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TAXING MIDDLE CLASS TRUST(S)

by

*Pamela Champine**

I. INTRODUCTION	507
II. TRUSTS AND THE MIDDLE CLASS TAXPAYER	510
<i>A. The Relevance of Taxes Paid on Trust Income to</i> <i>Middle Class Taxpayers</i>	511
1. <i>Direct Interests</i>	511
2. <i>Horizontal Equity</i>	515
<i>B. Tax Equity Between Trust Beneficiaries and</i> <i>Outright Owners</i>	519
1. <i>The Distribution Deduction</i>	520
2. <i>Other Adjustments to the Formula for</i> <i>Taxable Income</i>	523
III. HOW THE MIDDLE CLASS SLIPPED THROUGH THE CRACKS IN THE TWO PERCENT FLOOR	526
<i>A. The Two Percent Floor on Miscellaneous</i> <i>Itemized Deductions</i>	526
1. <i>The Dilemma about Trusts</i>	529
2. <i>The Statutory Resolution</i>	531
<i>B. Judicial Interpretations</i>	532
1. <i>The Profit-Maximizing Taxpayer v. The Cost-Averse</i> <i>Taxpayer</i>	533
2. <i>Incremental Costs v. Categorical Costs</i>	537
3. <i>The Weight of Authority</i>	542

*Professor of Law, New York Law School. B.S., Univ. of Illinois, J.D., Northwestern Univ. School of Law; LL.M., New York University.

IV. FILLING IN THE CRACKS IN THE TWO PERCENT FLOOR	545
<i>A. Statutory Grounding of the Contextualized Interpretation . . .</i>	<i>545</i>
1. <i>The Reasonable Taxpayer Standard</i>	<i>546</i>
2. <i>Asset Use as the Determinative Criterion</i>	<i>547</i>
3. <i>Accumulation-Distribution Distinction as Proxy for Asset Use</i>	<i>550</i>
<i>B. The Argument for Judicial Adoption</i>	<i>552</i>
1. <i>Quantitative Analysis</i>	<i>552</i>
2. <i>Qualitative Analysis</i>	<i>555</i>
3. <i>Judicious Allocation of Resources</i>	<i>559</i>
V. CONCLUSION	563

I. INTRODUCTION

The Internal Revenue Code¹ is, by all accounts, the Inequitable Revenue Code.² The middle class bears a disproportionately high percentage of the overall tax burden, in part, because complex interactions of various provisions of the Code produce unintended results.³ Tax simplification addresses this aspect of inequity, and so it is a centerpiece of tax reform.⁴ Simplification itself,

1. In this article, the “Code,” unless otherwise specified, refers to the Internal Revenue Code of 1986, as amended.

2. Public opinion about tax equity has changed dramatically in the past 50 years. See, Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go from Here 3-4* (W. W. Norton and Co.) (1999) (from the period following World War II until 1972 Americans considered the income tax to be the fairest tax in the nation, but since 1980 they have viewed it as the least fair). Part of this change may be attributed to the popular press, which has increased public awareness of tax inequity. See, e.g., David Cay Johnston, *Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich – and Cheat Everyone Else 11* (Portfolio) (2003) (citing studies at www.taxpolicycenter.org):

. . . [W]hen all federal taxes are considered – from those on gasoline and beer to Social Security taxes as well as income and estates taxes – the top 1%’s share [of taxes] drops to about a fourth of the total tax bill. That is not much more than their share of reported income. If you tally up the economic benefits to the top 1% that do not show up in income statistics – for reasons of written law and because of tax tricks of lawyers . . . – then the richest 1% are taxed more lightly than the middle class. The same data show that the poor are taxed almost as heavily as the rich are – and even more heavily than the super rich.

Another factor that may have contributed to this change is the increasing disparity in income among Americans, see, e.g., Isaac Shapiro, *New IRS Data Indicate Rising Income Inequality*, 200 Tax Notes 18 (Oct. 17, 2005), and the forthright acknowledgment by government agencies of tax improprieties. See, e.g., *Financial Management: Thousands of Civil Agency Contractors Abuse the Federal Tax Systems with Little Consequence*, GAO-05-637 (Jun. 16, 2005), at www.gao.gov. (Last visited July 6, 2006).

3. See, e.g., Robert W. Wood, *Will the IRS Pursue Attorney Fees Post-Banks?*, 108 Tax Notes Today 133-36 (Jul. 11, 2005) (discussing complexities involved in determining whether contingent attorneys’ fees are includible in the successful plaintiff’s gross income that remain after the Supreme Court addressed the issue). See generally, Kathryn J. Ball, *Comment, Horizontal Equity and the Tax Consequences of Attorney-Client Fee Agreements*, 74 Temp. L. Rev. 387 (2001).

4. President Bush appointed an advisory panel to study tax reform alternatives, which issued a set of far-reaching tax reform proposals. *Report of the President’s Advisory Panel on Federal Tax Reform, Simple, Fair and Pro-Growth: Proposals to Fix*

however, can produce unintended complexity and exacerbate inequity if the drafting and interpretation of the simplification provisions are removed from the realities to which they will apply.

A prime example of unintended inequity brought about by tax simplification is section 67(e).⁵ Section 67 denies individuals a deduction for specified expenditures (labeled “miscellaneous itemized deductions”) except to the extent that they exceed 2% of that individual’s adjusted gross income.⁶ Section 67(e) extends this “deduction reduction” to trusts except for expenditures that “. . . would not have been incurred if the property were not held in [trust].”⁷ The purpose of section 67(e), as its language suggests, was to assure that section 67’s “deduction reduction” could not be circumvented by placing income producing assets in trust. Yet section 67(e), as it is presently interpreted, affords a tax advantage to trusts established by taxpayers wealthy enough to accumulate income for future generations and at the same time disadvantages those who establish smaller trusts for non-tax purposes as well as outright owners.⁸

This inequity has come about because of the interplay between the specialized provisions of the Code that govern the income taxation of trusts and courts’ interpretations of section 67(e). Congress recognized the need to integrate these two parts of the Code, but it did not engage in the technical analysis required to achieve integration. Instead, Congress articulated a general principle embodying its objective, and relied on Treasury and the courts to translate the statutory principle so that it would achieve the intended result.⁹ In the 20 year history of section 67, however, Treasury has not issued regulations explaining how the 2% floor on miscellaneous itemized deductions applies to

America’s Tax System (Nov. 2005), at <http://www.Taxreformpanel.gov/final-report>. (last visited July 6, 2006). This has sparked dialogue about different conceptions of equity. See, e.g., Reuven S. Avi-Yonah, *The Report of the President’s Advisory Panel on Federal Tax Reform: A Critical Assessment and a Proposal*, at http://www.ssrn.com/sol3/papers.cfm?abstract_id=870578 (last visited July 6, 2006); AICPA, *Understanding Tax Reform: A Guide to 21st Century Alternatives*, at <http://www.tax.aicpa.org/resources/tax+advocacy+for+Members/taxlegislationandpolicy> (last visited July 6, 2006); Leonard E. Berman & William G. Gale, *A Preliminary Evaluation of the Tax Reform Panel’s Report*, 109 *Tax Notes* 1349 (2005).

5. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

6. IRC § 67(a).

7. IRC § 67(e).

8. See *infra* Part IV.B.

9. See *infra* notes 106-107, and accompanying text.

trusts and estates.¹⁰ This left courts to interpret the scope of the exception with no technical guidance. They struggled to achieve an equitable result, yet unintentionally failed to do so in every case even as the Circuits split on the meaning of section 67(e).¹¹

The purpose of this article is to explain how courts came to such an inequitable interpretation of section 67(e) even as they tried to avoid that result; to present an interpretation of section 67(e) based on the principle that underlies the Code's scheme for taxing trust income; and to illustrate how this interpretation produces optimal equity among trust beneficiaries as well as between trust beneficiaries and outright owners. The Code's scheme for taxing trust income, set forth in Subchapter J of the Code,¹² recognizes that the existence of a trust does not necessarily signify wealth or high income. The use of the trust income, however, does indicate whether the trust benefits a wealthy family or an individual with a modest income. Applying this principle of Subchapter J to the interpretation of section 67(e) is the key to achieving equity between trust beneficiaries and outright owners.

To explain the significance of this technical issue to larger issues of tax equity, Part II describes the relevance of taxes paid by trusts to middle class taxpayers.¹³ The specialized tax scheme of Subchapter J affects individuals who fall outside any notion of "wealthy" or "rich." It directly affects individuals at every income level because the taxing scheme that governs trusts also applies to decedents' estates. In addition, individuals of modest means will experience direct effects of the tax treatment of trusts in the many situations where such an individual establishes a trust to manage property that will support his or her dependents or others. Most importantly, the equity of the tax burden borne by individuals depends upon the relative burden borne by other taxpaying entities. Trusts and estates are particularly significant in this analysis because they

10. Treasury has issued regulations addressing matters other issues arising under § 67. Temp. Regs. §§ 1.67-1T (2% floor on miscellaneous itemized deductions); 1.67-2T (treatment of pass through entities); 1.67-3 (allocation of expenses by real estate mortgage investment conduits); 1.67-3T (same). There is a regulation reserved for the allocation of expenses by trusts and estates, § 1.67-4T, but no regulation has been issued to date.

11. See *infra* notes 112-166, and accompanying text.

12. IRC §§ 641-692.

13. See *infra* notes 17-86, and accompanying text.

account for almost three quarters of the aggregate gross income reported by taxpayers.¹⁴

Part III discusses the negative effect that the 2% floor on miscellaneous itemized deductions had on the equity that Subchapter J had previously produced.¹⁵ The problem stemmed from differences in the pre-existing formulas for computing taxable income of individuals, on the one hand, and trusts and estates, on the other. The formula for computing taxable income of trusts, unlike the formula for computing taxable income of individuals, could not incorporate the 2% floor without a modification. Section 67(e), which created an exemption for certain trust expenses, defined the result that the formula for computing taxable income should produce but not the technical rules for bringing about that result. When courts interpreted section 67(e), they attempted to achieve equity between trusts and outright owners. They failed to do so, however, because their interpretations did not account for either the diversity in the beneficiaries of trusts and estates or the similarity of costs incurred by trusts, estates and outright owners.

To achieve equity in the application of the 2% floor, the interpretation of the 2% floor must reflect the diversity of beneficiaries in the same way that the basic scheme of taxing trusts and estates does. Part IV presents a contextualized interpretation of section 67(e) that brings about this result, shows how it fits within the statutory language as well as any of the multiple “plain meaning” interpretations adopted by courts, and explains how it achieves greater equity than any other existing interpretation.¹⁶

II. TRUSTS AND THE MIDDLE CLASS TAXPAYER

The stereotypical middle class taxpayer works to earn income, and pays a significant portion of that income in federal income taxes.¹⁷ The tax rules applicable to trust income have no role in the computation of the taxes due on the wages this taxpayer earns. Nevertheless, the tax treatment of trust income has both direct and indirect effects on the segment of the taxpaying population who consider themselves (and would be considered by others to be) middle

14. Jacob M. Mikow, *Fiduciary Income Tax Returns, 1997* at 77 (Internal Revenue Service 2005) gross income for trusts and estates accounted for 73.8 % of aggregate gross income in 1997).

15. See *infra* notes 87-166, and accompanying text.

16. See *infra* notes 167-216 and accompanying text.

17. Scott A. Hodge, *Is Anyone Left in the Middle Class?*, at www.taxfoundation.org/news/show/92.html (last visited July 6, 2006).

class.¹⁸ These effects make the seemingly narrow applicability of section 67(e) of general interest.

A. The Relevance of Taxes Paid on Trust Income to Middle Class Taxpayers

Trusts serve a variety of objectives relating to property management and ownership. The defining feature of a trust is its division of title to property into a legal interest, held by the trustees, and an equitable interest held by the beneficiaries.¹⁹ In many situations it is advantageous, and sometimes necessary, to separate the legal and equitable interests in property.²⁰ Although some of these situations have relevance only for the wealthiest of individuals, others apply to middle class taxpayers as well.

In addition to direct interests as trust beneficiaries or as the grantor of a trust for others, individuals have an indirect interest in the taxation of trust income. The fairness of the tax burden borne by any individual depends, in large part, on how that burden compares to the tax burden borne by others. Thus, the fairness of the tax burden borne by the wage earner depends upon the tax burden borne by those whose income consists of distributions from trusts. The growing sense that middle class taxpayers bear a disproportionate burden of taxes makes the treatment of trust income, which is typically associated with wealthy individuals, particularly relevant to both perceptions and reality about equity in the apportionment of the income tax.

1. Direct Interests

Some types of trusts serve objectives that have relevance only for the wealthiest individuals. A “Dynasty Trust,” for example, is designed to preserve

18. There is no commonly accepted definition of “middle class.” See, *Who Is the Middle Class*, at www.wksu.org/news/features/familyseries/middleclass_transcript.html. (last visited July 6, 2006). In this article “middle class” refers to individuals whose wealth is not extensive enough to merit contemplation of objectives beyond providing for the needs of current family members.

19. 1 Austin W. Scott & Wm. Fratcher, *The Law of Trusts* § 2.3 (4th ed. 1987) [hereinafter “Scott on Trusts”] (describing trust as a fiduciary relationship with respect to property in which the legal title holder owes equitable duties to another).

20. *Id.* at 1 (describing the purposes of trusts to be “as unlimited as the imagination of lawyers”). See also, 1 A.J. Casner & Jeffrey N. Pennell, *Estate Planning* § 4.0 (6th ed. 1995) (“nothing serves as many functions for estate planners as trusts because settlors literally may write their own rules”).

and increase family wealth for successive generations.²¹ The idea of providing for unborn generations of descendants is not a serious possibility for most individuals, because their own needs together with the needs of their existing family members would be more than adequate to consume the individual's assets. Similarly, trusts designed to minimize generation skipping transfer taxes have no relevance to middle class taxpayers because those trusts, like dynasty trusts, contemplate the accumulation of wealth for the benefit of future generations.²² However labeled or characterized, the hallmark of these trusts is that they exist to accumulate income rather than distribute it.

In many situations, however, the division of property into separate legal and equitable interests is as necessary or helpful to the middle class taxpayer as it is to wealthier individuals.²³ One situation of wide applicability is the division of title into legal and equitable interests that occurs upon the death of an individual. Whether a decedent dies intestate or leaves a will, the property of the decedent vests in a personal representative who manages the property during the administration of the estate and ultimately distributes the property to the beneficiaries named in the will, or the intestate heirs, as the case may be.²⁴ The

21. Jerome A. Manning et al., *Estate Planning* ch. 4 at 4-6 (5th ed. 1995) (describing the dynasty trust as a trust "which is designed to continue for the benefit of successive generations for the maximum period that local law permits the trust to endure free of estate, gift and generation-skipping taxes").

22. The generation skipping transfer ("GST") tax is applicable to transfers for the benefit of descendants and others who are at least two generations removed (as defined for GST purposes) from the transferor. IRC § 2601 (imposing tax) and § 2611 (defining generation-skipping transfer). The exemption from GST tax is equal to the exemption equivalent for the estate tax, which rises incrementally until 2010, when either reinstatement or repeal of the estate tax is scheduled to take effect. IRC § 2631(a), (c). The exemption is \$1.5 million for 2005, \$2 million for 2006-2008, and \$3.5 million for 2009. Thus, GST trusts and GST planning in general is irrelevant only for individuals who have millions of dollars above and beyond whatever is left to their surviving spouse and children. See, Carol A. Harrington et al. *Generation-Skipping Transfer Tax*, ¶ 4.01 (2d ed. 2003).

23. See, e.g., Carolyn T. Geer, *Trust a Trust*, *Forbes*, Aug. 14, 1995, at 168 (describing trusts as "necessary" for the middle class and citing statistics indicative of the prevalence of these trusts); Doug H. Moy, *Inequitable Taxation of Estate and Trusts*, 39 *The Nat'l Public Accountant* 14 (Aug. 1994) (listing the following reasons the owner of a modest estate might consider creating a trust: "(1) to provide for asset management for a surviving spouse and ensure preservation and continuity of assets for the family . . . unit; (2) to protect and provide for the special needs of . . . children; (3) to avoid . . . conservatorships for [minor or disabled individuals]; and (4) to [relieve] beneficiaries from the burdens of managing property).

24. Patricia Cain et al., *Family Wealth Management* 75 (William J. Turnier & Grayson M.P. McCouch eds. 2005).

decedent does not affirmatively choose to divide property into legal and equitable interests, but the law imposes this arrangement in order to facilitate efficient administration of estates.²⁵ The property of the estate itself is not subject to income tax, but the income earned by the decedent's estate during the course of the estate administration is.²⁶ The taxation of estate income is governed by the same general scheme applicable to trusts because both involve fiduciaries who hold legal title to property for the benefit of other equitable owners.²⁷ Thus, the tax rules applicable to trust income will be relevant for middle class taxpayers who inherit property in intestacy or receive a bequest under a will.²⁸

An important use of trusts involves situations where an individual wishes to give property to a donee who would be unable to manage the property. In these situations, outright ownership is not an option, and a trust is often the best alternative.²⁹ A classic situation in which a middle class taxpayer would create this type of trust is the death of a taxpayer who has dependents. If the sole parent, or surviving parent, of a minor child, dies, for example, the will of the parent often will create a trust to hold all of the parent's property for the benefit of the child. The assets of the trust will consist of the parent's property – accumulated savings, the survivorship benefit in a pension plan, or a life

25. *Id.*

26. IRC § 102(a) and (b).

27. Estates and trusts, though they both involve fiduciary ownership, differ in important respects. Some of these differences justify or require different tax treatment, and for this reason Subchapter J treats estates and trusts differently for some purposes. See, e.g., IRC §§ 642(b) (personal exemption), 642(c)(2) (set aside of income for charitable purposes) 644 (taxable year of trusts). It has been argued that the differences between estates and trusts are so significant that it is not necessarily appropriate to apply even the same general scheme to both types of entities. Joseph M. Dodge, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 *Am. J. Tax Pol'y* 127, 127-128 (1997).

28. Typically, only residuary beneficiaries would bear the income tax consequences of estate taxation because bequests of property are exempt from income tax. IRC §§ 102, 663.

29. An outright bequest of property to a minor generally will require appointment of a guardian to hold the property even if the minor has a living parent. See, e.g., N.Y. Surr. Ct. Proc. Act § 1701 (McKinney 2005). Guardianships involve extensive court supervisions and commensurate limitations on the guardian's discretion to manage the minor's property and use funds for the minor's benefit. 3 Warren's *Heaton on Surrogate's Court Procedure* § 48.01 (Matthew Bender & Co. 2005). See also, Wayne M. Gazur & Robert M. Phillips, *Case Studies in Estate Planning* 137-139 (Aspen 2004) (discussing benefits of trust as compared to alternative arrangements for minors).

insurance policy. In effect, the income from the trust assets replaces the income stream of the parent, who would have provided for the child if he or she had survived.

Similarly, individuals who recover damages after suffering debilitating injuries often place the recovery in trust in order to secure the benefit of asset management that the individual is incapable of providing.³⁰ The recovery may be large in absolute dollar terms, but the medical expenses and other needs that the recovery must satisfy may well leave little or no additional income.³¹ For that reason, trusts funded with personal injury recoveries will tend to be property management devices rather than wealth accumulation vehicles.

Another reason that middle class taxpayers use trusts is to provide for support of multiple beneficiaries with a limited fund. During the taxpayer's lifetime, a trust typically would be unnecessary because the taxpayer would support the beneficiaries directly. The taxpayer could continue support for adults by leaving them outright bequests, but the property of the taxpayer might be insufficient to provide outright bequests for multiple beneficiaries in an amount necessary to cover anticipated needs.

One example of this type of situation involves the decedent who wishes to provide for both a surviving spouse and children. If the estate were large enough, the decedent could achieve both goals by leaving outright bequests to the spouse and the children. Where the estate is more modest, however, a trust is a better alternative because it assures that all assets will be available for the spouse's support and at the same time gives the children all of the property that is not necessary for this purpose.

30. Even if the individual is capable of managing assets, a trust may be desirable to secure the benefits of Medicaid coverage while allowing the individual to use the trust income and assets to cover other needs. For an overview of these types of trusts, see, e.g., Jule E. Stocker et al., *Stocker & Rikoon on Drawing Wills & Trusts* § 3.14 (PLI 1999). See also, Wesley E. Wright et al., *Planning Effectively to Cope with Medicaid Estate Recovery*, 32 *Est. Plan.* 20 (Aug. 2005); David J. Correia, *Disability Trusts That Allow a Client to Qualify for Medicaid*, 30 *Est. Plan.* 233 (May 2003).

31. These trusts do not impose a serious burden on Medicaid's resources because Medicaid is entitled to reimbursement from the trust assets upon the death of the beneficiary in an amount equal to the costs it paid for that beneficiary. *In re Barkema Trust*, 690 N.W.2d 50 (Iowa 2004); *Estate of De Martino v. Division of Medical Assistance and Health Services*, 861 A.2d 138 (N.J. 2004); Accord, Ellen O'Brien, *Medicaid's Coverage of Nursing Home Costs: Asset Shelter for the Wealthy or Essential Safety Net?* Georgetown Univ. Long Term Care Financing Project, May 2006 at 6, (concluding that there is little evidence the elderly engage in abusive wealth transfers in order to qualify for Medicaid).

Another example involves the decedent who paid the college tuition of multiple children (or grandchildren) who are still incurring educational expenses at the time of the decedent's death. If the decedent's priority is to cover the educational expenses of the children (or grandchildren) and the decedent cannot predict who will continue their educations or how much the cost will be, outright bequests will be unsatisfactory. A trust, on the other hand, would allow the decedent to fulfill her objective because the trustee could be directed to make distributions only for educational purposes.

These examples illustrate some of the possible uses of trusts by middle class taxpayers.³² The common theme in these uses, as compared to the dynastic trust used by the very wealthy, is that they provide for current rather than future needs.

2. *Horizontal Equity*

Some middle class taxpayers have no direct stake in the taxation of income received by a trust. These taxpayers do have an indirect stake in the tax treatment of trusts, however, because the tax treatment of others defines the allocation of the tax burden among all taxpayers. Evaluation of tax equity depends on the tax treatment of individual tax payers (or groups of taxpayers) relative to other individual taxpayers (or groups of taxpayers).

32. All of the examples discussed in the text involve carrying out the wishes of a donor who makes a gratuitous transfer. In some instances, however, a trust serves the interest of the grantor who created the trust. The most common example of this situation is the "living trust" created to avoid probate. This type of trust, a revocable trust, is not taxed as a trust. Instead, the income of such a trust is taxed directly to the grantor. IRC § 676. This is but one of many situations in which Subchapter J disregards the trust entity based on the substantial interest or control that the grantor retains over trust assets.

Generally, tax equity is a highly subjective concept.³³ The more limited principle of horizontal equity, however, is universal.³⁴ Horizontal equity posits that similarly situated taxpayers ought to bear similar tax burdens. In order to satisfy horizontal equity, there must be a justification for treating income from different sources, such as wage income as compared to trust income, differently.³⁵

The taxing scheme applicable to trust income, located in Subchapter J of the Code, reflects the principle of horizontal equity by paralleling, in a general way, the tax results that would occur if the trust property were owned outright by the beneficiaries.³⁶ Carrying out this principle for trust income

33. The issue of progressivity in tax rates is one of many examples. Many equate progressivity with equity based on the conviction that those who have a proportionately greater share of the income ought to pay a proportionately higher percentage of that income in taxes. C. Eugene Steurle, *Contemporary U.S. Tax Policy* 11-12 (describing different conceptions of vertical equity). See generally, Edward J. McCaffery, *Fair No Flat* 22 (2002); Edward J. McCaffery, *A New Understanding of Tax*, 103 *Mich. L. Rev.* 807, 829-32 (2005); Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 *Cal. L. Rev.* 1905 (1987). Yet a contrary conception of equity supports a “flat tax” that would exact a fixed rate of tax regardless of income level. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 *U. Chi. L. Rev.* 417 (1952).

34. See Steurle, *supra* note 33, at 10. Disagreements about how to assess equivalence preclude definitive judgments about horizontal equity on a broad range of questions, but definitive judgment will be possible for those cases in which there can be no legitimate disagreement about the equivalence of two situations. Thomas D. Griffith, *Should “Tax Norms” Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 *Wis. L. Rev.* 1115.

35. There is no definitive source outside of law for evaluating the propriety of tax treatment of any particular item of income. *Cf.*, *Thor Power and Tool Co. v. Comm’r*, 439 U.S. 522 (1979) (holding that methods of accounting that satisfied the standards of financial accounting would not necessarily satisfy federal income tax standards). This affords wide flexibility to treat different categories of income differently in the pursuit of particular policy objectives. Capital gains, for example, often enjoy a favorable tax rate as compared to ordinary income. IRC § 1(h). Other categories of income are excluded from the income tax base altogether. See, e.g., IRC § 103 (interest on state and local bonds); IRC § 104 (personal injury recoveries); IRC § 117 (scholarships for tuition and related expenses). As long as there is a legitimate basis for distinguishing a particular type of income, special treatment for that type of income will not definitively violate horizontal equity.

36. See *infra* notes 48-63 and accompanying text.

involves complexities that are inherent in any situation where an individual owns an interest in an income-producing entity.³⁷

Trusts involve an additional unique complication, which is that not all of the owners (beneficiaries) hold present interests in the trust.³⁸ Beneficiaries who hold future interests may have no resources to pay taxes assessed currently, and may never succeed to trust assets.³⁹ Consequently, trust income cannot “simply” flow through to the trust beneficiaries, as income earned by partnerships and S corporations flows through to their owners.⁴⁰

Instead, trust income is allocated between the trust and the beneficiaries who receive distributions of trust income.⁴¹ The premise of Subchapter J’s

37. Clearly, the income earned by an entity should bear tax, and an individual who receives that income should directly or indirectly bear the burden of that tax. This general principle leaves many questions unanswered, however, including whether the tax should be paid at the entity level, the individual level, or both; whether the individual should bear tax when the income is earned by the entity or when it is distributed to the individual; how the rate of tax for entity income should coordinate with the tax rates for individuals; and many others. The Code resolves these issues differently for different types of entities. For example, the Code establishes distinct schemes for partnerships as compared to corporations, but it allows corporations meeting specified requirements to elect a third scheme of taxation that largely, though not entirely, parallels the scheme for partnership taxation. IRC §§ 301-385 (comprising Subchapter C, which governs distributions from corporations), §§ 701-777 (comprising Subchapter K, which governs partners and partnerships) §§ 1361-1379 (comprising Subchapter S, which governs corporations that elect ‘S’ status).

38. A present interest in trust stands in contrast to the future interest, which though legally recognized at the inception of the trust, becomes distributable, if ever, at a future time. See generally, Thomas F. Bergin & Paul G. Haskell, Preface to *Estates in Land and Future Interests* 123 (1966). Restatement (Third) Trusts § 5, comment b. (noting that trusts bear a close resemblance to relationships between legal life tenants and remainder beneficiaries and to other relationships involving successive legal estates).

39. Many trusts condition a remainder beneficiary’s entitlement on surviving to the time the trust terminates. A typical example would be a trust created for the life benefit a spouse, with the remainder distributable to the children of the grantor who survive the grantor’s spouse and the issue of any deceased child. Conditioning entitlement on survivorship is so desirable that the 1993 revisions to the Uniform Probate Code impose a condition of survivorship on future interests held in trust, which requires the beneficiary to survive until the time the future interest takes effect in enjoyment or possession. Unif. Prob. Code § 2-707, 8 U.L.A. 194-196 (West 1998).

40. M. Carr Ferguson, James J. Freeland & Mark L. Ascher, *Federal Income Taxation of Estates, Trusts, & Beneficiaries* ¶ 5.01 (3d ed. 2005).

41. In this sense, the taxation of trust income is distinguishable from the treatment of income earned by C corporations, which is subject to double taxation, and similar to the treatment of income earned by a partnership or an S corporation. Compare

taxing scheme for trusts is that trusts should compute taxable income under the same rules that apply to individuals, and then allocate that taxable income between the trust entity and its beneficiaries in proportion to the allocation of the trust's actual income for the year.⁴² To the extent income is distributed to trust beneficiaries, they pay tax on the income at their respective marginal rates so that trust income in the hands of the beneficiary is treated like any other income received by the beneficiary. To the extent income of the trust is retained by the trust rather than distributed, the trust itself pays tax.⁴³ The tax imposed on income retained by trusts follows a compressed rate structure to preclude the possibility of using trusts to avoid the progressive rate structure of the Code.⁴⁴

This assures that recipients of trust income pay tax on that income at rates commensurate with the rates paid by individuals with the same amount of income from non-trust sources. At the same time, it assures that undistributed trust income is taxed on an annual basis at rates that preclude the opportunity to defer income tax for extended periods by simply placing income producing assets in trust.⁴⁵ The overall effect is to assure that trust beneficiaries have no unfair advantage over individuals who earn all of their income or receive it from other non-trust sources.

IRC § 11 (imposing tax on corporations) and § 301(c) (defining corporate dividends as gross income in the hands of shareholders) *with* (imposing income tax on partners but not the partnership entity). Jonathan G. Blattmachr & Arthur M. Michaelson, *Income Taxation of Estates and Trusts* § 2:1 (14th ed. 2003). See also, Kamin, *infra* note 46, at 215 (noting that the conduit structure for taxing trusts, estate and their beneficiaries was introduced in 1916).

42. IRC § 641(b).

43. IRC §§ 652, 662. The overview of the income taxation of trusts that follows is intended to illustrate the general framework of Subchapter J for purposes of understanding how the 2% floor on miscellaneous itemized deductions altered the pre-existing equity between trust beneficiaries and other individuals. For a more thorough yet readily accessible summary of Subchapter J, see Jeffrey G. Sherman, *All You Really Need to Know About Subchapter J You Learned from This Article*, 63 *Mo. L. Rev.* 1 (1998).

44. Compare IRC § 1(a)-(d) (tax rates for individuals); with § 1(e) (tax rates for trusts and estates).

45. Deferring taxation of trust income until distributed would afford a substantial benefit to trusts as a result of the time value of money. The value of deferral is a central feature of tax planning. See generally, Stephen F. Gertzman, *Federal Tax Accounting* ¶¶ 1.01, 11.01 (2nd ed. 1993 & Supp. 2005).

This general scheme has been in place since 1954.⁴⁶ Amendments to this scheme have occurred from time to time, but they have refined rather than replaced the basic view of horizontal equity between trust beneficiaries and other individuals.⁴⁷ The stability of this framework is a testament to its basic equity. In order to understand how § 67(e) disturbed the pre-existing equity between trust beneficiaries and other individuals, it is necessary to understand something about the formula for computing a trust's taxable income.

B. Tax Equity Between Trust Beneficiaries and Outright Owners

The specific rules that translate the premise of horizontal equity between trust beneficiaries and other individuals into a taxing scheme for trusts fall into two general categories: (1) rules that modify the requirements for deductibility of specific expenditures in order to express those requirements in the contextual terms of trusts rather than individuals,⁴⁸ and (2) rules that alter

46. Subchapter J is not immune from criticism, however. The complexity of Subchapter J has been a principal source of concern. See, Dodge, *supra* note 27; Sherwin Kamin, *A Proposal for the Income Taxation of Trusts and Estates, Their Grantors, and Their Beneficiaries*, 13 *Am. J. Tax Pol'y* 215 (1996).

47. Examples of changes designed to advance the basic objective of Subchapter J include the "separate share rule" under which a single trust or estate is treated as creating multiple trusts or estates in order to produce more appropriate allocations of the entity's taxable income, codified at IRC § 663(c), and extended to estates by the Taxpayer Relief Act of 1997, P.L. 105-34, § 1307(a)(1)-(2), 111 Stat. 788 (1997); the treatment of multiple trusts as a single trust for tax purposes where the trusts have substantive the same grantor, the same primary beneficiaries, and a principal purpose of the trusts is income tax avoidance, codified at IRC § 643(f), first introduced by the Deficit Reduction Act of 1984, P.L. 98-369, § 82(a); and the compression of tax brackets for trusts introduced by the Tax Reform Act of 1986, P.L. 99-514, 100 Stat 2065 (1986) (codified at IRC § 1(e)). One of the most significant changes to Subchapter J's scheme, the expansion of the definitions of principal and income to include state law definitions that departed from traditional definitions, was made by regulation rather than statutory change. Regs. § 1.643(b)-1 (amended by T.D. 9102, 69 Fed. Reg. 12-01).

48. Some of these rules may amount to little more than a technical adjustment. See, e.g., IRC §§ 167(h), 611(e), 642(f) (allocating depreciation deduction, depletion deduction and amortization deductions, respectively, between the current beneficiaries and the trust, which receives a portion of the deduction for the benefit of the remaindermen). If, however, trusts and individuals differ significantly in the specific attributes relevant to the requirements of the particular deduction, the substantive content of the deduction's requirements will differ as well. The deduction for charitable contributions is a prime example. The charitable deduction available to individuals applies only to contributions to charities recognized as tax exempt organizations and not to payments for charitable purposes made to needy individuals or entities that are not

the formula for computing taxable income to bring about the allocation of trust income between the trust entity and its beneficiaries.⁴⁹ Both types of rules contribute to equity, but it is the formula adjustments that express the general vision about how to create equity between individuals who have income from trusts and those who do not.

1. The Distribution Deduction

In order to allocate taxable income of a trust between the trust itself and the trust's beneficiaries, the Code allows trusts a deduction for distributions of income to beneficiaries.⁵⁰ Correspondingly, the Code requires the trust beneficiaries to include these distributions in their personal taxable income.⁵¹ The Code treats distributions as constituting income to the extent the trust has income, and treats any additional distributions as non-taxable principal.⁵² The actual source of the distribution is irrelevant. If the trust has \$1000 of income, and distributes an asset worth \$1000 to a beneficiary, that is a distribution of income even though the asset itself may have been principal rather than income in the hands of the trustee.⁵³

themselves tax-exempt organizations. IRC § 170(a). Trusts, in contrast, may deduct payments made for charitable purposes whether or not the recipient is a tax-qualified charity because the purpose of the trust may be to advance such charitable objectives. See generally, Zaritsky & Lane, *The Federal Income Taxation of Trusts, Estates and Beneficiaries* § 2.04 (3d ed. 2004) (discussing the differences between the charitable deduction available to individuals under § 170 and the charitable deduction available to trusts under § 642(c)).

49. IRC §§ 651, 661.

50. *Id.*

51. IRC §§ 652, 662.

52. This generalization disregards the special provisions applicable to bequests or gifts of principal from trusts and estates. The income tax applies only to the income earned by trusts and estates and not to their original corpus. Consequently, the Code must distinguish the original principal from the income subsequently generated by the entity. The essential provisions creating this distinction are IRC § 102 (excluding gifts and bequests of principal from gross income of individuals) and IRC § 663(a) (excluding gifts and bequests from the operation of the rules allocating trust income between the entity and its beneficiaries).

53. The alternative approach, tracing distributions to particular assets from the trustee, was followed by the Code prior to the enactment of Subchapter J. This approach was abandoned because it afforded the trustee an unacceptable level of control over trust assets and also created enormous complexity. See, *Harkness v. United States*, 199 Cl. Ct. 721, 469 F.2d 310 (1972).

The major issue involved in this allocation is determining whether, or to what extent, a distribution constitutes income as opposed to (non-taxable) distributions of trust principal. The Code defines the trust's income for federal income tax purposes, but state law defines the income of a trust, known as "fiduciary accounting income" or "FAI," for purposes of defining the rights of current income beneficiaries in the trust property. The two definitions classify many common receipts in the same way; stock dividends, rental income and taxable interest income are classified as income under both sets of law.⁵⁴ The primary differences are capital gains, which typically are classified as principal for state law purposes but as income for purposes of the Code,⁵⁵ and tax-exempt interest, which is classified as income for state law purposes but outside the definition of income for purposes of the Code.⁵⁶

To allocate the trust's taxable income fairly between the beneficiaries who receive current distributions and the trust, which holds assets for beneficiaries who will receive future distributions, the distribution deduction must account for the fact that capital gains and other income allocable to principal will not pass to income beneficiaries. The concept of "distributable net income" ("DNI") brings the taxable income of the trust closer to FAI.⁵⁷

To compute DNI, the trust first computes its taxable income but for the distribution deduction,⁵⁸ and then adjusts that figure by reversing the treatment of several items the tax treatment of which differs from treatment under state law. Thus, capital gains, allocable to principal under state law but included in taxable income under the Code, would be deducted from taxable income to compute DNI. Conversely, tax-exempt income, allocable to income under state law but excluded from taxable income under the Code, would be added to taxable income in the computation of DNI. The personal exemption claimed by the trust, a proper offset to income under the Code but not under state law, would be added back to taxable income as well.⁵⁹ These adjustments bring DNI

54. Compare Unif. Prin. & Inc. Act §§ 401(b) (dividends), 405 (rent), 406(a) (interest), 7B U.L.A. 160, 166, 167 (West 2000) with IRC § 61(a)(4) (dividends), (5) (interest) and (7) (rent).

55. Compare Unif. Prin. & Inc. Act § 404(2), 7B U.L.A. 165 (West 2000) with IRC §§ 61(a)(3).

56. Compare Unif. Prin. & Inc. Act § 406(a), 7B U.L.A. 167 (West 2000) with IRC § 103.

57. Zaritsky et al., *supra* note 48, at § 3.02, *citing* S. Rep. No. 1622, 83d Cong., 2d Sess. 343 (1954).

58. Sherman, *supra* note 43, at 16.

59. IRC § 643(a).

closer to FAI, but the two concepts are distinct. Consequently, DNI may exceed FAI⁶⁰ or vice versa.⁶¹

The distribution deduction may never exceed DNI.⁶² For “simple trusts,” which include trusts that distribute all of their income, distribute no principal, and have no charitable beneficiaries, the distribution deduction will be the lesser of DNI or FAI.⁶³ By denying simple trusts a deduction for distributions in excess of FAI, the Code assures that receipts allocable to principal under state law will not be taxed to beneficiaries who are not entitled to those receipts. For all other trusts, known as “complex trusts,” the distribution deduction may exceed FAI because the distributions of those trusts do not benefit income beneficiaries exclusively; principal beneficiaries and charitable beneficiaries may receive distributions as well. To the extent the trust has DNI, the distribution will be subject to tax.

To illustrate, suppose that a simple trust has stock dividends of \$1000 and capital gains of \$500, and that applicable state law allocates capital gain to principal. In that case, FAI will equal \$1000 and the taxable income before accounting for the distribution deduction would be \$1200 (the sum of the \$1000 stock dividends and the \$500 capital gains less the \$300 personal exemption). The DNI of the trust will be \$1000, representing the taxable income before accounting for the distribution deduction less the capital gains plus the personal exemption. In this case, DNI will equal FAI and the income beneficiaries will be taxed on the distributions of income (as determined under state law) that they actually receive.

60. Zaritsky et al., *supra* note 48, at ¶ 3.05[2] (citing the following examples of receipts that may cause DNI to exceed FAI: depreciation recapture on the sale of depreciable assets under §§ 1245 and 1250; recapture of intangible drilling cost deductions under § 1254; undistributed income of an S corporation of which the trust is a shareholder, IRC §§ 1361-1368; undistributed income realized by a controlled foreign corporation of which the trust is a shareholder, IRC §§ 951-964; items of income in respect of a decedent which are allocable to principal under state law, IRC § 691; and imputed income under the original issue discount rules. IRC §§ 1271-1275).

61. *Id.* note 48, at § 3.05[3] (citing deductible business expenses under § 162, investment expenses under § 212 and deductible losses as examples of expenditures that may cause FAI to exceed DNI).

62. IRC §§ 651(a) and (b), 661(a). For purposes of computing the distribution deduction, DNI excludes items which are not included in the gross income of the trust and deductions allocable to those items. IRC §§ 651(b), 661(c).

63. The term “simple trust” is not used in the Code, but it is used in the regulations. See Regs. § 1.651(a)-1.

2. Other Adjustments to the Formula for Taxable Income

Apart from the distribution deduction, the formula for computing taxable income established in Subchapter J differs from the formula for computing taxable income of individuals in two respects. First, the personal exemptions available to trusts are lower than those available to individuals.⁶⁴ Second, the standard deduction is unavailable to trusts.⁶⁵ These allowances, provided to taxpayers without regard to whether the taxpayer actually incurs expenditures that they exist to cover, define how the Code equates the situation of trust beneficiaries to other individuals.

The personal exemption for trusts differs from the personal exemption for individuals in both amount and in underlying rationale. For individuals, the personal exemption is allowed in an amount indexed for inflation,⁶⁶ which is \$3200 for 2005.⁶⁷ The personal exemption for trusts is meager, in contrast, either \$300 or \$100, neither being indexed for inflation.⁶⁸

The rationale of the personal exemption for individuals is to exempt from the tax base the income consumed by basic living expenses and thus unavailable to pay tax.⁶⁹ The financial benefit afforded by the personal exemption has varied over time, but the symbolic value of acknowledging that subsistence itself requires consumption has remained unchanged.⁷⁰ This rationale is inapplicable to trusts because trusts, by definition, incur no living expenses.⁷¹

The justification for granting a personal exemption to trusts is to eliminate the need for tax filings when the income of the trust is *de minimus*.⁷² The amount of the personal exemption is \$600 for an estate, \$300 for a trust that

64. Compare IRC § 151 (personal exemptions for individuals) with IRC § 642(b) (personal exemptions for trusts and estates).

65. IRC § 63(c)(6)(D).

66. IRC § 151(d)(4)(A). An individual can claim additional personal exemptions for a spouse with whom the individual files a joint return and certain dependents. IRC § 151(d)(4). An additional personal exemption is available for 2005 and 2006, up to a cumulative total of \$2000, for individuals who house victims of Hurricane Katrina. Katrina Emergency Tax Relief Act of 2005, P.L. 109-73, § 302, 199 Stat. 2016 (2005).

67. Rev. Proc. 2004-71, 2004-2 C.B. 970.

68. IRC § 642(b).

69. See, Thomas M. Humbert, *Ending the Tax Code's Anti-Family Bias by Increasing the Personal Exemption to \$6300*, *The Heritage Foundation*, Jan. 30, 1989.

70. *Id.*

71. Zaritsky, et al., *supra* note 48, at ¶ 2.03 n.7.

72. *Id.*

distributes all of its income, and \$100 for all other trusts.⁷³ The differences in these amounts are negligible financially, but important symbolically. The involuntary nature of an estate, as contrasted with the voluntary nature of a trust, justifies a larger exemption for estates.⁷⁴ Similarly, the difference between the personal exemptions for trusts reflects a difference in the degree of necessity for each type of trust. A trust that distributes all of its income serves current beneficiaries' needs, whereas a trust that accumulates some or all of its income serves (at least in part) the purely discretionary objective of accumulating wealth for the future.⁷⁵

Like the personal exemption, the standard deduction is fixed in amount, with no documentation requirements.⁷⁶ The amount of the basic standard deduction, which is indexed for inflation, ranges in 2005 from \$5,000 to \$10,000, depending on the filing status of the taxpayer.⁷⁷ The purpose of the standard deduction is to eliminate the need for individuals who incur only typical expenditures to maintain records that establish entitlement to specific itemized deductions.⁷⁸ In addition to alleviating an administrative burden, the standard deduction confers an economic benefit on individuals to the extent that the standard deduction exceeds the amount of their actual deductible expenditures. These benefits are available only to individuals who do not claim any itemized deductions; an individual cannot claim both the standard deduction and itemized deductions.⁷⁹

The rationale of the standard deduction is inapplicable to trustees, who have an obligation to keep records of their expenditures and other transactions.⁸⁰ The effect of denying the standard deduction to trusts is to maintain equity

73. IRC § 642(b).

74. Zaritsky, et al., *supra* note 48, at ¶ 2.03 n.7.

75. *Id.*

76. James Edward Maule and Lisa Maria Starcewki, *Deductions: Overview and Conceptual Aspects*, 503-2nd Tax Mgmt.(BNA) at A-25.

77. IRC § 63(c)(2). An additional standard deduction in the amount of \$1,000 for 2005 (\$1,250 for an unmarried taxpayer who is not a surviving spouse qualified to use the rates that apply to joint return filers) is available to taxpayers based on advanced age or blindness; taxpayers qualifying under both categories are entitled to two additional standard deductions. IRC § 63(c)(3), (f). The amounts adjusted for inflation for 2005 are set forth in Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

78. Maule & Starcewski, *supra* note 76, at A-25.

79. IRC § 63(b)(1).

80. Unif. Trust Code § 810, 7C U.L.A. 300 (West Supp. 2005).

between trust beneficiaries and other individuals by allowing the economic benefit of the standard deduction to both in equal amounts.⁸¹

The availability of the standard deduction to individuals requires them to compute adjusted gross income (“AGI”).⁸² AGI is a benchmark that separates deductions into two categories: the “above the line deductions” that are available to all individual, and the itemized (or “below the line”) deductions that are unavailable to individuals who claim the standard deduction. Computation of AGI clarifies whether the standard deduction or the itemized deductions provide a greater tax benefit.⁸³ Thus, the formula for computing taxable income of an individual is:

$$\begin{array}{r} \text{Gross Income} \\ \text{(Above the Line Deductions)} \\ \text{Adjusted Gross Income} \\ \text{(Below the Line Deductions OR Standard Deduction)} \\ \hline \text{Taxable Income}^{84} \end{array}$$

For trusts, which are not entitled to elect the standard deduction, computation of AGI had no relevance until section 67(e) was enacted. Before

81. See Ferguson, *supra* note 40, at § 5.02[C] (allowing trusts a standard deduction would unfairly duplicate the benefit of the standard deduction for trust beneficiaries).

82. Adjusted gross income is equal to gross income less “above the line” deductions, which are allowable regardless of whether the taxpayer itemizes or claims the standard deduction. These preferred deductions include: trade and business deductions, certain trade and business deductions of employees, losses from the sale or exchange of property, deductions attributable to rents and royalties, alimony, retirement contributions by self-employed individuals, moving expenses, and a handful of other deductions. IRC § 62(a).

83. In addition to facilitating the decision whether to claim the standard deduction, AGI serves as a threshold for determining the availability of a few of the itemized deductions. See, IRC §§ 170, 213 (itemized deductions for charitable contributions and medical expenses).

84. IRC § 63.

that time, the formula for computing the income of a trust that would be allocated between the trust entity and its beneficiaries was:⁸⁵

Gross income
(Deductions for Documented Expenditures)
(Personal Exemption)
Tentative Taxable Income⁸⁶

III. HOW THE MIDDLE CLASS SLIPPED THROUGH THE CRACKS IN THE TWO PERCENT FLOOR

The concept of AGI became relevant to trusts when the most recent overhaul of the Code, the Tax Reform Act of 1986 (“TRA 1986”),⁸⁷ introduced sweeping changes in most areas of income taxation. This overhaul left Subchapter J’s basic framework for computing taxable income of trusts and their beneficiaries intact,⁸⁸ but alterations to the basic formula for computing taxable income of individuals raised the question of how to maintain the preexisting horizontal equity between trust beneficiaries and other individuals.

A. The Two Percent Floor on Miscellaneous Itemized Deductions

The change in the formula for computing taxable income of individuals added a limitation on the amount of itemized deductions that individuals could claim. This provision, codified in section 67 of the Code and known as the 2% floor, disallowed deductions for a portion of a taxpayer’s expenditures that otherwise would have qualified under specific deduction provisions of the Code in an amount equal to 2% of the taxpayer’s adjusted gross income (AGI).⁸⁹ Section 67 had no bearing on the standard deduction, which is available to those

85. IRC § 641(b).

86. The final step in the computation would be the deduction for distributions to beneficiaries. This deduction would allocate the taxable income of the trust between the beneficiaries, who would be taxed to the extent of distributions received, and the trust, which would be taxed on the income it retained. See *supra* notes 49-63 and accompanying text.

87. The Tax Reform Act of 1986, P.L. 99-514, § 132(a), 100 Stat. 2085, 2113-16.

88. See Jonathan G. Blattmachr & Arthur M. Michaelson, *Income Taxation of Estates and Trusts* 2.1, at 2.2 n.2. (14th ed. 2003).

89. See *supra* note 84.

individual taxpayers who choose not to itemize deductions,⁹⁰ nor did it affect above the line deductions that are subtracted from gross income in order to arrive at AGI.⁹¹ Instead, section 67's limitation applied only to "miscellaneous itemized deductions," a new category of deductions that included all but 12 of the itemized deductions.⁹²

Section 67's 2% floor is the converse of the standard deduction: whereas the standard deduction affords a tax benefit for undocumented expenditures, the 2% floor denies a tax benefit for documented expenditures. Consequently, the net effect of section 67 is to decrease the benefit of itemizing deductions and correspondingly increase the likelihood that individuals will forego the itemized deductions, instead claiming the standard deduction.

To illustrate, assume Taxpayer has gross income of \$120,000, "above the line" deductions of \$20,000, resulting in AGI of \$100,000. Documented itemized deductions, all of which fall within the definition of "miscellaneous itemized deductions" amount to \$4,500, and the available standard deduction is equal to \$3,000. In the absence of section 67, Taxpayer would choose to itemize deductions rather than claiming the standard deduction, reporting taxable income of \$95,500 rather than \$97,000. With section 67, Taxpayer would claim the standard deduction because section 67 would reduce the itemized deductions to \$2,500 (\$4,500 documented deductions less \$2,000 (2% of \$100,000)).

The principal purpose of section 67 is to curtail perceived overuse and abuse of itemized deductions, particularly those that serve policy objectives other than accurate measurement of net income.⁹³ Rather than amending

90. IRC § 67(a).

91. IRC §§ 63(b), 63(d)(1), 67(a).

92. The 12 itemized deductions that are outside the definition of miscellaneous itemized deductions included deductions for: (1) interest (IRC § 163), (2) taxes (IRC § 164), (3) certain casualty, theft and wagering losses (IRC § 165), (4) charitable contributions (IRC § 170 for individuals and IRC § 642(c) for fiduciaries), (5) medical expenses (IRC § 213), (6) impairment related work expenses (available under multiple Code sections), (7) estate taxes paid that are attributable to items that are also subject to income tax after the date of the decedent's death (IRC § 691(c)), (8) person al property used in a short sale (available under multiple Code sections), (9) items previously included in gross income and subsequently refunded by the taxpayer to the original payor (IRC § 1341), (10) cessation of annuity payment before full recovery of investment (IRC § 72(b)(3)), (11) amortizable bond premium (IRC § 171), and (12) certain expenditures of cooperative housing corporations (IRC § 216).

93. The overuse of the included deductions stemmed in part from taxpayer errors and in part from the dual business-personal nature of many miscellaneous expenses. See, Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess.,

problematic deduction provisions of the Code or increasing enforcement of tax laws, Congress chose to simply deny a small percentage of the targeted deductions. This approach, undoubtedly simpler for Congress to enact than the alternatives, was billed as a simplification measure for taxpayers as well.⁹⁴ By raising the threshold at which itemizing deductions would be tax effective, section 67 would channel a greater number of taxpayers into the standard deduction.⁹⁵ Finally, the 2% floor was justified as a means to offset the revenue losses that other aspects of the 1986 overhaul of the Code were expected to produce.⁹⁶

General Explanation of the Tax Reform Act of 1986, 78-79 (Comm. Print 1987) [hereinafter “TRA 1986 Bluebook”]. Common errors mentioned included disregard of restrictions on home office deductions, disregard of limitations on the deduction for educational expenses, claiming deductions for safe deposit box fees that were used solely for personal purposes; and deducting the cost of subscriptions to business publications that had an insufficient business or investment purpose. *Id.* at 78 n.52. Elaborating on the overlap between business and personal interests, the Bluebook states:

The [2% floor] takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.

Id. at 79.

94. *Id.* at 78 (noting that deduction for investment expenses and other miscellaneous itemized deductions fostered significant complexity and imposed enforcement burdens on the IRS for relatively small amounts). The 2% floor, along with the alternative minimum tax and the phase out of itemized deductions under § 68, all increase taxes without repealing specific deductions. This “budget gimmickery” is inconsistent simplification. Cf. John Buckley, *The Tangled Web of the Individual AMT*, 108 *Tax Notes* 347. (July 18, 2005).

95. See TRA 1986 Bluebook, *supra* note 93, at 78. (“[The 2%] floor will relieve taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor.”)

96. The estimated budget effects of TRA 1986, set forth in the TRA 1986 Bluebook, group the changes to all miscellaneous itemized deductions together with employee business expenses, hobby losses, and business use of homes. See *id.* at 1360, Table A-2. The revenue increase attributable to these changes for the period 1987-1991 was projected to be \$19,447,000,000. *Id.*

1. The Dilemma about Trusts

The formula for computing taxable income for trusts, as it existed prior to the enactment of section 67, created a policy dilemma about the applicability of the 2% floor to trusts. Trusts computed taxable income by deducting the personal exemption, and other expenditures that qualified under the provisions of the Code, to arrive at tentative taxable income that would then be allocated between the trust and its beneficiaries.⁹⁷ The income remaining after the allocation to beneficiaries was the income taxable to the trust. This formula required no computation of AGI, because the principal function of AGI is to segregate above the line and below the line deductions in order to facilitate the decision whether to elect to itemize rather than claim the standard deduction.⁹⁸ Trusts were (and are) ineligible for the standard deduction, and so they simply claim the deductions to which they are entitled, however modest they might be.

The inverse relationship between the standard deduction and the 2% floor might seem to suggest that trusts ought not to be subject to the limitations of section 67. If trusts cannot claim the standard deduction, the 2% floor cannot serve the purpose of reducing recordkeeping by channeling these taxpayers into the standard deduction. Moreover, section 67's rationale of curtailing use of deductions serving policy objectives other than accurate measurement of net income⁹⁹ is largely inapplicable to trusts because trusts, by their nature, exist to produce income (or at least returns on property)¹⁰⁰ and correspondingly incur

97. IRC § 641(b).

98. See *supra* note 82.

99. See *supra* note 93.

100. The obligation of trustees traditionally required production of income, and preservation of principal as well, in order fulfill duties to income beneficiaries and remaindermen. This income-principal dichotomy distorted investment decisions, because the trustee was obliged to generate "income" as defined under state law (e.g., dividends, interest) rather than maximizing the total return from the trust. To avoid this distortion, the modern trend is to define "income" for state law purposes as a fixed return on trust assets (e.g., 4%) so that the trustee can invest for total return without jeopardizing the interests of either income beneficiaries or remaindermen. See, e.g., NY Est. Powers & Trusts Law § 11-2.4 (McKinney Supp. 2006) (authorizing election to define income as a fixed percentage). See generally, W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 Wash. & Lee L. Rev. 335 (1997).

expenses for the purpose of producing income rather than to serve consumptive ends.¹⁰¹

On the other hand, it would be inequitable to impose a limitation on deductions of individuals without imposing the same limitation on trusts. Although trusts do not incur the type of personal (non-income producing) expenditures that prompted enactment of section 67, trusts could (and can) claim any itemized deduction (as well as any above the line deduction) for which they qualify, including the miscellaneous itemized deductions to which section 67's limitation applies.¹⁰² If the Code were to subject individuals to deduction limitations while exempting trusts from the identical limitations, it would discriminate on its face in favor of existing trusts and those individuals who were positioned to transfer their assets in trust to secure this income tax advantage.¹⁰³ To avoid this possibility, Congress extended the applicability of section 67 to trusts.¹⁰⁴

The decision to subject trusts to section 67 advanced the goal of horizontal equity between trust beneficiaries and other individuals by assuring the same type of expenditure would be subject to the same deduction limitations regardless of who incurred the expenditure. A policy question remained, however, about how to define horizontal equity with respect to expenditures by trusts that did not parallel expenditures by individuals.¹⁰⁵

101. Examples of deductions serving consumptive ends include the deductions for and interest on home mortgages and medical expenses. See IRC §§ 163(h)(2)(D), (3), and 213.

102. IRC §§ 641(b), 642.

103. It seems unlikely that the tax savings would ever exceed the cost of creating and administering the otherwise unnecessary trust. Stanford L. Stevenson III, Note, *The Standard for Fully Deductible Trust Expenses Under Section 67(e): O'Neill Irrevocable Trust v. Comm'r*, 46 Tax Law 655, 661 (1993). Nevertheless, the appearance of fairness supports the application of the floor to trusts so long as it does not produce actual unfairness.

104. See, TRA 1986 Bluebook *supra* note 93, at 81.

105. This is a policy question because AGI is not a theoretically pure concept. The Code's basic division of deductions as above the line or below the line reflects, in at least a general way, the distinction between business expenses that reduce the income available to individuals to pay for their living expenses and other personal consumption, on the one hand, and other deductions which the Code allows for a variety of policy and political reasons. Boris I. Bittker et al., *Federal Income Taxation of Individuals* ¶ 2.1[3] (3d ed. 2002). The classification of several deductions, however, violates this conceptual distinction. See, e.g., IRC § 62(a)(17) and (18) (deductions for interest on education loans and higher education expenses under §§ 221 and 222 classified as "above the line deductions"); IRC § 212 (deduction for expenses incurred for the production of income classified as an itemized deduction).

One view of horizontal equity would subject all expenditures of trusts qualifying for deductibility under a section of the Code identified as a miscellaneous itemized deduction to the 2% floor. Although trusts might incur expenditures that had no analogue in the context of outright ownership of income-producing property, the expenditures arguably would be analogous nevertheless to expenditures of individuals because the Code would classify them analogously based upon the attributes that cause the expenditures to fall within the parameters of a miscellaneous itemized deduction.

The alternative view, equally viable as an implementation of horizontal equity, would allow full deductibility for expenditures of trusts that had no analogue in the context of outright ownership of income producing property. The absence of analogous expenses in the context of outright ownership would justify differential treatment. The deduction provisions of the Code would not identify these expenditures, but this category of expenditures undoubtedly did exist by virtue of the fact that holding property in trust costs more than holding property outright. These additional costs would not need to be subjected to the 2% floor in order to prevent individuals from using trusts to circumvent the 2% floor because an individual, by definition, would not incur them.

When two alternative views of horizontal equity are justifiable, the choice of which to adopt depends upon other considerations. In this context, the principal consideration is how important it is to subsidize the cost of holding property in trust. If trusts serve important objectives, or benefit individuals particularly meriting relief, a full above the line deduction for costs that do not parallel individual expenditures is appropriate. Conversely, if the purpose of trusts is not particularly important from a societal perspective, or they benefit individuals who hold no particular claim to tax relief, then subjecting all trust expenses falling within the ambit of the miscellaneous itemized deductions to the 2% floor would be appropriate.

2. The Statutory Resolution

Congress chose to exempt from the 2% floor expenditures of trusts that had no analogue in the context of outright ownership, reflecting the view that trusts serve important objectives. To this end, section 67(e) provides:

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that –

(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and

(2) the deductions allowable [for the personal exemption and distributions to beneficiaries] shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made [to Subchapter J] to take into account the provisions of this section.

This statutory framework identifies Congress' view of equity as between trust beneficiaries and other individuals in a general way, but it offers no detailed guidance as to how to bring about the intended result. Recognizing the need to coordinate the 2% floor with Subchapter J's elaborate provisions for taxing the income of trusts and their beneficiaries, Congress authorized the Treasury to issue legislative regulations to achieve this coordination.¹⁰⁶ On the less technical question of what "[expenditures] would not have been incurred if the property were not held in [trust]," Congress relied upon the availability of interpretive guidance, through either administrative promulgation or judicial decision, to provide the necessary elaboration.¹⁰⁷

B. Judicial Interpretations

The exemption from the 2% floor for costs that "would not have been incurred if the property were not held in [trust]" covers the costs attributable to trust ownership, as contrasted with the costs an outright owner would have incurred to manage the property.¹⁰⁸ This statutory standard offers no direct guidance about how to determine which costs are attributable to trust ownership.

The preexisting concept of AGI offers no guidance either, because that concept differentiates business from personal expenditures.¹⁰⁹ Under this bifurcation, all trust expenses should be above the line deductions because the function of a trust is to manage assets, and the only expenses trusts can incur

106. IRC § 67(e) (flush language).

107. IRC § 67(e)(1).

108. See *id.*

109. See *supra* note 105.

relate, directly or indirectly, to asset management.¹¹⁰ Yet expenses incurred for the production of income and asset management are deductible under section 212, which is classified as an itemized deduction, and under section 67(b), a miscellaneous itemized deduction.¹¹¹ This conceptual conflict between AGI and the classification of section 212's deduction for asset management expenses precludes any reasoned differentiation in the types of expenditures that trusts incur.

Not surprisingly, in the 20 year history of section 67(e) courts have splintered in their interpretations of the scope of the exemption for trust expenditures.¹¹² These include seven decisions by six courts that produced, among them, three different tests for determining which expenditures of trusts would be exempt from the 2% floor.¹¹³ All three tests focus on attributes of expenditures, but none identify the expenditures that are common to trusts and outright owners in a substantive, workable way.

1. The Profit-Maximizing Taxpayer v. The Cost-Averse Taxpayer

The first case to arise, *O'Neill v. Comm'r*, involved the smallest trust, a fund in excess of \$4.5 million established in 1965 for subsequent generations of the grantor's family.¹¹⁴ The trustees, individuals who had no expert

110. See supra note 19. A trust never incurs expenses for its own personal consumption because the trust entity cannot itself consume. A trustee may use assets of the trust to pay personal expenses of beneficiaries, but these payments are equivalent to distributions to the beneficiaries rather than costs of the trust. See, e.g., *Alfred I. duPont Testamentary Trust v. Comm'r*, 514 F.2d 917 (5th Cir. 1975) (expense of maintaining beneficiary's residence was not expense incurred for the conservation of property within the meaning of IRC § 212).

111. See supra note 92.

112. *Scott v. US*, 186 F. Supp. 2d 664 (E.D. Va. 2002), *aff'd*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. U.S.*, 47 Fed. Cl. 186 (2000), *aff'd*, 265 F.3d 1275 (Fed. Cir. 2001); *O'Neill v. Comm'r*, 98 T.C. 227 (1992), *rev'd*, 994 F.2d 302 (6th Cir. 1993); *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304 (2005), *app. pend.* (2nd Cir.).

113. These include a plain meaning interpretation classifying expenditures by their label, *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304 (2005); a plain meaning interpretation classifying expenditures based on the incremental difference in the amount of expenses expected by trusts and those expected by individuals, *Mellon Bank, N.A. v. U.S.*, 47 Fed. Cl. 186 (2000), *aff'd*, 265 F.3d 1275 (Fed. Cir. 2001); and an interpretation that determines deductibility based on whether the expenditure is mandatory for trusts but discretionary for individual. *O'Neill Irrevocable Trust v. Comm'r*, 994 F.2d 302 (6th Cir. 1993), *rev'd* 994 F. 2d 302 (6th Cir. 1992).

114. 98 T.C. at 228.

knowledge about investment, declined trustees' commissions and instead hired an investment advisor. The Tax Court concluded that an individual would incur investment advisory expenses, and accordingly, held that those expenses were subject to the 2% floor.¹¹⁵ On appeal, the 6th Circuit reversed.¹¹⁶

In the Tax Court's view, the plain meaning of section 67(e) exempts from the 2% floor only expenditures that are unique to trusts.¹¹⁷ As a different court later expressed the Tax Court's interpretation, the question is whether the expense at issue is "commonly incurred outside the administration of trusts."¹¹⁸ Trustees' fees, for example, would be fully deductible according to dictum in the Tax Court's *O'Neill* decision, because individuals, by definition, would not pay trustees' fees.¹¹⁹ Investment advisory fees, in contrast, would be subject to the 2% floor because individuals routinely incur this type of expense.¹²⁰

This standard is an objective standard, in the Tax Court's view, because subjective considerations cannot influence the scope of the exemption of trust expenses from the 2% floor.¹²¹ Thus, the outright owner contemplated by section 67(e) cannot be an actual individual associated with the trust (the beneficiary, the trustee, or the grantor). Instead, the outright owner who defines the scope of the exemption must be a hypothetical taxpayer.

The Tax Court did not explicitly discuss the attributes of the hypothetical taxpayer that would influence expenditure decisions, but the holding seems most consistent with a standard defined by a hypothetical taxpayer who would incur any and all discretionary expenses that would produce income and maximize return (a "profit-maximizing taxpayer"). The Tax Court's holding in *O'Neill* precludes the possibility that the outright owner

115. *Id.* at 231.

116. *O'Neill*, 994 F. 2d at 304-05.

117. *O'Neill*, 98 T.C. at 230.

118. *Scott*, 328 F.3d at 140.

119. 98 T.C. at 230. In addition to fiduciary commissions, fees for a trust accounting mandated by state law or the trust agreement also would qualify as unique to trusts and estates, and thus qualify for the exemption from the 2% floor in the view of the Tax Court. *Id.*

120. *Id.* at 230.

121. *Id.* at 231. The Tax Court discussed the need for objectivity in the § 67(e) standard in the course of rejecting the argument that the fiduciary duty to invest prudently, imposed by state law, obliged the trustees to hire an investment advisor. *Id.* at 230-31. After rejecting the argument that state law compelled expertise in the management of trust assets, the Tax Court stated that discretionary judgments of trustees could not define the scope of the exemption of trust costs from the 2% floor. *Id.* at 231. The objection to subjectivity, though framed in terms of the trustee, would apply equally to a standard defined by any actual individual.

contemplated by section 67(e) is a hypothetical taxpayer who refuses to incur any non-compulsory expenditures (a “cost-averse taxpayer”). The holding does not preclude a standard defined by a reasonable taxpayer, the most intuitive choice. The Tax Court’s rationale, however, is inconsistent with a reasonable taxpayer standard because a reasonable taxpayer would not necessarily incur expenses that other individuals routinely incur. Instead, a reasonable taxpayer would make decisions based on his or her own financial situation.

The 6th Circuit, the first appellate court to interpret section 67(e), rejected the Tax Court’s “plain meaning” interpretation, as well as its underlying factual assumption that an outright owner would incur investment advisory fees.¹²² Rather than attempting to analyze what expenses an outright owner would avoid, the 6th Circuit analyzed what expenses a trust could avoid. Discretionary expenses incurred by trusts would be analogous to expenses incurred by individuals, in the 6th Circuit’s view, because both taxpayers would have the freedom to incur or avoid them. Compulsory expenditures incurred by trustees to fulfill the fiduciary duties established by state trust law, however, had no analogue in the outright ownership context.¹²³ The 6th Circuit held that investment advice fell into the compulsory category in the case of the *O’Neill* trust because applicable state law required expertise in the investment of trust assets.¹²⁴ The trustees did not have this expertise, and did not receive compensation for providing this service as a result of their decision to waive fiduciary commissions.¹²⁵ Consequently, the Court held that investment advisory fees for this trust were exempt from the 2% floor.¹²⁶

This interpretation implicitly assumes that the outright owner contemplated by section 67(e) is a cost-averse taxpayer, who avoids all discretionary expenditures. Although the 6th Circuit framed its interpretation in terms of costs that a trust could avoid, as opposed to costs that an outright

122. *O’Neill*, 994 F.2d at 304-05.

123. *Id.* at 304.

124. *Id.* The 6th Circuit rejected the Tax Court’s conclusion that the trustees had no obligation to seek investment advice because the Tax Court erroneously relied on Ohio’s statutory list of prudent investments to support its conclusion that investing in those assets would fulfill the duty to invest prudently. *Id.* As the 6th Circuit noted, prudent investment requires diversification as well as continuing judgment about specific investments on an ongoing basis. *Id.* See also, Craig D. Bell & Julie A. King, Sweeping Up the Two Percent Floor: *Scott v. United States* and the Deductibility of Investment Advisory Fees, 38 *Real Prop. Prob. & Tr. J.* 589, 606-07 (2003).

125. *O’Neill*, 994 F.2d at 303.

126. *Id.* at 304.

owner would avoid if he or she were cost averse, the results under both formulations are identical.

The two formulations seemingly produce different results for two categories of expenditures: (1) those that would be compulsory for both trusts and individuals, and (2) expenditures never incurred by individuals that could be incurred voluntarily by trusts. The reason these two categories of expenditures do not produce different results under the 6th Circuit's interpretation and a cost-averse taxpayer interpretation is that both categories of expenditures are empty sets.

Neither category of expenditure describes any actual cost because asset management expenses (the only type of expenses that come within the scope of section 67(e)),¹²⁷ are never compulsory for individuals and never voluntary for trusts.¹²⁸ The specific amount of the expenses that a trust will incur depends upon who provides services to the trust and the compensation arrangements for those service providers.¹²⁹ State law does not mandate any particular choice, but it does impose the obligation to ensure that the necessary services are provided at reasonable cost. Hiring an investment advisor to perform services for which the trustee is already receiving compensation, for example, would be a breach

127. The reason that only asset management expenses come within § 67(e) is that the only function of a trust is to hold assets for the benefit of others, and thus the only costs trusts can incur and costs that advance this purpose. See *supra* note 19.

128. Trust expenditures may fall within deduction provisions other than § 212, such as interest (deductible under § 163) and taxes (deductible under § 164). Apart from those two items, neither of which are miscellaneous itemized deductions subject to the 2% floor, § 67(b), fiduciary fees and payments to other service providers are the only significant categories of deductible items paid by trusts. See, *Fiduciary Returns Filed for Tax Year 2002: Income Source, Deductions, and Tax Liability, classified by size of Gross Income*, at <http://www.irs.gov/pub/irs-soi/02fi01gi.xls>. See also, Donald M. Etheridge, Jr. *The 2% Solution for Miscellaneous Deductions after TRA_86*, *Prob. & Prop. Jan.-Feb. 1989*, at 28, 29. (noting that the principle expenses of trusts are fees to service providers).

129. The professional corporate fiduciary typically offers more services and charges larger commissions than an individual trustee. See, e.g., *In re Estate of Prankard*, 723 N.Y.S. 2d 315, 324 (Surr. Ct. 2000) (discussing the nature of services provided by corporate fiduciaries and the justifications for compensating them more generously than individual trustees).

of fiduciary duty.¹³⁰ Every legitimate expenditure of a trust, in other words, is traceable to a fiduciary duty.

The voluntary-discretionary distinction crafted by the 6th Circuit captures one, if not the only, defining difference between expenditures of trusts and those of outright owners. Furthermore, this distinction correlates with the business-personal distinction that separates above the line and below the line deductions. Like business expenses, trust expenses reduce the amount of income that the taxpayer actually receives from income-producing activities. These expenses have no personal or consumptive element to them because fiduciary duties limit expenditures to those that will produce a financial benefit.

The problem with this interpretation is that it amounts to a justification for treating all asset management expenses as above the line deductions. This is inconsistent with the classification of section 212 as a below the line deduction, as well as the statutory mandate to exempt some, but not all, trust expenses from the 2% floor.¹³¹ Recognizing this, all of the cases arising after *O'Neill* rejected that approach, and its corollary assumption that the cost-averse taxpayer defines the expenditures that “would not have been incurred if the property were not held in [trust].”¹³²

2. *Incremental Costs v. Categorical Costs*

The cases following *O'Neill* each involved long-term multi-million dollar trusts, a context in which the profit-maximizing taxpayer, the reasonable taxpayer, and the trustee who actually incurred the expenses would be

130. A well-respected treatise states:

A trustee should not receive credit for payments made to obtain the services of others for the trust, when the duties thus delegated should have been performed by the trustee himself. He cannot delegate the various tasks of the trusteeship to specialists, make payments from the trust funds to them for their services, reserve to himself merely the positions of employer and supervisor, and still collect a full commission for being trustee.

George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees*, § 972 at 433-35(2d ed. rev. 1983).

131. See *supra* note 105. Despite the similarities between asset management expenses and business expenditures, the differential treatment has a long history of support. *Higgins v. US*, 312 U.S. 212 (1941), superceded by IRC § 212(i).

132. See *Mellon Bank*, 47 Fed. Cl. at 186, *Scott*, 186 F. Supp. 2d at 664; *Rudkin*, 124 T.C. at 304.

synonymous.¹³³ The profit-maximizing taxpayer would incur all expenses designed to maximize income. The reasonable taxpayer would do the same because the assets would produce income greater than the outlays necessary to meet that taxpayer's expenses. The trustee, of course, did incur the expenses at issue, and so those expenses would be expenses incurred by an outright owner if the trustee's expenditures defined the expenses an outright owner would incur.

These later cases did not consider how, if at all, a reasonable taxpayer would differ from either a profit-maximizing taxpayer or the trustee who incurred the expenses, nor did the later cases consider the circumstances that would lead a reasonable individual to incur (or avoid) particular expenditures. Rather than searching for a basis to determine what costs an individual would incur, the courts analyzed trust expenditures in an attempt to find something about the expenditure that would reveal whether, or to what extent, an individual who owned the trust property outright would have incurred the same cost. Two different approaches emerged from this analysis: an incremental approach to identifying trust expenses exempt from the 2% floor articulated by the Court of Federal Claims,¹³⁴ and a categorical approach to identifying those trust expenses essentially identical to the Tax Court's formalistic approach.¹³⁵

In the first case to arise after *O'Neill, Mellon Bank, N.A. v. U.S.*, the Court of Federal Claims considered whether section 67(e) would allow 13 trusts created for the benefit of members of the Richard K. Mellon family to deduct fees paid to private investment advisors for investment strategy advice, as well as fees paid to Richard K. Mellon & Sons for accounting, tax preparation, and management services rendered to the trusts.¹³⁶ These deductions were claimed in addition to a deduction for trustees' commissions paid to Manufacturers' Hanover, a professional trustee.¹³⁷

The famously wealthy family, the sheer number of trusts involved, and the utilization of a family-owned entity to provide services typically provided by corporate trustees, highlighted the financial privilege that this trust

133. *Scott*, 328 F.3d at 136 (trust valued at \$25 million); Brief for Appellant at 4, *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001) (No. 01-5015) (combined trusts assets worth more than \$500 million). For the *Rudkin* case, publicly available documents do not state the value of the trust, but the decision does state that the trust's total income was \$624,816 for the year 2000). *Rudkin*, 124 T.C. at 306.

134. *Mellon Bank*, 47 Fed. Cl. at 189.

135. *O'Neill*, 98 T.C. at 227.

136. 47 Fed. Cl. at 188.

137. *Id.*

represented.¹³⁸ A reasonable taxpayer who held this wealth outright would pursue long term wealth maximization and, consequently, would incur profit-maximizing expenditures.

Recognizing this, the Court of Federal Claims followed the Tax Court in adopting the uniqueness test, and in using the profit-maximizing taxpayer as the implicit benchmark for comparing the expenditures of trusts and individuals.¹³⁹ The Court of Federal Claims differed from the Tax Court, however, because it sought to identify the uniqueness of trust expenditures based on the underlying services received by the trust in exchange for particular payments, rather than the label applied to the payments:

[T]he fact that costs can be characterized as trustee fees in a trust context says nothing about whether those costs would not have been incurred in a non-trust context. When a trustee assumes responsibility over trust property, the trustee must perform a variety of tasks, some of which are unique to a trust and some of which would have to be performed even if the property were not held in trust. Hence, characterizing the fees paid for the performance of these tasks as trustee fees and determining whether or not those fees would have been incurred in the absence of a trust are independent and not logically related inquiries. Whether costs for particular services can be characterized as trustee fees is not mentioned as a factor in IRC section 67(e)(1) and is simply not relevant to the application of the statute's plain meaning.¹⁴⁰

Under the Tax Court's more formalistic view, the expenditure would be exempt from the 2% floor if the label of the expenditure connoted a trust relationship, such as trustees' commission or trust accounting fees.¹⁴¹ In contrast, the Court of Federal Claims' approach would scrutinize the content of the services received in consideration for the trust's payment to determine whether individuals would be likely to incur similar expenses.¹⁴² This approach would require an analysis of the functions performed by the trustees, and a

138. The history of the financial institutions founded by the Mellon family is summarized at www.mellon.com/aboutmellon/history.html.

139. 47 Fed. Cl. at 190.

140. *Id.*

141. *O'Neill*, 98 T.C. at 230.

142. *Mellon Bank*, 47 Fed. Cl. at 189-90.

parceling of the deduction for trustees' fees based upon that task-based analysis.¹⁴³

The Court of Federal Claims' approach avoids the form over substance problem that the Tax Court's approach creates, recognizing that the difference between trust costs and outright ownership costs are a matter of degree rather than a difference in kind. Another virtue of the Court of Federal Claims' approach is that its rationale is more consistent with an interpretation of section 67(e) based on expenditures that a reasonable taxpayer would incur rather than those that a profit-maximizing taxpayer would incur. Specifically, the Court observed that the prudent person standard imposed by law on fiduciaries paralleled the investment behavior of a prudent individual.¹⁴⁴ This suggests that the hypothetical individual who defines the scope of section 67(e) would incur all of the expenditures that the trustees of the Mellon trusts incurred because compliance with state trust law requires adherence to a standard of prudence which a reasonable person would follow.

The problem with this approach is that it is inordinately, indeed impossibly, complex, without the addition of simplifying assumptions that have no basis in the Code. A simple example is the cost of preparing income tax returns. A trust may incur deductible expenses for the preparation of its income tax return (Form 1041), but an individual with similar assets would incur similar expenses for the preparation of an individual income tax return (Form 1040).¹⁴⁵ The collective costs for income tax return preparation typically will be greater when assets are held in trust, because both the trust and the beneficiaries have to prepare returns whereas the individual owner has only a single return to prepare. On the other hand, the amount of work required to prepare an income tax return (and thus the cost) depends much more on the income produced and the assets that produce it than on the owner of those assets.

No existing conceptual framework or empirical data suggest how to balance these factors. Continuing with the example of tax return preparation, there is no existing data that quantifies the difference between the cost of a fiduciary income tax return and the additional cost that would have been incurred by the beneficiaries if they had held the trust assets in their own names.

143. *Id.* at 190.

144. *Id.* at 191.

145. Regs. § 1.212-1(a)(1) (cost of preparing income tax returns is deductible under § 212). Etheridge, *supra* note 128, at 28 (discussing similarity of and differences between preparation of fiduciary returns and individual returns). See also, Stevenson, *supra* note 103, at 662 (discussing the similarity between trust accounting fees and costs of record-keeping incurred by individuals).

Segregating the portion of these expenses attributable to the trust form of ownership requires some legitimate basis, which presently is non-existent.

In the absence of regulations, the Court of Federal Claims' interpretation requires such unguided balancing in every case.¹⁴⁶ This would involve expenditure of time and money by the trust to establish, and by the IRS to verify. Disputes about the hypothetical data are easy to imagine, particularly because they would involve a set of questionable assumptions. Under a subjective approach, simplifying assumptions would be unwarranted. Instead, each trust would have to be analyzed individually. One trust might require a significant amount of investment advice that would have been incurred by a reasonable individual who held that level of wealth outright. Another trust might require a significant amount of discretionary judgment, which would not be incurred by a reasonable individual who held that level of wealth outright. Addressing these factual variances on a case by case basis would be wholly disproportionate to the amounts at issue under section 67(e).¹⁴⁷

To avoid the burden of this factual inquiry, the parties in *Mellon Bank* entered into a stipulation for purposes of advancing the case to the Federal Circuit Court of Appeals.¹⁴⁸ That stipulation, which provided that the trust would not submit proof of the expenditures that an individual would have incurred, established the facts necessary to grant the IRS' summary judgment motion.¹⁴⁹ The Circuit Court affirmed the Court of Federal Claims, but it did not address the differences between the Tax Court and the Court of Federal Claims.¹⁵⁰ Instead, it characterized its interpretation as "plain meaning" of the statute as if it were consistent with these divergent interpretations.¹⁵¹

146. Without an existing conceptual or empirical framework, any of the simplifications that a regulation might adopt would be baseless. The number and magnitude of other pressing issues affecting the integrity of the income tax system suggests that the use of Treasury's resources to develop a conceptual framework or empirical database for the interpretation of a provision that is directly applicable only to trusts and estates would be highly unlikely, if not irresponsible.

147. In *O'Neill*, the amount of tax in dispute was \$3534, based on an expenditure for investment advisory fees of \$15,374 for a \$4.5 million in trust. 98 Tax Ct. at 229.

148. *Mellon Bank, N.A. v. C.I.R.*, 86 AFTR 6432 (Fed. Cl. 2000).

149. *Id.*

150. Although the IRS, the trustee, and amicus all expressed a desire to avoid these complexities, the Court of Federal Claims stated that policy of achieving simplicity could not color the interpretation of the statute. The remedy for complexity, the Court's view, would be statutory amendment or regulatory interpretation that adopted simplifying assumptions. 47 Fed Cl. at 190.

151. 265 F.3d at 1276.

The Tax Court's categorical approach to analyzing trust expenditures would work rough justice in *Mellon Bank* because the only expenditures at issue in that case were investment advisory fees, tax preparation fees and management expenses. Each of these expenditures involved a relatively small incremental amount attributable to the trust form of ownership, so subjecting these expenditures to the 2% floor on a categorical basis would constitute a reasonable approximation for purposes of section 67(e). If all trust expenditures could be classified as predominantly analogous to costs of outright ownership or predominantly different from costs of outright ownership, the categorical approach could work.

The 100 pound gorilla that makes the categorical approach unworkable is trustees' fees. The government did not challenge the trustees' claim to a full deduction for their own trustees' fees in *Mellon Bank* (or any of the other cases). If it had, the Federal Circuit would have had to explain how its substantive approach could apply to trustees' fees without obviating section 67(e)'s purpose of allowing some, but not all, trust expenditures to qualify for full deductibility. Trustees' fees present this problem because professional trustees typically offer comprehensive services, including investment analysis and strategy, recordkeeping, and the exercise of discretionary judgments about distributions of income and principal.

If trustees' fees qualify for exemption from the 2% floor, then trusts employing corporate fiduciaries receive investment advice and other services that will qualify for full deductibility even though individuals paying for similar services would be subject to the 2% floor. Yet subjecting trustees' fees to the 2% floor would deny full deductibility for services such as the exercise of discretionary judgment about distributions, which have no direct analogue in the context of outright ownership. Those services are analogous in a loose sense to estate planning or financial planning that an individual might seek in order to provide for herself or her future beneficiaries, but the scope of the services (and thus the cost attributable to them) is quite different. If these costs are subject to the 2% floor, then virtually nothing qualifies for full deductibility.

3. *The Weight of Authority*

The next case to arise after *Mellon*, *Scott v. US*, involved a \$25.5 million testamentary trust held for the benefit of the settlor's granddaughters, who were the fourth generation of income beneficiaries of the trust.¹⁵² Like the

152. 328 F.3d at 136.

corporate trustee in *Mellon Bank*, the three lawyers who served as trustees in *Scott* claimed commissions and also paid custodian fees, investment advisory fees and fees for the preparation of income tax returns and trust accountings.¹⁵³ Like the trustees in *O'Neill*, these trustees had no experience in managing large amounts of assets and declined to serve as trustee unless the services of an investment adviser would be available.¹⁵⁴ The trustees brought this case in Federal District Court, the Eastern District of Virginia, a jurisdiction not bound by any of the existing precedent interpreting section 67(e).¹⁵⁵

The District Court chose to follow the existing precedent, applying both the uniqueness test adopted in *Mellon Bank* and the legal compulsion test adopted in *O'Neill*. Under either test, the District Court concluded, the trust's expenditure for investment advisory fees would be subject to the 2% floor.¹⁵⁶ Distinguishing the mandates of Virginia trust law from those of Ohio trust law applicable in *O'Neill*, the District Court concluded that the trustees were not compelled to secure investment advice in discharge of their fiduciary duties.¹⁵⁷ Consequently, the court said, the fees would be subject to the 2% floor under either the Federal Circuit or the 6th Circuit interpretation of section 67(e).¹⁵⁸

The District Court's analysis highlighted two problems inherent in the 6th Circuit's incorporation of state law into the interpretation of section 67(e) that had not surfaced in *O'Neill*. First, the incorporation of state law contravenes the general objective of simplifying the treatment of itemized deductions by adding another body of law to consider.¹⁵⁹ Second, this approach would encourage forum shopping for newly established trusts as well as existing trusts that would seek to change situs or governing law in order to achieve a tax advantage.¹⁶⁰

153. 186 F. Supp. 2d 664 (2002).

154. *Id.* at 665.

155. Taxpayers have the option of litigating disputes in the United States Tax Court, the federal district courts or the United States Court of Federal Claims. Bankruptcy Courts occasionally address federal tax issues as well. Camilla E. Watson & Brookes D. Billman, Jr., *Federal Tax Practice & Procedure* 67 (West 2005).

156. 186 F. Supp.2d at 667.

157. *Id.* at 667-668.

158. *Id.* at 660.

159. Danielle M. Hohos, Note, Fees Paid by Trustees for Investment Strategy Advice and Management Services Are Not Deductible Under Section 67(e)(1): *Mellon Bank, N/A. v. United States*, 54 *The Tax Lawyer* 693 (2001).

160. Trusts have significant flexibility in the selection of governing law and situs. See generally, 11 Eve Preminger et al., *Trusts and Estates Practice in New York* §5:1.42 (Lexis 1998).

The 4th Circuit rejected the 6th Circuit's interpretation as inconsistent with the plain meaning of the statute, and in that way avoided all of the complications that a state law analysis would have involved.¹⁶¹ This decision added support for the Tax Court's interpretation, which identified costs attributable to trust ownership based upon a plain meaning reading of the statute.¹⁶²

The Tax Court's plain meaning interpretation avoids complexity but it creates inequity and opportunities for manipulation that section 67(e) exists to prevent. Categorizing expenses based on the label of the expenditure, as the Tax Court's approach does, allows trusts to circumvent the 2% floor with ease by bundling their investment advisory fees and similar expenditures into trustees' compensation.¹⁶³ This, in turn, may distort the decision about who should serve as trustee. Virtually all trust costs will be fully deductible if a professional fiduciary manages the trust, whereas division of responsibilities between non-professional trustees and other service providers will cause the fees for investment advice and most other services to be subject to the 2% floor.¹⁶⁴

This weakness in the Tax Court's approach, addressed in the initial *O'Neill* decision, does not trouble the Tax Court. Tax consequences often turn on the structure of an arrangement that the taxpayer chooses, the Tax Court noted in *O'Neill*.¹⁶⁵ The Tax Court re-affirmed its view in 2005 in *Rudkin v. Comm'r*, a case appealable to the 2nd Circuit, which has not yet ruled on the interpretation of §67(e).¹⁶⁶ Neither *Rudkin* nor *O'Neill* nor the decisions of the 4th and the Federal Circuits that followed the Tax Court's interpretation explained how such a formalistic approach would square with the plain intention to prevent the applicability of the 2% floor from turning on the form of ownership. This gap in reasoning undermines the Tax Court's approach, both as a matter of statutory interpretation and as a matter of equity. With no

161. 328 F.3d at 132.

162. See supra notes 114-121 and accompanying text.

163. Stevenson, supra note 103 at 666.

164. This result cannot be avoided by claiming commissions and then paying investment advisors personally. An individual trustee who takes this approach would have to include commissions in income, but could offset income with the payment of investment advisory fees only to the extent that payment together with the individual's other miscellaneous itemized deductions exceeded the 2% floor. James L. Boring, *Trusts and the 2% Floor*, 29 ACTEC Notes 98 (2003).

165. 98 T.C. at 231. In the words of the Tax Court: "We must consider the tax consequences of the events as they actually transpired. The fact that some other method of meeting the trust objectives might conceivably have a different tax result is irrelevant here."

166. 124 T.C. 304 (2005).

alternative interpretation that produces better results, however, it remains the predominant interpretation of section 67(e).

IV. FILLING IN THE CRACKS IN THE TWO PERCENT FLOOR

The fundamental problem with section 67(e) is that it describes a category of expenses (expenses other than those an outright owner would incur) that are not readily identifiable. The difficulty in identifying these expenses is that outright owners exercise choice as to whether or not to incur asset management expenses, and so the statute requires assumptions (or information) about the exercise of this discretion. The challenge that section 67(e) presents is to identify a set of supportable assumptions that produces equitable results with minimal administrative effort.

The interpretation that meets this challenge defines expenses attributable to trust ownership as expenses of trusts that distribute all of their income in the taxable year for which expenses are incurred. Correspondingly, expenses of trusts that do not distribute all of their income in a given taxable year would be treated as asset management expenses analogous to those incurred by individuals, and thus would be subject to the 2% floor. Under this interpretation, the 2% floor applies to all of a trust's asset management expenses incurred in a taxable year, or none of them, depending upon whether or not the trust distributes all of its income.

This interpretation, referred to in the balance of this article as the contextualized interpretation, differs from other interpretations of section 67(e) because it focuses on the use of trust income rather than the character, label, amount or other attribute of a particular expense. Although it is less intuitive than the "plain meaning" interpretation, it fits the statutory text at least as well and it produces greater equity with less administrative effort.

A. Statutory Grounding of the Contextualized Interpretation

Section 67(e) invites a wide range of interpretations because it articulates a desired end rather than a means to achieve that end. The exemption from the 2% floor for "[expenses] that would not have been incurred if the property were not held in [trust]" requires uniform treatment for asset management expenses incurred by trusts and outright owners.¹⁶⁷ The quoted

167. *Cf.*, IRC § 67(e) (flush) (mandating application of the standard in a way that maintains the equity that Subchapter J produces for trust beneficiaries and other individuals without regard to the 2% floor).

phrase cannot function as a self-contained standard to achieve the articulated equitable objective, however, because it describes a hypothetical decision by an unidentified owner. The content of the standard depends upon the criteria that would influence the outright owner's expenditure decisions. To the extent that the criteria involve factual circumstances, those facts (or a process for determining those facts for the owner described in section 67(e)) would be an additional element of the substantive content of the standard.

When a statute articulates its objective rather than specifying a standard to achieve that objective, textual and purposive approaches to statutory construction coalesce rather than conflict.¹⁶⁸ There is no conflict between statutory text and legislative purpose of section 67(e) because both express a desired result and neither specifies how to achieve it. In this situation, there can be a singular "plain meaning" for the statute only if there is but one means of achieving the statutorily articulated objective.

The prevailing "plain meaning" interpretation of section 67(e) assumes that the outright owner will incur all of the expenses incurred by the trustee whose deductions are at issue other than expenses labeled as applicable to trusts only, such as "trustee commissions." An equally plausible, and arguably superior, set of assumptions underlies the contextualized interpretation. These assumptions, explained and supported below, are: (1) the outright owner contemplated by section 67(e) is a reasonable taxpayer; (2) the reasonable taxpayer will incur asset management expenses for assets that are invested but not for assets that will be consumed; and (3) the trust's distribution or accumulation of trust income signifies whether the reasonable taxpayer would invest or consume the trust assets if he or she held those assets outright.

1. The Reasonable Taxpayer Standard

Assumptions about expenditure decisions of the outright owner contemplated by section 67(e) begin with an assumption about the identity of

168. See generally, Michael Sinclair, *Guide to Statutory Interpretation* 155-172 (Matthew Bender & Co. 2000). It might be expected that the courts would have settled on an approach, or at least narrowed the spectrum of possible approaches, to interpret the Code. Despite the thoughtful consideration given to the interpretation of this unique statute, interpretive approaches are as varied for this statute as for any other. See, e.g., Rene Matteotti, *Struggling with Words in Tax Jurisprudence – A Plea for an Equal Treatment Mode of Analysis in Construing Tax Statutes*, 108 *Tax Notes* 247 (2005); Deborah A. Geier, *Textualism and Tax Cases*, 66 *Temp. L. Rev.* 445 (1993); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 *N.C.L. Rev.* 623 (1986).

the outright owner whose expenditure decisions define the scope of section 67(e). In order to produce an objective standard, this owner must be a hypothetical individual as opposed to an actual person associated with the trust whose deductions are at issue. This hypothetical individual cannot be the cost-averse taxpayer, who avoids all discretionary expenditures, because this standard would exempt every trust expense from the 2% floor rather than a subset of trust expenses that section 67(e) requires. The opposite hypothetical individual, the profit-maximizing taxpayer, produces a standard that arbitrarily categorizes expenses based on labels rather than substance.¹⁶⁹ This is equally unacceptable.

The only remaining hypothetical outright owner is the reasonable taxpayer. The reasonable taxpayer will take into account all relevant circumstances to reach decisions. The contextualized nature of the reasonable taxpayer standard is intuitively attractive in terms of fairness, but intuitively objectionable in terms of administrative simplicity. The crux of the challenge presented by section 67(e) is to identify a criterion drawn from the reasonable taxpayer's circumstances that indicates with reasonable accuracy the expenditure decisions that the reasonable taxpayer would make.

2. Asset Use as the Determinative Criterion

The reasonable taxpayer will decide whether or not to incur asset management expenses based on his or her anticipated use of the assets. If the assets will be invested for the long term, the reasonable taxpayer will incur investment advisory fees and other asset management expenses because asset management services advance the goal of maximizing wealth. Conversely, assets needed to meet current needs will not justify expenditures for asset management services because current consumption obviates wealth maximization objectives (and leaves no income available to pay for asset management expenses).

169. The approach of the Court of Federal Claims, which contemplates a pyramid of hypothetical facts, is as arbitrary as the formalism of the Tax Court's approach. The irrationality of the distinctions drawn under the "plain meaning" interpretations of the Tax Court and the Court of Federal Claims arguably violate horizontal equity. A definitive violation of horizontal equity occurs, however, only if there is no legitimate basis for the distinction drawn. See *supra* note 34. For example, if the rate of tax due depended upon the number of letters in the taxpayer's name, the tax rates would violate horizontal equity because there would be no legitimate basis for the different rates of tax.

If a trust is large enough, the size of the trust alone will establish that the reasonable taxpayer would invest for the long term and consequently incur the asset management expenses that advance that objective. The value of the Mellon trusts, for example, represented such significant wealth that it would be difficult to imagine a situation in which a reasonable outright owner would consume all of the income produced by the assets rather than using a portion of the income to purchase professional services devoted to maximizing the long term value of the assets.¹⁷⁰ Similarly, all of the other cases involved multi-million dollar trusts whose trustees determined that it would be cost-effective to litigate the disallowance of 2% of their investment advisory fees (and in the case of *Mellon Bank*, certain other expenses).¹⁷¹ Those facts alone suggest a level of wealth that would compel an outright owner to incur asset management expenses.

When a trust is not so large as to preclude any reasonable possibility that the reasonable taxpayer would consume the trust assets rather than investing them, trust size alone offers no information about the use of the trust's assets by a reasonable taxpayer. A very small trust could be devoted to long-term wealth accumulation if the outright owner had other sources of income and no unusual expenses. Other aspects of the individual's financial situation, however, could change the reasonable taxpayer's analysis. If, for example, the trust is the sole source of income and the individual has unusually high expenses or other financial obligations, the assets might be depleted in a short period. In that situation, a reasonable individual might choose to avoid discretionary expenditures for asset management.¹⁷²

The divergent conclusions reached by the Tax Court and 6th Circuit in *O'Neill* support the contention that trust size is important only if it compels the conclusion that the trust assets would be invested rather than consumed by a reasonable outright owner.¹⁷³ The trust in that case, worth \$4.5 million, would justify expenditures for asset management by a reasonable individual in many circumstances.¹⁷⁴ Yet it is possible to envision circumstances that would cause a reasonable taxpayer to consume all of the trust income and thus avoid

170. Appellant's Opening Brief at 4, *Mellon Bank, N.A. v. US*, 265 F.3d 1275 (2001) (No. 01-5015) (combined trusts assets worth more than \$500 million).

171. *Id.* *Scott*, 328 F.3d at 136 (trust valued at \$25.5 million); For the *Rudkin* case, publicly available documents do not state the value of the trust, but the decision does state that the trust's total income was \$624,816 for the year 2000). *Rudkin*, 124 T.C. at 307.

172. See *supra* notes 29-30, and accompanying text.

173. *O'Neill*, 98 T.C. 227.

174. *Id.*

incurring asset management expenses. If, for example, the trust supported 10 beneficiaries each of whom had significant expenses and no other source of income, the reasonable taxpayer might conclude that it would be more desirable to invest in no-load mutual funds or utilize other arrangements that did not require expenditure of trust assets.

If it is difficult to envision a reasonable taxpayer choosing to avoid asset management expenses, the reason is that a trust fund is, by definition, money set aside for others or for one's own future use. If the reasonable taxpayer had such funds to set aside, albeit not in trust, it would be clear that those funds would be held for wealth accumulation rather than current consumption. This conception of the reasonable taxpayer – one who owns the entire trust fund outright – equates the reasonable taxpayer with the profit-maximizing taxpayer.

The flaw in this conception of the reasonable taxpayer is that no one connected with the trust necessarily has, or could have had, access to or control over the entire trust fund. The existence of the trust prevents anyone from having such control because a trust divides ownership of into legal and beneficial interests. Beneficiaries enjoy the value (beneficial ownership) of trust property and bear the consequences of asset management decisions, but beneficiaries have no control over those decisions. Trustees have control but no beneficial ownership. The grantor of the trust has less control than the outright owner, and often no control at all over trust assets. By establishing the trust, the grantor divests himself or herself of ownership and retains rights only as provided in the trust instrument.¹⁷⁵

The grantor of the trust bears a close resemblance to the reasonable taxpayer, however, in the sense that the grantor owned all of the trust assets outright before creating the trust. As an outright owner, the grantor had the opportunity to hold the trust assets outright with no obligation to incur asset management expenses.

The difference between the grantor of the trust and the reasonable taxpayer is that the grantor does not necessarily have an opportunity to retain outright ownership to the point in time when the asset management expenses are incurred. Testamentary trusts, for example, commence upon the death of the grantor and thus do not constitute an alternative to outright ownership by the grantor. Outright ownership by a different individual, a beneficiary named in the

175. The roles of beneficiary, trustee and grantor may overlap but the overlap can never vest an individual with complete beneficial and legal ownership of trust property. If it did, that individual would possess outright ownership and a trust would not exist.

grantor's will (or an intestate heir in the case of a grantor who leaves no will), may be possible but this is not necessarily so.

A testamentary trust may be established because an outright bequest to the selected beneficiary is impossible or impracticable. A trust for a minor child, for example, is not an alternative to an outright bequest but rather an alternative to guardianship, a fiduciary relationship that typically is more cumbersome than a trust arrangement.¹⁷⁶ In other situations, a grantor may choose to establish a testamentary trust rather than leaving outright bequests in order to minimize transfer taxes borne by descendants.

If the purpose of the trust is long term wealth maximization, it is appropriate to conceive of the reasonable taxpayer as outright owner of the entire trust fund because an individual connected with the trust (the grantor or his or her successor in interest) could have owned the trust assets outright. If, however, the purpose of the trust is to provide for the current needs of a beneficiary, then the trust assets are not akin to a fund that an individual would hold. Instead, the fund would be more analogous to the income stream that an outright owner (like the reasonable taxpayer) would use to cover living expenses and other current consumption.

For example, a trust for the benefit of a minor child that is funded with insurance proceeds paid as a result of the grantor's death covers expenditures that the grantor would have paid from current earnings had he or she survived. This trust represents the liquidation of the grantor's income producing years. If the grantor had not died, there would be no income producing asset with respect to which the grantor might have contemplated asset management services. An outright owner, like the reasonable taxpayer, would have an income stream rather than a fund holding assets equivalent to the present value of a lifetime of earnings.

3. Accumulation-Distribution Distinction as Proxy for Asset Use

The purpose of a trust is a simplified basis for drawing conclusions about the expenditures that a reasonable taxpayer would incur, but it is not simple enough. One problem with the purpose criterion is that the purpose of a trust may change over time. A trust originally established for long term wealth accumulation, for example, may eventually function as a support trust if the

176. See *supra* note 29.

beneficiaries' circumstances change for the worse.¹⁷⁷ Moreover, many trusts serve more than one objective, such a trust established to support a disabled child and to accumulate wealth for other issue that will be distributed at the death of the disabled child or some later time.¹⁷⁸ Section 67(e) would require only a determination whether a trust fit into one of two categories (long term wealth accumulation or current consumption), but even this generalized categorization is not executable without undue complexity.¹⁷⁹

A good proxy for the distinction between support trusts and long term wealth accumulation trusts is the distinction Subchapter J draws between trusts that distribute all of their income (“distribution trusts”) and those that do not (“accumulation trusts”) for purposes of determining the applicable personal exemption.¹⁸⁰ The distinction between distribution trusts and accumulation trusts evidences the use of the trust assets and thus signifies whether or not an outright owner would incur asset management expenses. Accumulation of trust income connotes financial privilege available only to those whose income exceeds their consumption. Distribution trusts do not carry the same connotation, however, because the beneficiaries who receive the trust income may need, or choose, to consume it. It is possible, of course, that the beneficiaries of a distribution trust may be wealthy enough to save all of the trust income. In that situation, however, the income distributed to them will be taxed at a rate that reflects their privileged position to the same extent that income from other sources would be

177. Estate planners often recommend drafting trusts flexibility to permit the trust to change its function as circumstances change. See Stocker et al., *supra* note 30, at 3-25.

178. *Id.*

179. The extent of the difficulty involved in defining the purpose of a trust in such general terms is well illustrated by the history of the “grantor trust rules,” a highly detailed set of objective rules that define whether a trust will be recognized as a separate taxable entity. IRC §§ 671-679. In an earlier era, the grantor’s subjective purpose for establishing a trust determined whether the trust was recognized as a separate taxable entity or disregarded so that its income was taxed to the grantor. See *Helvering v. Clifford*, 309 U.S. 331 (1940). The gestalt approach to ascertaining subjective intent produced such unsatisfactory results that it was replaced first with detailed regulations, and later with even more detailed statutory rules that identify with particularity trust terms indicative of a purpose to retain control over the assets so substantial that the grantor ought to be taxed as if she owned the assets herself. Regs. § 29.22(a)-1 (“Clifford regulations” issued after the *Clifford* decision and before the promulgation of the grantor trust rules in Subchapter J); IRC §§ 671-679 (current grantor trust rules). Although the grantor trust rules serve a different specific objective than does § 67(e), they amply illustrate the need for objective criteria to serve as a proxy for an inquiry into the purpose of a trust.

180. IRC § 642(b). See *supra* note 75.

taxed.¹⁸¹ The accumulation-distribution distinction thus effectively captures the essential difference between support trusts and wealth accumulation trusts.

Although the distribution-accumulation distinction is a fairly accurate proxy for achieving horizontal equity in the taxation of trust income, it is decidedly imperfect. Trusts that accumulate income do not always serve long term wealth accumulation goals and trusts that distribute all of their income sometimes do contribute to long term wealth accumulation. A small trust for the benefit of an orphaned minor child, for example, would accumulate trust income for the child's college education or other adult expenditures if the current support expenses of the child are minimal and simply absorbed into the household expenses of the child's guardian. Conversely, a dynasty trust could provide for distribution of its income without jeopardizing its transfer tax objectives if the trust generates little income (as opposed to capital gain that is allocable to corpus and thus, by definition, not distributable to the income beneficiary).¹⁸² These imperfections are necessary, however, to achieve the degree of administrative simplicity that §67(e) requires.¹⁸³

B. The Argument for Judicial Adoption

The textual analysis of the contextualized interpretation set forth in Section A, addresses the threshold question whether this interpretation is viable as a matter of statutory construction. After crossing that threshold, the question becomes whether this interpretation produces results at least as satisfactory as those produced by the prevailing interpretation. This Section addresses that question by comparing results of the two interpretations based on several criteria.

1. Quantitative Analysis

Any interpretation of section 67(e) that is administratively feasible must incorporate simplifying assumptions. Simplifying assumptions create the possibility, if not probability or certainty, that a particular taxpayer would be treated differently if actual facts rather than simplifying assumptions determined tax treatment. The "plain meaning" approach assumes that a label including the term "trust" or "trustee" connotes a service that an individual could not

181. See supra note 51.

182 See supra notes 51-63 and accompanying text.

183 Cf., *Harkness v. US*, 199 Cl. Ct. 721, 459 F.2d 310 (1972), cert. Den., 414 U.S. 820 (1973) (illustrating situation in which Subchapter J's use of distributable net income rather than income as defined under state law produced unfairness that would not have occurred under the more complex scheme for taxing trusts that was in force prior to enactment of Subchapter J).

purchase. The contextualized interpretation incorporates a different simplifying assumption, namely that the trust's accumulations of some or all of the trust income signifies that an outright owner would hold the trust assets for investment and incur asset management expenditures.

The existence and effect of the simplifying assumption incorporated in the contextualized interpretation is more apparent than the simplifying assumption inherent in the plain meaning interpretation. This difference in transparency may create the false impression that the simplifying assumption in the plain meaning interpretation is less significant. A quantitative comparison illustrates the fallacy of this assumption. Trusts that distribute all of their income and pay commissions to fiduciaries rather than paying other service providers (e.g., investment advisors) would be treated exactly the same under both approaches: the commissions would be exempt from the 2% floor. Trusts that accumulate income and pay other service providers in lieu of commissions would be treated exactly the same under both approaches as well. In that case, the payments to other service providers would be subject to the 2% floor. Different results would occur in two cases. The first would be where a trust distributed all of its income but paid other service providers in lieu of commissions. The other would be where a trust accumulated income and paid commissions rather than outside service providers.

The charts below show the taxable income¹⁸⁴ of a \$1 million trust and \$10 million trust under the "plain meaning" interpretation and the contextualized interpretation based on the following assumptions: (1) the \$ 1 million trust pays \$12,000 for services, whether to an outside service provider or a professional fiduciary; and (2) the \$10 million trust pays \$61,000 for services, whether to an outside service provider or a professional fiduciary.

184. If the trust accumulates its income (as is the case for the trusts shown in the right hand column of the charts), the income shown is the taxable income of the trust. If the trust distributes its income, the income shown is passed out to the beneficiaries (to the extent of distributable net income as described in Part I.B).

\$1 Million Trust:

	Trust Distributes Income and Pays Outside Service Providers	Trust Accumulates Income and Pays Commissions
“Plain Meaning”	\$987,941 ¹⁸⁵	\$987,900 ¹⁸⁶
Contextualized	\$987,700 ¹⁸⁷	\$987,700 ¹⁸⁸

For a trust of \$1 million that distributes income, the difference between the results of the two interpretations is negligible. If the trust pays outside service provider, the contextualized interpretation produces \$241 less income than does the “plain meaning” interpretation. If the trust pays commissions rather than outside service providers the results, as noted, are identical.

The difference between the two interpretations is noteworthy if the trust pays “commissions” and accumulates income rather than distributing it. As the chart above illustrates, the “plain meaning” interpretation would treat the commissions as fully deductible whereas the contextualized interpretation would treat the commissions as management expenses equivalent to those an outright owner would incur. This amounts to a \$12,000 difference in taxable income, representing the full amount of commissions paid.

185. The “plain meaning” interpretation creates inordinate complexity in the computation of taxable income whenever the trust distribution can reasonably be expected to exceed the trust’s distributable net income (“DNI”). A set of interrelated computations is required, which is explained for tax preparers. 2005 Instructions for Form 1041 and Schedules A, B, D, G, I, J and K-1 at 18-19. The computations for the scenario described in the text would be:

$$\begin{aligned}
 \text{AMID} &= \$12,000 - .02\text{AGI} \\
 \text{AGI} &= \$1 \text{ million} - \text{DNI} - 300 \\
 \text{AGI} &= \$999,700 - \text{DNI} \\
 \text{AMID} &= \$12,000 - (.02[999,700 - \text{DNI}]) \\
 \text{DNI} &= \$1 \text{ million} - \text{AMID} \\
 \text{AMID} &= \$12,000 - (.02[999,700 - (\$1 \text{ million} - \text{AMID})]) = \$11,759 \\
 \text{TTI} &= \$1 \text{ million} - \$11,759 - \$300 = 987,941
 \end{aligned}$$

186. \$1 million less \$12,000 commissions (deductible above the line) less \$100 (personal exemption) = \$987,900.

187. \$1 million less \$12,000 commissions less \$300 personal exemption = \$987,700.

188. \$1 million less \$12,000 commissions less \$300 personal exemption = \$987,700.

\$10 million Trust:

	Trust Distributes Income and Pays Outside Service Providers	Trust Accumulates Income and Pays Commissions
“Plain meaning”	\$9,939,902 ¹⁸⁹	\$9,938,900 ¹⁹⁰
Contextualized	\$9,938,700 ¹⁹¹	\$9,999,900 ¹⁹²

For the \$10 million trust, the difference between the contextualized interpretation and the “plain meaning” interpretation remains negligible for trusts that distribute all of their income. The difference between the two interpretations remains significant for trusts that accumulate income.

This quantitative analysis illustrates that only trusts that accumulate income have a real stake in the interpretation of section 67(e). This places a premium on the equitable arguments favoring distribution trusts over accumulation trusts.

2. Qualitative Analysis

The primary equitable argument for the contextualized interpretation of section 67(e) rests on the proposition that trusts serving current needs and trusts established to accumulate wealth for future use or future beneficiaries differ in their social value. Managing property for current use serves the important social function of providing for individuals who otherwise might need government support. Trusts for long term wealth accumulation, on the other hand, do not serve the same immediate support function, and arguably create a social harm that the tax law ought to discourage rather than encourage.¹⁹³

Distinguishing trust expenditures on this basis alleviates some of the

189. $AMID = \$61,000 - .02AGI$

$AGI = \$10 \text{ million} - DNI - 300$

$AGI = \$9,999,700 - DNI$

$AMID = \$61,000 - (.02[9,999,700 - DNI])$

$DNI = \$10 \text{ million} - AMID$

$AMID = \$61,000 - (.029,999,700 - (\$10 \text{ million} - AMID)) = \$59,798$

$TTI = \$10 \text{ million} - \$59,798 - \$300 = 9,939,902$

190. $\$10 \text{ million less } \$61,000 \text{ less } \$100 = \$9,938,900.$

191. $\$10 \text{ million} - \$61,000 - \$300 = \$9,938,700.$

192. $\$10 \text{ million less } \$100 = \$9,999,900.$

193. See Ira Mark Bloom, *The GST Tail is Killing the Rule Against Perpetuities*, 87 *Tax Notes* 569 (2000) (describing perpetual trusts as interfering with societal objectives, including keeping property responsive to current needs, facilitating productive use of wealth, and affording living individuals some degree of control over property).

financial burden of the trust form of ownership for property management trusts without creating the possibility that the tax system would make use of a trust more cost effective than outright ownership. The contextualized interpretation of section 67(e) achieves equity between outright owners and trust beneficiaries in the same measure that Subchapter J creates equity between these two groups with respect to other elements of the income tax computation. Subchapter J's integration of the accumulation-distribution distinction in the taxation of trust income evidences Congress' support for this objective.

In addition to the equity of taxing trusts that serve the wealthiest individuals more heavily than other trusts, the contextualized interpretation serves equity by assuring equal treatment for similarly situated trusts. The standard's grounding in the Code's accumulation distribution distinction is independent of state law and impervious to manipulations by taxpayers. A cost-based interpretation runs the risk that the applicability of the 2% floor would depend on state law. Even more objectionable is the ability of taxpayers to secure full deductibility of asset management expenses by bundling necessary services as fiduciary commissions as opposed to payments for outside service providers.¹⁹⁴

194. For different reasons, both the "plain meaning" interpretation" and the discretionary-mandatory interpretation of the 6th Circuit classify fiduciary compensation as exempt from the 2% floor. *Scott v. US*, 328 F.3d at 136 (the plain meaning of § 67(e) exempts trustees' commissions from the 2% floor); *O'Neill v. US*, 994 F.2d at 305 (all expenses that are mandatory for trustees are exempt from the 2% floor); *Rudkin v. US*, 124 T.C. at 305 (plain meaning of § 67(e) exempts trustees' commissions from the 2% floor). The Court of Federal Claims' interpretation would have denied deductibility for an increment of trustees' commissions, but the Federal Circuit's decision on appeal expressly states that the treatment of costs turns on form rather than substance:

The Supreme Court has "observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. at 148; see also *Rite Aid Corp. v. United States*, 255 F.3d 1357, 1360 (Fed. Cir. 2001) ("A taxpayer is free to organize his affairs as he chooses, but once organized, he must accept the tax consequences of his choice."). *Mellon Bank* chose to hire outside consultants to satisfy their fiduciary duty as trustees. The plain meaning of IRC § 67(e)(1) prevents the deduction of fees thus incurred unless they satisfy the general requirement of IRC § 67(a).

Mellon Bank, N.A. v. U.S., 265 F.3d at 1281-1282. Although trustees' fees were not at issue in the case, this language strongly suggests that trustees' fees would be treated categorically rather than incrementally.

Incorporation of state law into federal tax standard presents perplexing, often unavoidable issues.¹⁹⁵ In some instances, the Code specifically defers to state law in the determination of tax consequences. In Subchapter J, for example, the definition of trust income under state law (and the governing instrument) plays an integral role in determining the allocation of taxable income between the trust and its beneficiaries.¹⁹⁶ Where the Code does not itself expressly defer to state law, however, the recent trend has been to avoid reliance on state law in the interest of jurisdictional uniformity in the application of federal tax law.¹⁹⁷ This assures equity between similarly situated beneficiaries who reside in different jurisdictions. Moreover, this approach has the virtue of protecting state law from the pressure to evolve in a manner that produces optimal tax results rather than optimal protection for those who hold property in trust.¹⁹⁸

The role of state law is most apparent in the 6th Circuit's interpretation, which turns on whether applicable trust law compels the expenditure.¹⁹⁹ State law also plays a role, however, in the Tax Court's interpretation.²⁰⁰ Under that interpretation, treatment of trust accounting fees under § 67(e) depends upon whether the accounting is mandated by the governing instrument or applicable state law.²⁰¹ Every trustee has the obligation to account to beneficiaries, but the

195. *Riggs v. Del Drago*, 317 U.S. 95 (1942).

196. See *supra* notes 49-63 and accompanying text (discussing the role of fiduciary accounting income, a state law concept, in the federal income taxation of trusts).

197. See, e.g., *Comm'r v. Banks*, 523 U.S. 426 (2005) (holding that gross recovery, including contingent legal fees owed to the plaintiff's attorney, constitute gross income, despite attorney's security interest in the fee under state law).

198. A good example of this phenomenon is the pressure tax law exerted on state courts to reform wills that failed to qualify for tax benefits. The enactment of retroactive changes to requirements for tax benefits made it all but impossible for courts to adhere to the historic interpretation of the statute of wills which precluded reformation. The change in will reformation doctrine instigated by the Code began with tax cases but eventually spread to others until the reformation doctrine was turned on its head. To be sure, this development has its advocates. Restatement (Third) of Prop: Donative Transfers §§ 12.1, 12.2 (2005) (adopting the view that wills should be subject to reformation in any type of case, and creating a doctrine of modification to give courts extensive to make changes that advance tax purposes). John H. Langbein & Lawrence W. Waggoner, *Reformation of Wills on the Ground of Mistake: Change in the Direction of American Law?*, 130 U. Pa. L. Rev. 521 (1982) (advance the argument for reversing the historic prohibition on reformation of testamentary instruments). But see, Pamela R. Champine, *My Will Be Done: Accommodating the Erring and the Atypical Testator*, 80 Neb. L. Rev. 387 (2001) (advocating limits on reformation of wills). The motivation for it, however, is unfortunate.

199. See *supra* note 116.

200. See *supra* note 119.

201. Bogert, *supra* note 130, at §975.

timing, form, extent and expenses of fiduciary accountings vary from jurisdiction to jurisdiction.²⁰²

Another example of state law's effect on the Tax Court's interpretation of section 67(e) relates to fiduciary compensation. Some states establish a commission rate for trustees based on asset value, and require the trustee to provide necessary services or pay for them out of commissions.²⁰³ In a different jurisdiction, a trustee may receive compensation based upon the time spent on trust matters and the authority to secure outside service providers to cover services not personally rendered.²⁰⁴ Under the Tax Court's interpretation trusts in the first jurisdiction would be entitled to a larger deduction than would trusts in the second jurisdiction even if the total amounts expended and the services received for those expenditures were identical.

Apart from jurisdiction differences, cost-based interpretations produce different treatment for similarly situated trusts that use different fiduciary compensation arrangements. The extent of a trust's expenditures to outside (i.e., non-trustee) service providers depends, in large part, upon the compensation arrangement with the trustee. Professionally-managed trusts, for example, will incur few outside expenses because the trust companies and banks that serve as trustees offer comprehensive services for which they charge a higher rate of trustees' commissions than would be chargeable by an individual.²⁰⁵ Conversely, trusts managed by individual trustees who choose to serve without compensation, tend to incur higher expenditures for outside service providers because the uncompensated trustee may not perform management or record-keeping services that would be within the scope of the trustee's responsibilities.²⁰⁶

Under a nature of the expenditure approach, trustee's commissions are treated as fully deductible whereas expenditures for services that some trustees provide (e.g., investment advisory fees) may be subject to the 2% floor.²⁰⁷ This

202. 2A Scott on trusts, *supra* note 19, at §164.

203. Bogert, *supra* note 130, at §975, footnote 61.

204. *Id.*

205. *Matter of Prankard*, 723 N.Y.S.2d 315 (West. Surr. 2000) (discussing compensation of corporate fiduciaries). Presently, fees charged by professional fiduciaries in New York City for a \$1 million trust range generally from \$19,200 to \$42,500. Internal Memorandum of the Bank of New York (on file with the author). This contrasts sharply with the statutory annual commission due to an individual trustee for a \$1 million trust, which would be \$6,900. NY SCPA § 2309 (McKinney 2004). Even for a trust of \$10 million, the differential in fees is significant: \$36,900 for an individual trustee as compared to \$61,900 to \$89,000, depending upon the particular bank or trust company.

206. In the case of a trust managed by an individual trustee who receives compensation, expenditures for outside service providers will be appropriate to the extent the services are outside the scope of the trustee's responsibilities.

207. See *Mellon Bank, N.A. v. US*, 47 Fed. Cl. 186, 189 (2000).

benefits professionally managed trusts like those involved in *Mellon Bank*, which offer comprehensive fiduciaries in exchange for fiduciary compensation, and correspondingly disadvantages trusts for which a family member or friend is willing to serve without compensation but requires assistance with investments, tax preparation or other aspects of fiduciary responsibilities.²⁰⁸ The professionally managed trust is much more likely to be a wealth accumulation trust because the fees charged by professional fiduciaries are cost prohibitive for all but the largest trusts. The trust-based interpretation avoids this regressive result, treating expenditures as fully deductible or not on a basis independent of the compensation structure for the trust.

3. *Judicious Allocation of Resources*

From the broader perspective of taxpayers generally, as opposed to taxpayers directly affected by the taxation of trust income, the contextualized interpretation offers an important advantage. Unlike the “plain meaning” interpretation, which is not tethered to any existing legal or empirical framework, the contextualized interpretation derives from Subchapter J. The existing framework creates a basis upon which interpretations, whether judicial or regulatory, can build with ease. The benefit to taxpayers as a group is that the legal system, including the Courts, Treasury and Congress, can devote their limited resources to larger issues rather than parsing or revising § 67(e). To read § 67(e) in a way that requires such an effort is ironic, if not altogether self-defeating.

The extent of the analysis required to arrive at the contextualized interpretation suggests that the adoption of a regulation embodying this interpretation would be helpful.²⁰⁹ The underpinning in Subchapter J, however, makes the regulatory project far less costly than it otherwise would be. With the judicial adoption of the contextualized interpretation of § 67(e), it would be efficient and effective for Treasury to address the specific issues that the contextualized interpretation does not expressly cover.

The treatment of expenses incurred by estates would be the most important of these issues. The accumulation-distribution distinction applicable

208. Michael R. O'Malley, *Deductibility of Investment Advisory Fees*, 8 Prob. & Prop. 23 (1994). See also, David H. Kirk: Note, *To Be or Not to Be: A Trust's Investment Expense Deduction Subject to the 2% Limitation Under IRC § 67*, 1 Pitt. Tax Rev. 223, 247-8 (2004) (suggesting trusts convert asset based investment fees to transaction based fees in order to secure full cost recovery through basis addition rather than having a deduction subject to the 2% floor).

209. As a practical matter, Treasury regulations typically withstand challenge, whether they are interpretive regulations issued under § 7805(a) or legislative regulations issued pursuant to a specific directive to in the Code. Geir, *supra* note 168, at footnote 51.

to trusts is not directly applicable to estates because estates are intended to be short term entities that distribute all of their property within a few years.²¹⁰ Retention of estate income by the personal representative does not signify an objective of long term wealth accumulation, and distribution does not signify a support objective. Instead, retention or distribution of estate income depends upon the details of the estate administration, such as whether the estate has satisfied or provided for obligations that take priority over distribution to beneficiaries; whether the estate assets are liquid or alternatively in a form that allows the personal representative to make distributions in kind; and whether there are probate or constructional issues that raise questions about the identity of the beneficiaries of the estate. Income tax planning is sometimes possible in the distribution of estate income, but the short term nature of estates limits the significance of this possibility.²¹¹

There would be a justification for either subjecting estate expenses to the 2% floor or to exempting them from the floor. Estates could be analogized to accumulation trusts on the grounds that Subchapter J subjects estates to the provisions applicable to accumulation trusts regardless of whether the estate distributes all of its income or not.²¹² On the other hand, estates could be analogized to distribution trusts on the ground that estates cannot themselves serve the objective of long term wealth accumulation.²¹³ A third alternative would be to determine the treatment of estate expenses based on whether the estate actually distributed all of its income or not in the taxable year in which the expenses were incurred. The involuntary nature of estates together with the limitations on the ability to exploit income tax advantages from them suggests that the most equitable resolution would be to exempt estate expenditures from

210. Regs. § 1.641(b)-3 (providing that an estate is considered terminated for federal income tax purposes after a reasonable period for the performance by the executor of all the duties of administration regardless of whether the estate is actually terminated).

211. Without the limitation on the duration of estates, the opportunities to minimize income tax would be of concern. For a discussion of these opportunities, see generally, Preminger *supra* note 160, at §§ 11:76, 11:92-96, 11:129, 11:172, 11:146-158, 11:208-209 (discussing post-mortem income tax planning opportunities for qualified plan and Individual Retirement Account elections, fiduciary compensation, exercise of the election to claim particular expenses on the estate tax return or the income tax return, timing of distributions, and choice of taxable year); Marc S. Bekerman, *Post-Mortem Planning – Income Tax Issues* (PLI 2004) (discussing limitations on estate duration, allocation of appreciation in the estate, treatment of income in respect of a decedent and other issues).

212. Estates do not necessarily distribute all of their income and thus do not necessarily encounter the double tax problem that distribution trusts encounter are classified as “complex trusts” because they, by definition, cannot be required to distribute their income on an annual basis. See *supra* note 27.

213. See *supra* note 24.

the 2% floor. The short term duration of estates limits the importance of the issue for all taxpayers, however, suggesting that certainty is as, or more, important that the actual resolution of the issue.

Another issue that it would be useful for the regulations to address would be the treatment of expenses incurred by a trust in a year that the trust had no net income. This could occur if the trust investments performed poorly; the trust invested in assets that produced gains attributable to principal rather than returns classified as income such as dividends and interest; or the trust incurred extraordinary expenses. In these types of situations, the accumulation distribution distinction would not determine the treatment of expenses because there would be no net income either to accumulate or distribute.

As with the treatment of expenditures of estates, the treatment of the expenditures of these trusts could be justified whether the resolution was to subject them to the 2% floor or to exempt them from the floor. This is more difficult to resolve than the estate income issue, however, because exempting expenses of these trusts would create an opportunity for a trust that served the objective of long term wealth accumulation to secure a full deduction for its expenditures by investing in assets that returned income classified as principal for fiduciary accounting purposes. On the other hand, a trust subjecting these expenditures to the 2% floor would penalize beneficiaries of support trusts whose income was already reduced by poor returns, extraordinary expenses or other economic circumstances.

This type of issue is particularly suited to regulatory resolution, because regulations can create a series of detailed rules that address the most typical situations. The regulation could provide, for example, that trusts mandated to distribute income would be entitled to exemption from the 2% floor even if there was no income to distribute. This would allow trusts that, by their terms must function as support trusts, to benefit from the exemption from the 2% floor. Regulations also could provide presumptions that would provide clear guidance for trustees, but at the same time preserve an opportunity for the IRS to challenge abusive practice. Such a regulatory provision might provide that trusts with no income for taxable would be classified as a distribution trust or an accumulation trust based upon the use of trust income in the last year in which the trust had income to distribute or accumulate. This provision could be limited by a time period, after which the trust would be denied exemption for expenses from the 2% floor, either absolutely, or subject to showing that the trust was not functioning as an accumulation trust.

A third issue that regulations, if issued, should address is the treatment of trusts that are required to, but do not, distribute income. This situation arises when there is a question about who is entitled to trust income²¹⁴ or an income

214. See, e.g., Estate of Mildred Bruchman, 53 T.C. 403 (1960).

beneficiary refuses to accept a distribution.²¹⁵ These trusts should be entitled to deduct expenses because the terms of the trust indicate that the trust does not serve the objective of long term wealth accumulation.

Other situations could justify regulatory treatment as well if they would arise with sufficient frequency to merit special consideration.²¹⁶ The objective of regulations, if issued, should be to clarify the application of the accumulation-distribution distinction rather than to create a new standard for determining the scope of the 2% floor or to accommodate every idiosyncratic situation that might arise. The amounts involved in this issue simply do not merit extensive attention by Treasury. If they merit extensive attention by the trustees of a particular trust, then the trust is probably large enough to justify subjecting its expenses to the 2% floor.

The following text, which addresses the issues discussed above, could serve as a regulatory standard for section 67(e):

General Rule. For purposes of section 67(e), costs “that would not have been incurred had the property not been held in trust or by an estate” include all costs incurred by trusts that distribute all of their income within the meaning of section 641(c) for the taxable year in which such expenditures are incurred, and no costs incurred by trusts that distribute less than all of their income.

Estates. For purposes of section 67(e), expenses incurred by an estate shall be treated as exempt from section 67(a) for as long as the estate is recognized as a separate taxable entity under Regs. section 1.641(b)-3.

Trusts with No Income for a Taxable Year. The treatment of expenses incurred by a trust that has no income to distribute in a given taxable year shall depend upon the use of the trust income in the last year that the trust had income. If, however, the trust has not earned income in its last three consecutive taxable years, the trust expenses shall be subject to the limitations of section 67(a).

215. See, e.g., *Seligson v. Comm’r*, 63 T.C.M. (CCH) 3101 (1992), *aff’d mem.* 15 F.3d 1089 (9th Cir. 1994).

216. The treatment of deductions in the year of the termination of a trust or estate is another issue that perhaps might merit regulatory treatment. *Etheridge*, *supra* note 128, at 28. The general rule permits deductions in excess of income to pass through to beneficiaries in the year of termination. IRC § 642(h)(2). Under the trust-based interpretation, there would be no reason to deviate from the general rule.

Trusts Required to Distribute All of their Income. The treatment of expenses incurred by a trust that is required to distribute all of its income within the meaning of section 641(c) shall be treated as exempt from section 67(a), whether or not the trust actually distributes all of its income in the taxable year that expenses are incurred.

V. CONCLUSION

The inequity brought about by section 67(e) happened because the adoption of that provision and subsequent interpretations of it assumed that trusts had no relevance to middle class taxpayers. This issue is important to equity both substantively and symbolically. Substantively, trusts established by wealthy individuals for long term wealth accumulation to benefit descendants in the future would contribute more to tax revenues and the burden on other taxpayers would be relieved in a corresponding amount. The symbolic importance of the issue is that it highlights the need to understand who tax provisions affect and what that effect is. Without this understanding, tax reform can never move beyond the simplistic rhetoric that has brought the once respected Internal Revenue Code into disrepute.