New York State Bar Association

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NYSBA

April 5, 1999

The Honorable Donald C. Lubick
Assistant Secretary, Tax Policy
Department of the Treasury
Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000
111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose comments of the New York State Bar Association Tax Section on the proposed amendments that address the impact of the payment of administration expenses on both the estate tax charitable and marital deductions under sections 2055 and 2056 of the Internal Revenue Code. The comments agree fundamentally with the approach taken in the proposed amendment, but suggest certain modifications. Because the modifications do differ from the provisions in the proposed amendments, we suggest that if the modifications are

incorporated in the regulations, the regulations be issued in proposed form to give others an opportunity to share their comments.

Please let me know if we can be of any further assistance in addressing these issues.

Very truly yours,

Harold R. Handler
Chair

cc: The Honorable Stuart L. Brown
Beth Kaufman, Esq.
Deborah S. Ryan, Esq

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON PROPOSED AMENDMENTS TO THE TREASURY REGULATIONS THAT DEAL WITH THE EFFECT OF ADMINISTRATION EXPENSES ON THE MARITAL AND CHARITABLE DEDUCTIONS[1]

This report comments on proposed amendments to the regulations that deal with the extent to which an estate's administration expenses should reduce the amount of its marital and charitable deductions. The proposed amendments, which were published on December 16, 1998, reflect many of the suggestions contained in the June 24, 1998 report we submitted to Treasury and to the Internal Revenue Service in response to their request for comments contained in Notice 97-63.[2] We believe the proposed amendments will help conform the existing regulations to the economic realities of estate administration. Nevertheless, we think that the modifications suggested below are necessary to complete the job. Because the modifications suggested below contain some provisions that differ materially from the proposed amendments, we suggest that, if it is decided to incorporate these modifications in the regulations, the regulations be issued in proposed form in order to give others an opportunity to share their comments.

I. BACKGROUND

Code section 2055(a)[3] permits a deduction for the value of any property that is included in the decedent's gross estate and transferred by the decedent at death to charity outright or in certain qualifying trusts, the "charitable deduction." Likewise, Code section 2056(a) permits a deduction, the "marital deduction," for the value of property included in the

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1. This report was prepared by the Committee on Estates and Trusts of the Tax Section of the New York State Bar Association. Its principal drafters were Mildred Kalik and Carlyn S. McCaffrey.

2. 1997-47 I.R.B. 6.; New York State Bar Association Report on the Impact of Administration Expenses on Amount of Estate Tax Deduction for Charitable and Marital Bequests, 98 TNT 127-19 (July 2, 1998).

3. References to "Code" refer to the Internal Revenue Code of 1986, as amended.

decedent's gross estate and that passes from the decedent to the decedent's surviving spouse outright or in certain qualifying trusts.[4]

One of the important issues that arises in connection with these deduction rules is the extent to which administration expenses, paid or payable from either the principal of, or the post-death income generated by, property passing to charity or to a spouse, reduce the amount of the charitable or marital deduction. The Supreme Court addressed this issue in the *Hubert* case.[5]

Administration expenses are deductible, independently of the charitable or marital deduction, under Code section 2053.[6] As a result, in many cases the source of the payment of the administration expenses will have no tax consequences.

The source of the payment of administration expenses is tax significant when (1) there are estate beneficiaries other than charity or the decedent's spouse or (2) the executor of the estate elects to deduct administration expenses on the estate's income tax return.[7]

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4. Both deductions impose certain requirements on the form of the property interest passing to charity or to the spouse.

5. *Commissioner v. Estate of Hubert*, 520 U.S. 93, 117 S. Ct. 1124 (1997).

6. Deductible estate administration expenses are those "expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. . . . Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses." Treas. Reg. section 20.2053-3(a), "Miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in preserving and distributing the estate are deductible, including the cost of storing or maintaining property of the estate, if it is impossible to effect immediate distribution to the beneficiaries." Treas. Reg. Sec. 20.2053-3(d).

7. For simplicity, this report focuses on the issues discussed in the context of an estate and its executor. The same issues arise, however, when a decedent uses a revocable trust or other testamentary document to dispose of her property at death. In that case, the administration expenses are the administration expenses of the trust and the person making the allocation decisions is the trustee (unless there is also an executor, in which case she may make these decisions).

Amounts deductible under Code section 2053 are not deductible for income tax purposes unless the right to deduct such amounts under Code section 2053 has been waived. Code section 642(g).

The Supreme Court's *Hubert* decision does not resolve the confusing and not entirely consistent, pattern of regulations, rulings, and judicial decisions that have surrounded this issue since the inception of the two deductions[8]. The concurring opinion, written by Justice O'Connor and joined in by Justices Souter and Thomas, expresses discomfort with the state of chaos surrounding this issue and invites the Treasury to resolve the issue by regulation. Treasury's proposed amendments issued in response to this invitation are the subject of this report.

II. THE PROPOSED AMENDMENTS

The proposed amendments recommend three changes to the existing regulations. The most significant of the proposed changes is the addition of a new paragraph (e) to Treas. Reg. Sec. 20.2056(b)-4. Paragraph (e) divides administration expenses into two categories, "estate transmission expenses" and "estate management expenses." The amount of estate transmission expenses charged either to property passing to a spouse or to the income it produces will reduce the amount of the marital deduction. Estate management expenses will not.

The term "estate management expenses" is defined as,

> "expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees, and interest."

The term "estate transmission expenses" is defined as all estate administration expenses that are not estate management expenses, including

> "expenses incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property to those who are entitled to receive it. Examples of these expenses include executor commissions and attorney fees (except to the extent specifically related

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8. The marital deduction became part of the Code in 1948. Revenue Act of 1948 ch. 168, section 361, 62 Stat. 117. In its original form, it was limited to 50% of a decedent's adjusted gross estate and was not available for community property. These limitations were removed in 1976 and 1981. Tax Reform Act of 1976, 90 Stat. 1520, section 1902; Economic Recovery Tax Act of 1981, 95 Stat. 172, section 403. The charitable deduction was added to the Code as part of the Revenue Act of 1918, Public No. 254, 65th Cong., approved Feb. 24, 1919.

For a more detailed discussion of the pre-Hubert regulations, rulings and judicial decisions affecting this issue, see the New York State Bar Association Report on the Impact of Administration Expenses on Amount of Estate Tax Deduction for Charitable and Marital Bequests, 98 TNT 127-19 (July 2, 1998).

to investment, preservation, and maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees."

Paragraph (e) also sets forth a special rule that applies to estate management expenses that are paid from property (or its income) passing to a spouse and that are deducted as administration expenses on the estate's federal estate tax return. The special rule requires the reduction of the marital deduction by the amount of federal estate taxes that would have been paid from the property (or its income) passing to the spouse if the expenses had not been deducted on the federal estate tax return.

The other two proposed amendments are mechanical ones. The first states that the rules to be set forth in the portion of the marital deduction regulations that determine the effect of administration expenses on the amount of the marital deduction will apply to the charitable deduction as well.

The second deletes the last two sentences of paragraph (a) of Treas. Reg. Sec. 20.2056(b)-4. The deleted sentences provide as follows:

"In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate."

These sentences are no longer needed since the new rule does not distinguish between expenses paid from income and those paid from principal.

III. COMMENTS

A. Preventing Estate Administration Expenses Paid by Charitable and Marital Beneficiaries From Reducing Estate Taxes Imposed on Bequests Passing to Others

1. The Problem

Under the proposed amendment, a management expense payable from the marital share may be deducted as an administration expense under Code section 2053, thereby enabling the

estate to shelter estate tax on the non-marital share by expenses paid from the marital share. This is, in effect, the grant of a double deduction for the same expense.[9]

If a decedent's estate management expenses are chargeable against property entitled to a marital or charitable deduction, if those expenses are deducted on the decedent's estate tax return under Code section 2053, and if property includable in the decedent's estate passes to someone other than charity or the decedent's husband, the Code section 2053 deduction will protect property passing to others from estate taxes. We believe this is an inappropriate result. We also believe that it is inconsistent with Code section 2056(b)(9), which precludes the deduction for federal estate tax purposes of the value of any interest in property more than once.

Consider the following example:

> **Example 1:** D dies with a gross estate worth $2,000,000, $90,000 of which is a death benefit payable to D's daughter under a life insurance policy on D's life owned by D at the time of her death. As a result of gifts made during her lifetime, D's estate will be in a 55% estate tax bracket. The state estate tax equals the state tax credit available under Code section 2011. D's will gives her entire estate to her husband outright. State law requires the daughter to pay the estate taxes attributable to the life insurance proceeds. Estate management expenses amount to $90,000. D's executor deducts the $90,000 as an administration expense on D's federal estate tax return. Total estate tax deductions are now $2,000,000 ($1,910,000 marital and $90,000 administrative). As a result, no estate tax is imposed on the life insurance proceeds passing to D's daughter.[10]

The special rule in Proposed regulation section 20.2056(b)-4(e)(2)(ii) restricts the benefits of this double deduction in part. Code section 2056(b)(4) requires reduction of the marital deduction for death taxes payable from the marital share. The effect of the special rule is to provide that the amount of the federal estate tax that reduces the marital share is determined as if the management expenses were not deductible under Code section 2053. The special rule states that the marital deduction will not be increased as a result of the decrease in federal estate tax liability attributable to estate management expenses that are deducted as expenses of administration on the estate's estate tax return. The restriction appears to be

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9. Actually it is a deduction once (under Code section 2053) combined with a failure to reduce the deduction under Code section 2056 for expenses being taken from the property (or its income) passing to the spouse.

10. There is a similar impact even in a non-taxable estate because a formula amount credit shelter bequest will be increased by an amount equal to the Code section 2053 management expenses paid by the marital share.

applicable only to those estates that impose responsibility for the payment of estate taxes on the property passing to the spouse or to charity.

Suppose, for example, that the will of D, the decedent described in Example 1, required that D's husband pay the estate taxes on the daughter's life insurance proceeds. Before taking administration expenses into account, federal and state estate taxes will be $110,000. The amount of total estate taxes is more than $49,500 (55% of $90,000) because the marital deduction is reduced by the amount of estate taxes imposed on the marital bequest. The estate taxes, therefore, are imposed not only on the life insurance proceeds but also on the funds used to pay the estate tax. The marital deduction in this case would be $1,800,000 ($1,910,000 reduced by estate taxes of $110,000), leaving a taxable estate of $200,000. In the absence of the special rule, the deduction on the estate tax return of the $90,000 worth of estate management expenses would completely eliminate the estate tax by increasing estate tax deductions to $2,000,000.

The special rule reduces the extent of the estate tax reduction by prohibiting an increase in the marital deduction by the amount of the decrease in estate taxes caused by the deduction of the administration expenses on the federal estate tax return. In this case, if the $90,000 of administration expenses were deducted on the estate tax return, the special rule would require the marital deduction to remain at $1,800,000. But total deductions would be increased to $1,890,000 by the addition of the $90,000 deduction for administration expenses. As a result, the taxable estate is decreased from $200,000 to $110,000; estate taxes are reduced from $110,000 to $60,500.

We do not believe the restriction goes far enough. Expenses paid by charitable and marital beneficiaries or charged against funds that would otherwise be paid to them should not create an estate tax benefit for other beneficiaries. This should be true regardless of the nature of those expenses and regardless of whether the expenses were charged against income or principal.

2. Proposed Solution

In order to prevent non-charitable and non-marital beneficiaries from benefitting from the deduction of expenses borne by charitable and marital beneficiaries, we suggest that the text of Proposed regulation section 20.2056(b)-4(e)(2)(ii) be changed to read as follows:

> "(ii) SPECIAL RULE WHERE ESTATE MANAGEMENT EXPENSES ARE DEDUCTED ON THE FEDERAL ESTATE TAX RETURN. For purposes of determining the marital deduction, the value of the deductible property interest that passed from the decedent to the surviving spouse is decreased by the amount of estate management expenses deducted under section 2053 and paid from the principal of the deductible property interest or from income therefrom to the extent such income would otherwise have passed to the

spouse as a result of the passing to the spouse of the deductible property interest or have been added to the principal of the deductible property interest."

The following examples could be added to illustrate the special rule:

"EXAMPLE __. D dies in 1999 with a gross estate of $2,000,000, consisting of $100,000 worth of life insurance proceeds payable to her daughter and $1,900,000 worth of probate assets all of which are bequeathed to her husband. State law requires the daughter to pay the estate taxes imposed on the life insurance proceeds. The estate incurs estate management expenses of $100,000. D's executor deducts these expenses on D's estate tax return as administration expenses. The $100,000 administration expense deduction reduces the marital deduction to $1,800,000, leaving a taxable estate of $100,000. The amount of the taxable estate is the same as it would have been if the $100,000 in estate management expenses had not been deducted on the estate's estate tax return.

"EXAMPLE __. Assume the same facts as in Example ___, except that D's executor deducts the estate management expenses on the estate's income tax return. In this case, the marital deduction is not reduced by the management expense. The marital deduction remains $1,900,000 and the taxable estate, $100,000.

B. Reduction of Marital Deduction by Estate Transmission Expenses Paid From Income Produced by Deductible Property Interest

1. The Problem

The first sentence of subparagraph (1) of Proposed regulation section 20.2056(b)-4(e) requires the reduction of the marital deduction by estate transmission expenses incurred during the administration of the decedent's estate if the expenses are paid from the income earned by the principal of the property interest passing to the spouse. Reducing the deduction by such expenses is appropriate only if the spouse is entitled to the income earned by such property interest. This will not always be so. Consider, for example, an outright bequest to a spouse of a fixed sum of money. In most states, that bequest may be entitled to interest if not paid within a specified period of time but is not likely to be entitled to receive a share of the estate's income proportionate to the spouse's share of the estate.

2. Proposed Solution

We suggest that the first sentence of subparagraph (1) of Proposed regulation section 20.2056(b)-4(e) be changed to read as follows:

"For purposes of determining the marital deduction, the value of any deductible property interest that passed from the decedent to the surviving spouse shall be

reduced by the amount of estate transmission expenses incurred during the administration of the decedent's estate and paid from the principal of the deductible property interest or from the income produced by the property interest (but, in the case of expenses paid from income, only to the extent that such income would otherwise have passed to the spouse as a result of the passing to the spouse of the deductible property interest or have been added to the principal of the deductible property interest)."

The following examples could be added to illustrate this provision:

"EXAMPLE __. D dies in 1999 with a probate estate and a gross estate of $2,000,000. D's will gives $1,000,000 outright to her husband and the balance of her estate to her children. State law allocates all income earned by the estate to the children, as residuary beneficiaries. It requires that interest of 7% be paid on the $1,000,000 bequest for the period commencing 9 months after the date of death and ending on the payment date. The executor pays the $1,000,000 to the husband 2 years after the date of death along with interest of $87,500. During that 2-year period, the estate earned income of $400,000, consisting of $200,000 of dividends and $200,000 of capital gains. All of the dividend income and $25,000 of the capital gain income was used to pay estate transmission expenses. The marital deduction of $1,000,000 is not reduced by the estate transmission expenses charged to dividend income or to capital gain income because the husband is not entitled, under state law, to share in either type of income.

EXAMPLE __. Assume the same facts as in Example ___, but assume that state law entitles the husband to a pro rata share of the estate's trust accounting income (dividends, interest, rent, and the like). The charge of estate transmission expenses reduced his income entitlement from $100,000 to zero. The marital deduction, therefore, is reduced by $100,000.

C. Reduction of Marital Deduction by Estate Management Expenses Paid From the Principal of a Deductible Property Interest if the Income of Such Interest Passes to Another

1. The Problem

The second sentence of subparagraph (2) of Proposed regulation section 20.2056(b)-4(e) requires the reduction of the marital deduction by:

"the amount of any estate management expenses incurred in connection with property that passed to a beneficiary other than the surviving spouse if a beneficiary other than the surviving spouse is entitled to the income from the

property and the expenses are charged to the deductible property interest which passed to the surviving spouse."

The negative implication of this rule is that no reduction is required if the surviving spouse is entitled to the income from the non-marital deduction property. We believe this is inappropriate. We believe that this rule should be changed to provide that whenever estate management expenses with respect to property not qualifying for the martial deduction (or the income therefrom) are charged to property qualifying for the martial deduction (or the income therefrom) the marital deduction should be reduced by the amount of the those expenses.

2. Proposed Solution

We suggest that the second sentence of subparagraph (2) of Proposed regulation section 20.2056(b)-4(e) be changed to read as follows:

"For marital deduction purposes, the value of any deductible property interest that passed from the decedent to the surviving spouse shall be reduced by the amount of any estate management expenses incurred in connection with any nondeductible property interest except to the extent that the charge relieves the surviving spouse or property or income payable to the surviving spouse from an obligation to pay such expenses."

D. Technical Matters

1. Special Rule Where Estate Management Expenses Are Deducted on the Federal Estate Tax Return

a. Applicability of Special Rule to Estate Management Expenses That Reduce the Marital Deduction

(1) The Problem

The special rule in Proposed regulation section 20.2056(b)-4(e)(2)(ii) states that the marital deduction will not be increased as a result of the decrease in federal estate tax liability attributable to estate management expenses that are deducted as expenses of administration on the estate's estate tax return. As discussed above, we believe that the special rule should be replaced. If it is retained, however, it should be modified so that it does not apply to estate management expenses that do reduce the marital deduction.

The purpose of the special rule, we believe, is to counteract, in part, the tax advantage of claiming an estate tax deduction for estate management expenses paid from property passing to a surviving spouse without reducing the amount of the marital deduction allowed for such property. If the amount of the marital deduction is reduced by the estate management expenses, no such advantage exists. The application of the special rule in this case makes

estate management expenses that reduce the marital deduction more costly than estate transmission expenses that reduce the marital deduction.

A comparison of Example 1 with Example 3 in the Proposed regulations illustrates this point. In Example 1, dealing with $400,000 worth of estate transmission expenses, the marital deduction is reduced by $400,000. When the estate deducts the expenses on the estate tax return, however, the marital deduction is not reduced by the decrease in estate taxes that the estate tax return deduction produces when compared with the estate taxes that would have been paid if the deduction had been taken on the estate's income tax return rather than on its estate tax return. In Example 3, dealing with $400,000 worth of estate management expenses that also reduce the marital deduction, the marital deduction is decreased by the reduction of estate tax resulting from the Code section 2053 deduction for those expenses. As a result, if the administration expenses are deducted on the estate's estate tax return, the marital deduction in Example 1 is $3,500,000 while in Example 3 it is only $3,011,111. There is no justification for this difference in result.

(2) Proposed Solution

We suggest that the following sentence be added to Proposed regulation section 20.2056(b)-4(e)(2)(ii), if such section is retained.

> "This rule shall not apply to estate management expenses that reduce the marital deduction."

Example 3 should be deleted.

b. Reference to "Federal Estate Tax Liability"

The special rule refers to the decrease in "federal estate tax liability." Examples 2 and 3, which illustrate the application of the special rule, refer to the decrease in "federal and state estate taxes." Either the special rule should be changed to refer to federal and state estate taxes or the examples should be changed to refer only to federal estate taxes.

2. Classification of Expenses as Estate Transmission Expenses or Estate Management Expenses

Some commentators have suggested that the definition of estate transmission expenses set forth in Proposed regulation 20.2056(b)-4(e)(1) implies that executor commissions will always be treated as estate transmission expenses. That should not be the case to the extent it can be shown that the expense relates to the investment of estate assets or with their preservation or maintenance during the period of administration. To clarify this matter, we suggest that the text in the parenthesis following the phrase "executor commissions and attorney fees" be changed to read as follows:

"(except to the extent such executor commissions or attorney fees are specifically related to investment, preservation, and maintenance of the assets)"

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