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JUDGE SONIA SOTOMAYOR'S TAX OPINIONS[1]

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This article examines Judge Sonia Sotomayor's three published opinions in cases involving federal taxation, one as a District Court judge and two as a Court of Appeals judge. Two of the opinions deal with routine matters and will therefore be discussed only briefly. The third opinion, which was reviewed by the Supreme Court, will be discussed at greater length. Although Chief Justice Roberts, writing for the Supreme Court, affirmed the result in this third opinion, he criticized Judge Sotomayor's reasoning (despite the fact that both the Solicitor General and the Department of the Treasury had endorsed it) and offered instead a different rationale. After a careful reading, I find the rationale of Judge Sotomayor's opinion as least as valid as, and probably preferable to, that of Chief Justice Roberts. I also find Chief Justice Roberts' criticism of Judge Sotomayor's rationale logically flawed and therefore unwarranted.

Judge Sotomayor's first tax opinion, *Toker v U.S.*, 982 F. Supp. 197 (1997), written when she was a District Court judge, was affirmed without opinion by the Second Circuit, 133 F. 3d 908 (2d Cir. 1997). The taxpayers in *Toker* deducted losses for the years 1982, 1983, and 1984 in connection with a car leasing partnership. After receiving a deficiency notice from the IRS for 1982, the taxpayers filed a petition contesting the deficiency with the U.S. Tax court. Two years later, pursuant to a stipulation between the taxpayers and the IRS, the Tax Court affirmed the deficiency, which the taxpayers paid shortly thereafter. After receiving additional deficiency notices from the IRS for 1983 and 1984, the taxpayers entered into a binding written agreement with the IRS to settle the dispute and pay the deficiencies.

Other participants in the car leasing partnership declined settlement offers from the IRS and contested asserted deficiencies before the Tax Court, where they ultimately prevailed. The taxpayers

[1] I am grateful to Ken Bacon, Daniel Halperin, Laura Sager, and Ethan Yale for comments on an earlier draft of this article.

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in *Toker* then filed suit in the District Court, claiming that the IRS had agreed to refund their payment of asserted deficiencies if other partners prevailed in litigation claiming the deductions.

Judge Sotomayor's opinion granted the government's motion for summary judgment. With respect to the 1982 deductions, Judge Sotomayor found that the District Court lacked subject matter jurisdiction under § 6512(a), which provides that a taxpayer who files a petition with the Tax Court is precluded from suing to recover the disputed tax payment in another court.

With respect to the 1983 and 1984 deductions, Judge Sotomayor ruled that the District Court had jurisdiction because the taxpayers did not previously petition the Tax Court regarding their 1983 and 1984 tax liability. However, she granted summary judgment because the written agreement with the IRS clearly and unequivocally indicated that they entered into a final, binding settlement.

Judge Sotomayor rejected, as barred by the parole evidence rule, the taxpayers' contention that the IRS agreed orally that if there was a later determination that the deductions were correct, they would be entitled to recover the payment of the deficiencies. In reaching this conclusion, she followed decisions of the Second Circuit, barring parole evidence to interpret agreements between taxpayers and the IRS unless the written terms are ambiguous.

Judge Sotomayor also dismissed the taxpayers' contention that the parole evidence rule should be disregarded because they justifiably relied on fraudulent statements by IRS employees that the settlement agreement would not affect their substantive rights. She cited the rule that justifiable reliance in fraud cases must consider whether the truth was readily ascertainable by the allegedly defrauded person. She then noted that Mr. Toker, an attorney and a judge, could ascertain the true effect of the signed agreement simply by referring to the plain language describing the settlement agreement as a final, binding agreement.

Judge Sotomayor's second opinion involving federal taxation was as a Court of Appeals judge in *Addington v. Commissioner*, 205

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F.3d 54 (2nd Cir. 2000). Her affirmance of a Tax Court decision in favor of the IRS was joined by then Chief Judge Ralph Winter and Senior Judge Jon Newman. The taxpayers claimed that the Tax Court erred in upholding the IRS assessment of negligence and valuation overstatement penalties in connection with their 1981 and 1982 tax returns. The taxpayers invested in leasing partnerships that acquired plastics recycling equipment. Although this equipment had a fair market value not in excess of $50,000, the taxpayers claimed tax deductions and credits based on assigning the equipment a value of over $1 million.

Negligence penalties are imposed by § 6653 for "a lack of due care or a failure to do what a reasonable and prudent person would do under the circumstances." *Chimblo v. Commissioner*, 177 F.3d 119, 126 (2d Cir. 1999) (citing *Goldman v. Commissioner*, 39 F.3d 402, 406 (2d Cir. 1994). Similarly, under § 6659(e), the IRS may waive the valuation overstatement penalty "on a showing by the taxpayer that there was a reasonable basis for the valuation . . . ." The taxpayers claimed that they should be relieved of both negligence and valuation overstatement penalties because of their reliance on the advice of a professor of tax law at New York University Law School and a tax attorney who helped prepare the equipment leasing partnership prospectus. Judge Sotomayor ruled that it was unreasonable to rely on the law professor who stated to the taxpayers that he was uncertain whether the prospectus correctly valued the equipment and proposed that the taxpayers hire an independent appraiser. She added that reliance on the opinion of the tax attorney who was involved in preparing the prospectus was also unjustified. Therefore, she concluded, the imposition of penalties was valid.

The taxpayers also contended that they should be afforded the same treatment as other investors in the partnership who were relieved of negligence penalties in settlement agreements with the IRS. Judge Sotomayor rejected that argument, noting that the Commissioner made the same settlement offer to the taxpayers who refused it.

Judge Sotomayor's first two opinions involving taxation are thoroughly researched, well reasoned, and clearly written.

Nevertheless, the reasoning and results are unremarkable in the sense that it is difficult to imagine the cases coming out any other way. Her third opinion, however, in *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (2d Cir. 2006), aff'd sub nom. *Knight v. Commissioner*, 552 U.S. 181, 128 S. Ct. 782 (2008), generated a difference of opinion with Chief Justice Roberts concerning the proper interpretation of § 67(e)(1).

The issue in *Rudkin* was whether investment advisory fees incurred by a trust are "miscellaneous itemized deductions," deductible only to the extent that they (and other such deductions) exceed 2% of the taxpayer's adjusted gross income. The relevant statutory provision, § 67(e)(1), provides that the expenses of a trust are not treated as miscellaneous itemized deductions if the expenses "would not have been incurred if the property were not held in trust."[2]

The language of the statute is not susceptible of easy application because it refers to a counterfactual. The language directs us to assume that the property in question, which is in fact held by a trust, is not held by a trust. We are then to determine whether, in those hypothetical, counterfactual circumstances, the owner would have incurred the expenses. Instead of applying the law to facts that have occurred, we are asked to apply the law to counterfactuals and imagine what would have occurred had the facts been counter to what they were.

Given such problematic language, as well as an absence of clear legislative intent, it is unsurprising that courts of appeal disagreed about the meaning of § 67(e)(1). The Sixth Circuit interpreted the language to mean that all expenses attributable to a trustee's fiduciary were expenses that "would not have been incurred if the property were not held in trust." Therefore, the Sixth Circuit held that investment advisory fees incurred by a trust qualified under § 67(e)(1) because a trustee has a fiduciary duty to obtain investment advice. *O'Neill v. Commssioner*, 994 F.2d 302. (6th Cir. 1993). On

[2] If exempted from the miscellaneous itemized deductions category, such expenses are fully deductible from gross income for the purpose of calculating adjusted gross income.

the other hand, the Federal Circuit held that § 67(e)(1) applies only to expenses that are "not *customarily* incurred outside of trusts [emphasis added]." Therefore, because investment advisory fees are customarily incurred by individuals, such fees do not fall under § 67(e)(1). *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001). The Fourth Circuit agreed, ruling that investment advisory fees do not qualify because they are customarily incurred outside the context of trust administration. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003).

Judge Sotomayor properly rejected the Sixth Circuit's construction of Section 67(e)(1) as contrary to the language of that provision, which asks, not whether the expenses were incurred because of the trustee's fiduciary duty, but rather whether the expenses would have been incurred had the property been held by an individual owner:

> [T]he phrase "if such property were not held in trust" more logically directs the inquiry away from the trust and back toward the hypothetical ownership of property by an individual . . . . It focuses the inquiry, instead, on the hypothetical situation where the assets are in the hands of an individual. 467 F.3d 155.

She was concerned, however, that the construction adopted by the Federal and Fourth Circuits—focusing on whether an individual owner would *customarily* incur the expenses—involves a subjective and uncertain standard. She argued that "the statute demands not a "subjective" inquiry "but rather an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are incapable of incurring." 467 F. 3d 156:

> While the Federal and Fourth Circuits' approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is

> unnecessary and less consistent with the statutory language. We believe that the plain text of § 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. We therefore hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner. 467 F.3d 156.[3]

On appeal, the Supreme Court affirmed the Second Circuit's decision but preferred the construction of Section 67(e)(1) adopted by the Federal and Fourth Circuits: that Section 67(e)(1) exempts expenses that would not *customarily* be incurred if an individual owned the property held in trust. *Knight v. Commissioner*, 552 U.S. 181, ___; 128 S. Ct. 782, 789 (2008).

Chief Justice Roberts conceded the subjective and uncertain nature of the inquiry under this construction:

> The question whether a trust-related expense is fully deductible turns on a prediction about what would happen if a fact were changed—specifically, if the property were held by an individual rather than a trust. In the context of making such a prediction, when there is uncertainty about the answer, the word "would" is best read as "express[ing] concepts such as custom, habit, natural disposition, or probability," [citations omitted]. . . .The text requires determining what would happen if a fact were changed; such an exercise

[3] Examples of such costs that individuals are incapable of incurring are "fees paid to trustees, expenses associated with judicial accountings, the costs of preparing and filing fiduciary income tax returns." 467 F.3d 156.

> necessarily entail a prediction; and predictions are based on what would customarily or commonly occur." 552 U.S. 181, ___; 128 S.Ct. 782, 789-790.

Chief Justice Roberts also criticized Judge Sotomayor's reasoning:

> In applying the statute, the Court of Appeals below asked whether the cost at issue *could* have been incurred by an individual. This approach flies in the face of the statutory language. The provision at issue asks whether the costs "would not have been incurred if the property were not held" in trust . . . not, as the Court of Appeals would have it, whether the costs "could not have been incurred in such a case . . . . The fact that an individual could not do something is one reason he would not, but not the only possible reason. If Congress had intended the Court of Appeals; reading, it could easily have replaced "would" in the statute with "could," and presumably would have." The fact that it did not adopt this readily available and apparent alternative strongly supports rejecting the Court of Appeals' reading. 552 U.S. 181, ___, 128 S. Ct. 787.

Chief Justice Roberts' criticism of Judge Sotomayor, however, begs the question. If Congress had intended his preferred reading of Section 67(e)(1), it could have easily inserted the word "customarily" in the provision. Why, in his own words, doesn't "[t]he fact that it did not adopt this readily available and apparent alternative strongly [support] rejecting" his reading of the provision?

In fact, there are at least two plausible readings of the language of Section 67(e)(1). It could be interpreted by reading into the statute after the words "would not" the word "customarily." Or it could be interpreted by reading into the statute after the words "would

not" the word "ever." Either reading is plausible. In the first case, the statute is interpreted to read "would not customarily have been incurred" and requires a subjective judgment about what is customary. In the second case, the statute is interpreted to read "would not ever have been incurred," and requires determining whether the expense was one that an individual could not incur. Neither Chief Justice Roberts', nor Judge Sotomayor's construction "flies in the face of the statutory language." Chief Justice Roberts' criticism of Judge Sotomayor is unpersuasive and overstated.

Justice Roberts also claimed that Judge Sotomayor disregarded the first clause of Section 67(e)(1), which refers to costs "paid or incurred in connection with the administration" of a trust. He stated:

> [I]f the Court of Appeals' reading were correct, it is not clear why Congress would have included in the statute the first clause of § 67(e)(1). If the only costs that are fully deductible are those that *could* not be incurred outside the trust context-that is, that could *only* be incurred by trusts-then there would be no reason to place the further condition on full deductibility that the costs be "paid or incurred in connection with the administration of the ... trust,"§ 67(e)(1). We can think of no expense that could be incurred exclusively by a trust but would nevertheless *not* be "paid or incurred in connection with" its administration. 552 U.S. 181, ___, 128 S. Ct. 787.

This criticism, however, itself misreads the statutory scheme by disregarding Section 67(e)(2). Section 67(e) divides all trust deductions into two categories: (1) deductions for costs incurred in connection with the administration of a trust; and (2) the standard deduction and deductions for distributions to trust beneficiaries. Section 67(e)(1) requires that deductions in the first category (that is, deductions incurred in connection with the administration of a trust) "would not have been incurred if the property were not held in such trust." Section 67(e)(2), in contrast, does not impose such a "would not have been incurred" requirement for either the standard deduction or distributions to trust beneficiaries. Thus, the purpose of the "paid or incurred in connection with the administration of [a] trust" language

in the first clause of Section 67(e)(1) is to separate deductions subject to the "would not have been incurred" requirement from specified deductions under Section 67(e)(2) that are not subject to that requirement. Obviously, the first clause of Section 67(e)(1) serves this purpose under either Judge Sotomayor's or Judge Roberts' reading of the "would not have been incurred language" of the second clause of Section 67(e)(2).

Both the Treasury and the Solicitor General affirmed the validity, and perhaps the superiority, of Judge Sotomayor's approach. Following the issuance of her opinion, the Treasury proposed interpretive regulations adopting her reading of the statute. In addition, the Solicitor General's brief to the Supreme Court, urged that her second circuit opinion be approved as "an easily administrable rule." 552 U.S. 181, ___, n. 3; 128 S.Ct. 782, 787, n. 3.

Others have criticized Justice Roberts' opinion for creating confusion and uncertainty:

> By adopting the Fourth and Federal Circuits' interpretation of the second condition of § 67(e)(1), the [Supreme] Court has added to the confusion surrounding the exception, rather than clarifying its application. By focusing the inquiry on what expenses are "uncommon (or unusual, or unlikely) for . . . a hypothetical individual to incur," it is unclear which expenses will qualify for the exception and which expenses will not. While this standard is not as restrictive as the Second Circuit's interpretation, its application is more difficult and burdensome. The Court's standard does not develop a bright line test subjecting all investment advisory fees to the 2% floor. Rather, only those fees that are "commonly incurred by individuals" are subject to the floor. During oral argument, the Court struggled with how the "commonly incurred" language would be applied to determine the deductibility of other expenses. Based on the

> lack of certainty in this standard, there is room to argue that certain fees incurred by a trust were for specialized services that are not commonly incurred by individuals. In such a situation, the dicta in the last paragraph of the Court's decision may require the trustee to bifurcate the fee into fees commonly incurred by individuals and fees not commonly incurred by individuals. This potential requirement, created by the dicta of the opinion, adds even more confusion to an already confusing standard: Those fees attributable to services that are common for individuals are subject to the 2% floor of § 67(a), while those fees attributable to specialized services for the trust and not common for individuals are not subject to the 2% floor and are fully deductible by the trust. This standard leaves much to be desired. It suggests that financial advisors have the burden of tracking and separating fees into categories of those common for individuals and those that are not.[4]

Another commentator echoes this concern:

> [T]he Court in *Knight* conceded that figuring what costs are common is an uncertain exercise and even difficult to administer without regulatory guidance. In spite of that admission, it further complicated the tax treatment of investment advisory fees by declaring that such fees could merit full deductibility if there were special charges on

[4] Lindsay Roshkind, *Interpreting I.R.C. § 67(e): The Supreme Court's Attempt to Nail Investment Advisory Fees to the Floor*, 60 FLA. L. REV. 961, 970-972 (2008).

account of the trust's fiduciary duties.[5]

In contrast, Judge Sotomayor's opinion in *Knight* was informed by her awareness of and concern for the real world consequences of adopting one interpretation of Section 67(e)(1) or the other. Given two plausible ways of reading the statute, she preferred an interpretation that affords more certainty and less confusion. She was sensitive to the practical implications of her decision for taxpayers and their advisors struggling to cope with a complex and often badly drafted tax statute.

[5] Dean Roy, *Is That the End? Section 67(e)(1) and Trust Investment Advisory Fees after Knight v. Commissioner*, 61 TAX LAW. 321, 326 (2007).