphasis in original).
17. *Ibid.*
18. *Ibid.,* at pp. 309-310.
19. *Ibid.,* at p. 310 (*citing Scott v. U.S.,* 328 F.3d 132 (4th Cir. 2003) (*Scott II*), *aff'g Scott v. U.S.,* 186 F. Supp.2d 664 (2002) *(Scott I)* (emphasis in original).
20. *Rudkin II, supra* note 9.
21. Previously, we argued that "it is difficult to come up with any trust administration cost that meets the Second Circuit's definition of the second [requirement]. Applied strictly, this definition would not allow for full deductibility of trust administration costs that the court itself conceded would be fully deductible. The definition is so restrictive that it has the potential to make Section 67(e) superfluous, certainly a result that no canon of statutory construction can support." Janiga and Harrison, *supra* note 3, at p. 47.
22. *Rudkin II, supra* note 9. In January 2007, the Second Circuit refused to reconsider its ruling.
23. The attorney for the petitioner is Professor Peter J. Rubin of the Georgetown University Law Center in Washington; the attorney for the respondent is listed as Paul D. Clement, the U.S. solicitor general, and Gregory F. Taylor. Robert J. Brinkmann and Irving Warden are counsel for the American Bankers Association.
24. Petition for *writ of certiorari,* U.S. No. 06-1286 (filed March 25, 2007), at p. 14.
25. *Ibid.,* at p. 19 (*citing Comm'r v. Bilder,* 369 U.S. 499, 501 (1962)).
26. *Ibid.,* at p. 21.
27. *Ibid.*
28. *Ibid.,* at pp. 21-23.
29. *Ibid.,* at pp. 21-22.
30. *Ibid.,* at pp. 22-23.
31. *Ibid.,* at p. 23.
32. *Ibid.,* at pp. 23-24.
33. *Ibid,* at pp. 24-25.
34. *Amici curiae* brief of American Bankers Association (ABA) and New York Bankers Association (NYBA), No. 06-1286 (filed May 25, 2007), at pp. 3-7.
35. *Ibid.,* at pp. 4-7.
36. *Ibid.,* at p. 7.
37. *Ibid.*
38. *Ibid.,* at pp. 8-10 (emphasis added).
39. *Ibid.,* at pp. 10-13.
40. *Ibid.,* at p. 12.
41. *Ibid.,* at p. 13.
42. *Ibid.*
43. Brief of respondent Commissioner of Internal Revenue Service in opposition, U.S. No. 06-1286 (filed May 25, 2007), at p. 5 (Respondent Brief).
44. *Ibid.,* at pp. 5-6.
45. *Ibid.,* at p. 6.
46. *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.,* 545 U.S. 967 (2005) *(Brand X).*
47. *Chevron U.S.A. Inc. v. NRDC,* 467 U.S. 837 (1984), (*Chevron*).
48. *Brand X, supra* note 46, at p. 982.
49. Respondent Brief, *supra* note 43.
50. *Ibid.,* at p. 8.
51. *Ibid.,* at pp. 10-11.
52. *Ibid.,* at p. 11.
53. *Ibid.,* at p. 12 (*citing* 26 U.S.C. 1(e) and S. Rep. No. 313, 99th Cong., 2d Sess. (1986), at pp. 78-79).
54. *Ibid.*
55. Reply brief of petitioner Michael J. Knight trustee of the William L. Rudkin Testamentary Trust, U.S. No. 06-1286 (filed June 4, 2007), at p. 2 (Reply Brief).
56. *National Muffler Dealers Association v. United States,* 440 U.S. 472 (1979).
57. Reply Brief, *supra* note 55, at p. 2 (*citing Brand X, supra* note 46, at p. 983).
58. *Ibid.,* at pp. 2-3 (*citing Brand X, supra* note 46, at p. 984).
59. *Ibid.,* at p. 3.
60. *Ibid.*
61. *Ibid.,* at p. 5.
62. *Ibid.,* at p. 7.
63. *Ibid.,* at p. 8.
64. *Ibid.* at p. 6.
65. *Ibid.*
66. *See* Janiga and Harrison, *supra* note 3, at p. 48.