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Past Sotomayor Opinions Not Encouraging for Opponents of State Tax Overreaching

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Introduction

Following President Barack Obama's nomination of Second Circuit Court of Appeals Judge Sonia Sotomayor to the United States Supreme Court, journalists, legal scholars, and political pundits began perusing her legal opinions, journal writings, and speeches to examine how she might alter the high court's political tilt. Notwithstanding the discussion about some of her past statements (most notably her remark, "I would hope that a wise Latina woman with the richness of her experiences would more often than not reach a better conclusion than a white male who hasn't lived that life"), many view her as a "safe pick" by President Obama and one that will easily be confirmed by the Senate.

Whether Judge Sotomayor gets an easy confirmation or not, a review of her judicial record is both educational and expected. When it comes to tax-related cases, Judge Sotomayor has had her share over her seventeen years on the federal bench. While serving as a judge for the Southern District of New York and the Second Circuit Court of Appeals, Sotomayor has heard tax-related cases ranging from evasion to fraud. As a District Court judge, she had original jurisdiction for taxpayers who had paid their federal taxes and thereafter chose to dispute them, as well as all federal tax-related criminal offenses. While her decisions in such cases clearly affected the lives of the citizens involved in the case, the nature of the role means that few if any have any far-reaching effect.

Rather it has been her time as a judge on the Court of Appeals that begs further examination. Two cases handed down during Judge Sotomayor's time on the Second Circuit appear to provide

insight as to how she may handle important tax questions on the Supreme Court: *Swedenburg v. Kelly* and *William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue*.

Swedenburg v. Kelly

One issue that needs Supreme Court resolution is the recent trend of aggressive actions by states to tax beyond their borders. In *Quill Corp. v. North Dakota* (1992), the Court held that a state cannot require an out-of-state company (one with no “substantial nexus,” meaning no property or employees in the state) to collect the state’s sales tax.¹ This ruling is in accord with the principle that states’ taxing power extends only to their geographical limits, thus preventing a state from burdening the flow of interstate commerce.

Nevertheless, states have increasingly pushed against the limits of *Quill*. West Virginia, capitalizing on the fact that the tax at issue in *Quill* was sales tax (although the reasoning could easily apply to all taxes), decided that it had the power to impose an income tax on an out-of-state company with no employees or property in the state. New York, Rhode Island, and a handful of other states have imposed “Amazon taxes” that require out-of-state Internet companies to collect sales taxes if they have relationships with in-state affiliates. (Companies have responded in states adopting such taxes by terminating such relationships, and the constitutionality of these taxes remains mired in litigation.)

Judge Sotomayor has yet to rule on a nexus case, but she has had experience ruling in cases dealing with the part of the Constitution governing such cases: the Commerce Clause of Article I, Section 8. One such case was *Swedenburg v. Kelly*.²

Juanita Swedenburg owned an independent winery in Virginia and wanted to sell her wine directly to customers in New York, in violation of a New York law prohibiting out-of-state wineries (but not in-state wineries) from selling in the state. Typically such a law would run afoul of the Commerce Clause, but New York argued that its power under the 21st Amendment to the Constitution (which repealed Prohibition, nebulously vesting power to regulate alcohol to the states) overrode its obligation not to burden interstate commerce.

To many individuals, this case was of greatest importance as it raised issues of internet commerce, free trade among the states, and oppressive business and consumer regulations. However, states viewed this case in terms of tax revenue and protecting in-state interests. New York feared that an adverse decision would cause a decrease in revenue from in-state alcohol sales, a standard motivation behind laws struck down by the Commerce Clause.

Judge Sotomayor was part of a three-judge panel finding New York's discriminatory position toward out-of-state wine shippers to be constitutional, affirming the trial court ruling. Forced to reconcile the Commerce Clause with the 21st Amendment, the court’s opinion picked a state protectionist scheme disguised as a liquor regulation as more deserving of judicial protection than Ms. Swedenburg’s right to ship legal goods across state lines. While it acknowledged the state’s desire to keep tax revenue, the Court found that the possible positives that could come out of restricting the interstate shipment of liquor (particularly hindering the shipment of alcohol to underage minors) outweighed the real negatives to out-of-state wineries.

The panel opinion in *Swedenberg* was eventually appealed to the U.S. Supreme Court and reversed.³ The Court, in a 5-4 opinion, held that the 21st Amendment returned state power to the *status quo* that existed before Prohibition, and did not create a new state power to regulate liquor even if it disrupts interstate commerce. Before Prohibition, the states did not have the power to violate the Commerce Clause, and the 21st Amendment was not intended to grant them this power. Since this ruling, many more states have permitted direct shipping from wineries, with 35 states permitting at least some form of direct winery-to-consumer shipping.

The reason this case is important for tax jurisprudence is that more and more states are implementing discriminatory or expansive taxes that appear to be in violation of the Commerce Clause. The Tax Foundation's Center for Legal Reform has filed friend-of-the-court briefs and written reports about many of these cases, where overreaching by state tax authorities to advance a protectionist motive have hurt business and consumers.

William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue

The U.S. Supreme Court has granted review in seven cases where Judge Sotomayor wrote the appellate court majority opinion. One of those cases, *William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue*, involved the deductibility of fees paid by a trust to an outside investment firm. Michael Knight, the trustee of a large trust⁴, claimed that he lacked the proper investment training and knowledge to manage the trust and thus hired an outside investment firm at an annual fee of 0.8% of the trust's assets. In 2000, the trust claimed a \$22,241 deduction for the fees on line 15a of its tax return for "deductions not subject to the 2% floor."⁵ The IRS disallowed the full deduction, permitting the trust to deduct the fees only to the extent that an individual would be able to do so (in other words, only the portion that exceeded 2% of the trust's income). Knight petitioned the Tax Court, arguing that a full deduction was permitted under Section 67(e) of the Internal Revenue Code.

Consistent with decisions of the Fourth and Federal Circuits, the Tax Court ruled against Knight, holding that only costs which are not "customarily" or "commonly" incurred by individuals are fully deductible by trusts and estates. Thus, Knight could not deduct the costs associated with earning income in this instance.

On appeal, the Second Circuit affirmed the Tax Court holding in an opinion authored by Judge Sotomayor.⁶ She wrote:

[I]n determining whether costs such as investment advisory fees are fully deductible or subject to the 2% floor, Section 67(e) 'directs the inquiry toward the counterfactual condition of assets held individually instead of trust,' and requires 'an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are *incapable* of incurring.'⁷

In other words, since an individual could pay for investment-advice services, and since the individual's payment would not be fully deductible, Section 67(e) did not permit a trust to fully deduct payment for the same services. Judge Sotomayor's opinion was more exacting than the Fourth and Federal Circuits, allowing "full deduction only for those costs that *could not have*

been incurred by the individual property owner,” not merely those that didn’t happen.⁸ The net result is a rule that is harsher on taxpayers and easier on government.

The Supreme Court granted certiorari in this case, as different appeals courts disagreed on the deductibility of the fees.⁹ In the meantime, the IRS adopted a regulation interpreting Section 67(e) that essentially adopted Judge Sotomayor’s position. The proposed regulation permits deductibility only to costs which are “unique” to trusts and estates and defines a cost as “unique” to a trust “if an individual could not have incurred that cost” in connection with property not held in trust.

However, the Supreme Court unanimously rejected that approach by Judge Sotomayor, stating that it “flies in the face of the statutory language.” As explained by Chief Justice Roberts in an opinion affirming the Second Circuit opinion but rejecting part of its reasoning:

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 easily could 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.¹⁰

The Court held that if an expense incurred by a trust is of a type that would also be incurred by an individual taxpayer, the expense is subject to the same deduction limits applied to individual expenses. Chief Justice Roberts reasoned that the tax statute at issue requires that a court determine whether or not an individual customarily would spend money on the type of service at issue. If so, the expense would not be fully deductible by a trust.

Conclusion

While a nominee’s prior voting record or political affiliation is not always a guarantee as to how he or she will decide cases as a Supreme Court justice, these two different cases may provide some insight into Judge Sotomayor’s judicial performance.

Her reading of the tax code, when it fills in ambiguous or unclear areas, may be harsher on taxpayers and more favorable to the government, as seen in *Rudkin*. She also has shown an inclination to approve the constitutionality of state regulations at face value, even in the face of evidence of protectionist motivations and consequences as in *Swedenburg*.

In our June report reviewing Justice Souter’s tax jurisprudence, we concluded:

Over the course of his 19 years on the Supreme Court, Justice Souter has been accused of transforming from a moderate "conservative" to a reliable "liberal" vote. Insofar as his views on discriminatory taxes go, there has been a shift. A justice who was once eager to question states' protectionist use of their taxing authority (to the detriment of the national

market) has become over time a justice willing to twist the precedents to uphold such laws. Having begun on one side of the issue, Justice Souter will retire on the opposite side.¹¹

Judge Sotomayor, if confirmed, may start her tax law judicial opinions on the high court where Justice Souter left off.

Notes

1. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
2. 358 F.3d 223 (2d Cir. 2004).
3. See *Granholm v. Heald*, 544 U.S. 460 (2005).
4. The trust was funded with proceeds from the sale of Pepperidge Farm, a profitable food products company.
5. The “2% floor” for itemized deductions was implemented as part of the 1986 tax reform to deal with the previous system which required “extensive [taxpayer] recordkeeping with regard to what commonly are small expenditures,” as well as “significant administrative and enforcement problems for the Internal Revenue Service. See H. R. Rep. No. 99-426, p. 109 (1985).
6. *William L. Rudkin Testamentary Trust v. C.I.R.*, 467 F.3d 149 (2d Cir. 2006).
7. *Id.* at 155, 156.
8. *Rudkin*, 467 F. 3d at 156 (emphasis added).
9. The Sixth Circuit found that investment advisory fees for a trust were fully deductible, whereas the Fourth, Federal, and, now, Second Circuit found that such fees were subject to the 2% floor.
10. *Knight v. C.I.R.*, 552 U.S. 181 (2008), citing *Rudkin*, 467 F. 3d at 155 (emphasis added).
11. Travis Greaves, “Justice Souter’s Tax Opinions Show Steady Erosion of Respect for Commerce Clause,” *Tax Foundation Fiscal Fact No. 173*, June 2009, at <http://www.taxfoundation.org/publications/show/24740.html>.

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⁶ *William L. Rudkin Testamentary Trust v. C.I.R.*, 467 F.3d 149 (2d Cir. 2006).

⁷ *Id.* at 155, 156.

⁸ *Rudkin*, 467 F. 3d at 156 (emphasis added).

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¹⁰ *Knight v. C.I.R.*, 552 U.S. 181 (2008), *citing Rudkin*, 467 F. 3d at 155 (emphasis added).

¹¹ Travis Greaves, “Justice Souter’s Tax Opinions Show Steady Erosion of Respect for Commerce Clause,” *Tax Foundation Fiscal Fact No. 173*, June 2009, at <http://www.taxfoundation.org/publications/show/24740.html>.