Tax Report #931

New York State Bar Association

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June 24, 1998

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
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section responding to the request in Notice 97-63, 1997-47 I.R.B. 6, for comment on alternatives for proposed regulations being considered in light of the Supreme Court opinion in Commissioner v. Estate of Hubert, 520 U.S. 93 (1997).

The report addresses the impact of the payment of administration expenses on both the estate tax charitable and marital deductions and suggests modifications to the regulations under section 2055 and 2056 of the Internal Revenue Code. It recommends that the

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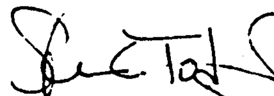
value of property subject to the charitable or marital deduction should be reduced by expenses incurred in connection with the collection of estate assets, the payment of debts and death taxes, and the ultimate distribution of estate assets -- "estate transmission expenses" -- charged against such property. On the other hand, "estate investment expenses" -- those expenses incurred in connection with the investment of estate assets and with the preservation and maintenance of the estate during the administration period -- should not reduce the charitable or marital deductions. State law distinctions between expenses chargeable to income or principal should not impact the federal estate tax deduction, unless state law affects the amount of property passing to the charity or spouse.

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

Very truly yours,



Steven C. Toddrys
Chair

cc: The Honorable Stuart L. Brown
Beth Kaufman, Esq.
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NEW YORK STATE BAR ASSOCIATION TAX SECTION

IMPACT OF ADMINISTRATION EXPENSES ON AMOUNT OF ESTATE TAX DEDUCTION FOR CHARITABLE AND MARITAL BEQUESTS[1]

This report responds to Notice 97-63.[2] It suggests a method for determining whether the payment of administration expenses from cash or other property that would otherwise have been distributed to a spouse or charity reduces the amount of the estate tax charitable and marital deductions.

I. BACKGROUND

Code § 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, the "charitable deduction." Likewise, Code § 2056(a) permits a deduction, the "marital deduction," for the value of property included in the decedent's gross estate and that passes from the decedent to the decedent's surviving spouse during her lifetime or at death.[4]

Since inception,[5] these seemingly simple deduction rules have generated a

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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 drafter was Carlyn. S. McCaffrey. Helpful comments were received from Jonathan Blattmachr and Sherwin Kamin.

2. 1997-47 I.R.B. 6.

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

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

5. 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 (continued...)

confusing, and not entirely consistent, pattern of regulations, rulings, and judicial decisions that explain how to calculate the amount of the deduction.

In the *Hubert* case,[6] the Supreme Court addressed one aspect of the calculation confusion - the extent to which administration expenses, paid or payable from the principal of, or post-death income generated by, property passing to charity or to a spouse, reduce the amount of the charitable or marital deduction.

The issue arises when a bequest to charity or to a spouse actually contributes, is required to contribute, or, in the discretion of the executor, may contribute to the costs of administering the estate. Such contribution generally occurs when the charitable or marital bequest is a bequest of the residuary estate or of a portion of the residuary estate. The issue also arises when a revocable trust or similar testamentary instrument provides for a distribution to charity or to a spouse of a portion or all of a trust fund after paying expenses incurred in connection with terminating the trust.[7]

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5. (...continued)
limitations were removed in 1981. P.L. 97-34 § 403. The charitable deduction was added to the Code as part of the Revenue Act of 1918, Public No. 254, 65th Cong. (H.R. 12863), approved Feb. 24, 1919.

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

7. The same issue seems to arise whenever it is necessary under the Code to calculate the amount of cash or other property that passes to one person from the gross estate of another and the property or its income can be used to pay administration expenses. Under Code § 2013, for example, it is necessary to calculate the amount that has passed to one decedent from another in order to calculate the credit allowed under Code § 2013. Similarly, under Chapter 13 of the Code, it is necessary to calculate the amount that has passed to a skip person in order to calculate either the generation-skipping transfer ("GST") tax or the inclusion ratio of a trust to which GST exemption has been allocated. Whatever solution is adopted for purposes of determining the amount of the charitable and marital deduction, presumably, should also apply for purposes of Code § 2013 and Chapter 13. See, for example, TAM 9822001 (May 29, 1998) in which the Internal Revenue Service concluded that interest payable on a GST tax underpayment does not reduce the taxable amount of a residuary bequest to a skip person and *E. Peterson Marital Trust v. Commissioner*, 102 T.C. 790 (1994), *aff'd on other issue*, 78 F.3d 795 (2d Cir. 1996) in which the Tax Court reached a contrary
(continued...)

Administration expenses are deductible, independently of the charitable or marital deduction, under Code § 2053.[8] As a result, in many cases the source of the payment of the administration expenses will have no tax consequences. For example, if D leaves her entire $1,000,000 estate to charity and if administration expenses are $100,000, no estate tax will be imposed on her estate whether $100,000 is deducted under Code § 2053 and $900,000 under Code § 2055, whether $100,000 is deducted under Code § 2053 and $1,000,000 under Code § 2055 or whether nothing is deducted under Code § 2053 and $1,000,000 is deducted under Code § 2055.

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

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7. (..continued)
conclusion.

A related issue arises whenever it is necessary under the Code to calculate the amount of a bequest and the payment of that bequest is deferred, thereby depriving the legatee of the profits generated by the bequest during the period of deferral. This issue is essentially a "time value of money problem." Its resolution is beyond the scope of this report. We note, however, that Treasury has resolved this issue in the context of the GST tax by requiring that unless "appropriate interest" is paid on a pecuniary bequest, it will not reduce the amount of a residual transfer to which GST exemption is to be allocated on a dollar for dollar basis. See Treas. Reg. § 26.2642-2(b)(3). See also Treas. Reg. § 26.2654-1.

8. 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. § 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. § 20.2053-3(d).

executor of the estate elects to deduct administration expenses on the estate's income tax return.[9]

Two examples will illustrate.

Example 1: D dies with a gross estate worth $1,000,000. As a result of gifts made during her lifetime, D's estate will be in a 55% estate tax bracket. D's will gives $200,000 to her daughter, subject to her obligation to pay the estate taxes attributable to the bequest, and the balance to charity. Administration expenses amount to $200,000. D's executor deducts $200,000 under Code § 2053. If the amount of the charitable deduction must be reduced from $800,000 to $600,000 to reflect the payment of administration expenses, the taxable estate will be $200,000 and the estate taxes will be $110,000. If the amount of the charitable deduction is not required to be reduced, the taxable estate will be zero and there will be no estate taxes.

Example 2: D, the decedent described above, gives her entire estate to her husband. D's executor deducts the administration expenses on the estate's income tax return.[10] As required by the Code as a condition for taking an income tax deduction for the administration expenses, D's

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9. 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).

10. Estate administration expenses are generally deductible for income tax purposes under Code § 212. "Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212 notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income." Treas. Reg. § 1.212-1(i). See also *Bingham v. Commissioner*, 325 U.S. 365 (1945). Certain kinds of administrative expenses, interest, for example, are deductible under other sections. *E.g.*, Code § 163.

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executor waives the right to deduct the expenses under Code § 2053.[11] The estate tax consequences of reducing or not reducing the marital deduction by the $200,000 of administration expenses are similar to those described in Example 1. A requirement that the marital deduction be reduced will increase the taxable estate, in this case to $444,444. The loss of a $200,000 deduction increases the estate tax by more than $200,000 because the estate taxes must be paid not only on the $200,000 but also on the funds used to pay the estate taxes. The estate taxes will be $244,444. If the marital deduction is not reduced, the taxable estate will be zero and there will be no estate taxes.

II. STATUTORY FRAMEWORK

Code § 2055(a) permits a deduction from the gross estate of "the amount of all bequests, legacies, devises, or transfers" to certain governmental and charitable organizations. The corresponding language in Code § 2056 permits a deduction of "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate."

Neither Code section specifically addresses how the deduction should be calculated if the amount that is to pass to charity or the spouse is, or may, bear the costs of administration expenses. Code § 2055(c), which requires that a charitable transfer be reduced by death taxes to which it is subject, and Code § 2056(b)(4), which requires that the value of a property interest passing to a surviving spouse take into account death taxes and other encumbrances to which it is subject, can, however, be read to suggest a general Congressional intent that the charitable and marital deduction

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11. Code § 642(g) provides that "[a]mounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054."

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be limited to the value of the property available to be distributed to charity or the surviving spouse.[12]

III. REGULATORY FRAMEWORK

The regulations do not provide much help.

Treas. Reg. § 20.2055-2(b) tells us that if a person "is empowered to divert. . . [charity's] property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power."

It is not clear whether the payment of administration expenses is a nondeductible use. But, if it is, the mere power to use charity's fund to make such a payment would result in a disallowance of the charitable deduction to the extent the fund could have been so used.

Treas. Reg. § 20.2056(b)-4(a) states that,

> "The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death. . . . The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, *the same principles being applicable as if the amount of a gift to*

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12. "The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction." S. Rep. No. 1013, 80th Cong., 2d Sess., pt. 2, p. 6 (1948). Virtually identical language was used in the Senate report that accompanied the enactment of Code § 2013 to define the value of property that passed from one decedent to another for purposes of calculating the credit for tax on prior transfers. S. Rept. No. 1622, 83d Cong., 2d Sess., p. 467 (1954).

the spouse were being determined [emphasis added]. 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."

The reference in this regulation to the gift tax method of valuing a gift to a spouse directs the reader to Code § 2523, the section that permits a marital deduction for gift tax purposes, and to Code § 2523's regulations. Unfortunately, neither Code § 2523 nor its regulations addresses the issue of reducing the amount of the gift tax marital deduction by the administration expenses to be paid by the spouse. This is not surprising because administration expenses are rarely paid by the donee of a gift. And, to the extent there are costs associated with the making of a gift that are borne by the donor (the gift tax analogue to estate administration expenses) the Internal Revenue Service seems never to have taken the position that these costs are to be included in the amount of the gift. In the absence of a position that they be included, their deductibility is not relevant.

The only provisions in the gift tax marital deduction portion of the Code or regulations that appear to focus on this issue are Treas. Reg. §§ 25.2523(e)-1(f)(3) and (4). Their purpose is to establish guidelines for determining whether a spouse is entitled to receive from property held in trust all of its income payable at least annually. Such entitlement is a prerequisite for the qualification of certain interests in trust[13] for either the estate tax or the gift tax marital deduction. These provisions state that rules that require the trustee to allocate certain kinds of receipts and expenses to income or principal, including trustee commissions, will not disqualify a trust interest for the marital deduction unless the effect of the rules is to deprive the spouse of the substantial beneficial enjoyment of the property during life. Similarly, provisions in a trust instrument that give a trustee discretion as to how to allocate receipts and expenses between income and principal will not disqualify a trust "if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers." Treas. Reg. § 25.2523(e)-1(f)(4).

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13. This requirement applies to property subject to the spouse's general power of appointment, Code §§ 2056(b)(5) and 2523(e), and so-called "qualified terminable interest property," Code §§ 2056(b)(7) and 2523(f).

Virtually identical provisions appear in the estate tax marital deduction regulations.[14] In Revenue Ruling 69-56,[15] the Internal Revenue Service has interpreted these regulatory provisions to permit, without loss of the marital deduction for an interest transferred in trust, a provision in the trust document requiring the executor or trustee, or giving the executor or trustee the discretion, to charge to income certain administration expenses such as executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses. Neither set of regulations addresses how the requirement or the discretion to allocate such administration expenses to either the income or the principal of a trust affect the amount of the marital deduction. The revenue ruling suggests that such requirement or discretion does not diminish the marital deduction but does not discuss the consequences of an actual payment of such expenses from either income or principal. In any event, the regulations and the revenue ruling are addressed only to marital bequests in trust. They have no apparent relevance to outright marital bequests or to charitable bequests.

IV. JUDICIAL FRAMEWORK PRIOR TO THE SUPREME COURT'S DECISION IN *HUBERT*

Pre-*Hubert* case law provides conflicting approaches to the determination of the extent to which administration expenses, paid or payable from the principal of, or post-death income generated by, property passing to charity or to a spouse, reduce the amount of the charitable or marital deduction. All seem to agree that administrative expenses (other than interest) that were paid out of principal should reduce the charitable or marital deduction, dollar for dollar. The Court of Appeals for the Federal Circuit, the Court of Federal Claims, and the Sixth Circuit would have reduced the charitable or marital deduction, dollar for dollar, by administration expenses (other than interest) paid either from income or principal, regardless of whether such expenses are properly chargeable to income or principal under state law or under the terms of the will.[16] The United States Tax Court and the Court of Appeals for the Eleventh Circuit would permit the amount of the deduction to remain intact if the administration expense

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14. Treas. Reg. § 20.2056(b)-5(f)(3) and (4).

15. 1969-1 C.B. 224.

16. *Burke v. United States*, 994 F.2d 1576 (Fed. Cir. 1993); *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992); *Fisher v. United States*, 28 Fed. Cl. 88 (Ct. of Fed. Claims 1993); *Rifkind v. United States*, 5. Cl. Ct. 362 (Claims Ct. 1984).

is charged to income, not principal, if the charge to income is permitted by local law, and if the executor's discretion to pay administration expenses out of income is not a material limitation on the right to receive income.[17]

Interest on deferred estate taxes and on estate tax deficiencies has been subject to special treatment. The Court of Appeals for the Seventh Circuit and the Court of Appeals for the Sixth Circuit, as well as the Tax Court, have all agreed that such interest expenses charged to income should not reduce the charitable or marital deduction.[18] The Internal Revenue Service has agreed with this position and has extended it to the payment of interest on obligations even if the interest is payable from principal rather than income.[19] This treatment seems justified by the estate's ability to invest the funds that were not used to pay taxes. The interest charge can be viewed as merely offsetting the estate's investment return on these funds so that the property passing to charity or to the spouse is not reduced.

V. THE SUPREME COURT'S *HUBERT* DECISION

The Supreme Court's decision in *Hubert* has not resolved the matter. Four Justices, Chief Justice Rehnquist, Justice Kennedy, who authored the plurality opinion, and Justices Ginsburg and Stevens, affirmed the Tax Court decision but, in the course of doing so, introduced a new theory for determining when administration expenses will reduce a charitable or marital deduction. Justice Kennedy's opinion states that if income may be used to pay administration expenses and if it is necessary to take into account that income in order to value the property passing to charity or to a spouse, the value of the charitable or marital deduction would be reduced not by the actual amount

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17. *Estate of Hubert v. Commissioner*, 101 T.C. 314 (1993), aff'd 63 F.2d 1083 (11th Cir. 1995), aff'd 520 U.S. 93, 117 S.Ct. 1124 (1997); *Estate of Street v. Commissioner*, T.C. Memo 1988-553, rev'd as to this issue, 974 F.2d 723 (6th Cir.).

18. *Estate of Whittle v. Commissioner*, 994 F.2d 379 (7th Cir. 1993); *Estate of Street v. Commissioner*, T.C. Memo 1988-553, aff'd on this issue 974 F.2d 723 (6th Cir. 1992); *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987).

19. Rev. Rul. 93-48, 1993-2 C.B. 270. Although interest is generally chargeable to income, there are exceptions. For example, in the absence of a direction to the contrary in the will, New York law requires that interest resulting from the late payment of estate taxes be charged wholly to principal. New York Estates, Powers and Trusts Law, § 2-1.8(c)(4).

paid and charged against income, but by "the present value (as of the controlling valuation date) [i.e., the date of death or the alternate valuation date] of the income expected to be used to pay administration expenses."[20] This approach, which would be a difficult one to administer, had not been suggested previously by either the Internal Revenue Service or the courts.[21] As a practical matter, in most cases it is impossible to predict with any reasonable degree of precision on the date of a decedent's death (or on the date six months thereafter) what the administration costs will be.[22] It was not necessary in this case to make this calculation because Treas. Reg. § 20.2056(b)-4(a) provides that limitations on a spouse's right to income are to be taken into account only if they constitute a "material limitation," and the Tax Court had concluded as a factual matter in this case that the right to pay administration expenses out of income was not such a material limitation.

The concurring opinion, which was authored by Justice O'Connor and joined in by Justices Souter and Thomas, relies on the Internal Revenue Service's position as to interest as set forth in Revenue Ruling 93-48.[23] As discussed above, in that Ruling, the Service announced that it would not "ordinarily" reduce a charitable or marital deduction by interest accruing on obligations payable from principal, including estate tax obligations, even if the interest is chargeable to principal under state law. Justice O'Connor's opinion concludes that the administration expenses in Hubert were indistinguishable from interest expenses and that the Revenue Ruling creates a "quantitative rule for § 20.2056(b)-4(a) applicable to all administration expenses. That a limitation affects the marital deduction only upon reaching a certain quantum of

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20. *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124, 1129 (1997).

21. This approach may be correct from a theoretical perspective but would be impractical to administer and is inconsistent with the allowance under Code § 2053 of a dollar for dollar deduction for administration expenses.

22. Justice Kennedy's opinion suggests that this approach "should be just as administrable, if not more so, than valuing property interests like going-concern businesses. . . involving much greater complexity and uncertainty." *Id* at 1129. But, unlike "going concern businesses," estates have no pattern of prior activity which can be used as a basis for predicting future events.

23. 1993-2 C.B. 270.

substantiality is not a concept alien to the law of taxation."[24] After stating this theory, she reaches the same conclusion that Justice Kennedy reached for the plurality - the Internal Revenue Service had not met its burden of proving that the administration expenses charged to income were quantitatively material and, therefore, the Tax Court was justified in concluding the expenses were not material.[25]

The dissenters, Justices Scalia and Breyer, in an opinion authored by Justice Scalia conclude that the charitable and marital deductions should be reduced whenever post-death income from the deductible property interest is used to pay administration expenses.

At the beginning of Justice O'Connor's opinion, she expresses discomfort with the state of chaos in which this issue rests. At the end, she quite reasonably concludes that there is no reason why the labyrinth of contradictory authority that surrounds it should continue "especially when the Commissioner is empowered to promulgate new regulations and make the answer clear."[26] Commendably, in Notice 97-63, the Internal Revenue Service has indicated its willingness to do so.

VI. RECOMMENDATION

The proposed regulations can be written on a clean slate, and we think they should be. The manner in which the existing marital deduction regulations have been construed, to depend in part on local law distinctions between principal and income and on an undefined concept of materiality, is in large part responsible for the confusion in this area. An attempt to fit the proposed regulations into the pattern of the existing regulations would be ill-advised.

We believe the proposed regulations should satisfy three criteria. They should reflect the economic realities of the estate administration process; they should not be administratively difficult to apply; and they should apply uniformly to all estates, regardless of the state law to which their administration is subject, except to the extent

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24. *Estate of Hubert v. Commissioner,* 520 U.S. ___, 117 S. Ct. 1124, 1138 (1997).

25. The burden of proof was on the Internal Revenue Service in this case because it had not included a challenge to the administration expense in the original Notice of Deficiency.

26. Id. at _____, and 1139.

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that state law would actually reduce the quantity of property passing to charity or to the spouse that would otherwise be deductible.

A. Economic Realities

The economic reality is simple. The object is to determine the value as of the date of death (or as of the alternate valuation date) of the property passing from the decedent to charity or to her spouse. During the period of estate administration, regardless of how long the process lasts, the property that is destined to pass to charity or to a spouse will be invested with the objective of earning an investment return, either trust accounting income, such as dividends and interest, or capital appreciation, or some combination of the two.

During that same period, the estate will incur administration expenses. Some of these expenses will be incurred in connection with the collection of estate assets, the process of paying debts and death taxes, and the ultimate distribution of estate assets. We refer to these types of expenses as "estate transmission expenses." They include executor commissions that relate to the original value of the estate, attorney fees, probate fees, expenses incurred in defending the will against will contests, appraisal fees, and the like. Others of these expenses will be incurred in connection with the investment of estate assets and with its preservation and maintenance during the administration period. We refer to these expenses as "estate investment expenses." They include investment advisory fees, accountant fees relating to the estate's income (including gains from the disposition of assets), custody fees, interest and the like.

The proposed regulations should provide that estate transmission expenses, regardless of whether they are paid from principal passing to charity or to a spouse or from the income produced by such property and regardless of what state law regards as their proper source, should always reduce the size of the marital or charitable deduction. Estate investment expenses should not.

Estate transmission expenses represent the costs of passing estate property from the decedent to charity or to her spouse. Funds expended for such a purpose do not pass to the estate beneficiaries. In contrast, estate investment expenses, in effect, do pass to the beneficiaries. They are incurred for their benefit and, in many cases, are the same sorts of expenses that they would have incurred for their own account if the period of estate administration had been shorter and if they had, therefore, received their property sooner.

We do not mean to suggest that the extent of the deduction be determined by investment performance but only that a distinction between the two types of expenses is economically justified. Expenses that are not incurred in connection with the effort to produce a post-death investment return, diminish the value of the property passing to the estate's beneficiaries; expenses that are incurred in connection with the effort to produce such income, are intended to enhance the estate's value and should not reduce the value of such property for estate tax purposes.[27]

B. Administrative Simplicity

In most cases, distinguishing between the two types of administration expenses will not be difficult. In general, estate investment expenses will be those that would be allowed as income tax deductions under Code § 212 by a trustee administering a trust that was not in the process of transmitting property at the death of an individual. Estate transmission expenses will be all other expenses allowed under Code § 2053.

A pure application of the approach suggested above would focus not on the estate transmission expenses actually incurred but, as Justice Kennedy suggests in his opinion in *Hubert*, on the present value as of the date of the decedent's death of the anticipated estate transmission expenses. We believe that this approach would prove

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27. The approach we suggest is similar in effect to the first alternative approach described in Notice 97-63, 1997-47 I.R.B. This approach is directed at distinguishing "between administration expenses that are properly charged to principal," which, if paid from income would then be deemed to be a material limitation on income and "those that are properly charged to income." There are three differences between this approach and the approach we suggest. First, the Notice's approach continues a semantic link with the language generally used to distinguish between income and principal for local law trust accounting purposes. This semantic link has caused confusion in the past, and we believe the link ought to be broken. Similarly, the Notice's approach appears to use to the concept of a "material limitation on a spouse's right to income from property" as the ultimate test for determining whether to reduce the amount of the deduction. This phraseology has also caused confusion in the past and more properly belongs with the rules that determine whether a bequest to a spousal trust qualifies for the marital deduction. Finally, the Notice's approach does not make it clear that expenses properly charged to principal under local law should not reduce the amount of the charitable or marital deduction if the expenses were incurred in connection with the investment of estate assets and with its preservation and maintenance during the period of administration.

impossible to administer. As of the date of a decedent's death, neither her executor nor the Internal Revenue Service is likely to be in a position to determine reasonably what the estate transmission expenses will be.

Therefore, in the interest of simplicity and practicality, we suggest that the proposed regulations focus on actual instead of estimated expenses.

C. Effect of State Law

In most cases, neither state law nor a direction in the will as to whether a particular estate administration expense is properly charged to income or principal, should impact the federal estate tax consequences. The focus of the proposed regulations should be on economic reality, not on the labels the laws of a particular state use to classify the different types of investment return for the purpose of allocating them between income and principal beneficiaries.

In the case of outright residuary bequests to charity or to a spouse, the labels are irrelevant because the charity or the spouse will receive the benefit of the total investment return whether it is classified as income or principal. Thus, in Examples 1 and 2 discussed above, the charitable residuary beneficiary and the spouse will receive exactly the same amount of property regardless of whether the administration expenses are charged to income or principal. Since the labels do not affect what the beneficiary receives, it would be irrational to permit the labels to determine deductibility. In the case of residual marital deduction bequests to trusts that qualify for the marital deduction under Code § 2056(b)(5) or (7), the classification will make a difference to the spouse, but not to the trust that receives the bequest. But, since the amount deductible is the amount passing to the trust, not the value of the spouse's income interest, it would be irrational to permit the labels that affect the value of the income interest to affect the amount of the deduction.

There are some exceptions. In some cases, state law allocation of investment returns between income and principal will affect the quantity of property passing to charity or to a spouse. If it does, then the labels must be respected. For example, suppose a decedent bequeathed her residuary estate to a trust to pay an annuity to charity for 20 years and then to pay the remaining trust property to her children. The annuity was defined as 8% of the residuary estate. Estate administration expenses were incurred that were charged under state law to principal. Since they were charged to principal, they reduced the size of the residue and, therefore, the size of charity's annuity. If the expenses had been charged to income, the annuity would not have been

reduced. In this case, the charitable deduction must be reduced to the actuarial value of an annuity equal to 8% of the residue remaining after payment of the administration expenses that were chargeable to principal.

Alternatively, suppose the decedent bequeathed to her spouse a remainder interest in a residuary trust following a term of years given to another person. Estate administration expenses were incurred that were charged under state law to principal. As above, the charge to principal will actually reduce the amount that eventually passes to the spouse. Therefore, the marital deduction should be equal to the present value of the right to receive the reduced principal at the end of the term of years.

The proposed regulations should distinguish carefully between the issue presented in *Hubert* and the superficially similar but fundamentally different issue of the qualification of a trust for the marital deduction under Code § 206(b)(5) or (7). Qualification requires that the spouse who is the trust beneficiary receive annually all of the income from the property held in the trust. Since income is a term defined under state law and not under federal law, the determination of whether this requirement has been satisfied must necessarily depend on state law. Current regulations make this point clearly.[28] The proposed regulations defining the amount of the deduction need only distinguish themselves from the qualification regulations.

D. Proposal

1. Charitable Deduction

We suggest that the caption of Treas. Reg. § 20.2055-3 be changed to "Death taxes and administration expenses payable out of charitable transfers." and that the following new provisions be added at the end thereof:

> (d) In the determination of the value of any property interest the transfer of which would otherwise be allowable as a deduction under section 2055, the value of such property must be reduced by the amount, adjusted as provided below, of any administration expense incurred in connection with the collection of estate assets, the payment of debts and death taxes, and the distribution of estate assets to the beneficiaries that is actually charged against such property (collectively, "estate transmission expenses"). Estate transmission expenses include, for

28. Treas. Reg. § 20.2056(b)-5(f)(3) and (4).

example, executor commissions that relate to the original value of the estate, attorney fees, probate fees, expenses incurred in defending the will against will contests, appraisal fees, fees incurred in connection with the disposition of estate assets (to extent the amount of proceeds of such disposition was included in the gross estate) and the like and similar expenses incurred by trustees in connection with the termination of a trust at the death of its grantor. The value of such property shall not be reduced by any administration expense incurred in connection with the investment of such property and with its preservation and maintenance during the administration period, such as investment advisory fees, accountant fees and asset disposition costs relating to the estate's post-death income (including post-death appreciation as well as dividends, interest and the like), income taxes, custody fees, and the like (collectively "estate investment expenses"). Estate investment expenses shall not reduce the value of such property regardless of whether, under local law, such expenses are charged to income or principal.

2. Marital Deduction

We suggest the elimination of the following final two sentences from Treas. Reg. § 20.2056(b)-4(a):

"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."

We suggest the addition of the following at the end of Treas. Reg. § 20.2056(b)-4:

(e) Effect of certain administration expenses. In the determination of the value of any property interest the transfer of which would otherwise be allowable as a deduction under section 2055, the value of such property must be reduced by the amount, adjusted as provided below, of any administration expense incurred in connection with the collection of

estate assets, the payment of debts and death taxes, and the distribution of estate assets to the beneficiaries that is actually charged against such property (collectively, "estate transmission expenses"). Estate transmission expenses include, for example, executor commissions that relate to the original value of the estate, attorney fees, probate fees, expenses incurred in defending the will against will contests, appraisal fees, fees incurred in connection with the disposition of estate assets (to extent the amount of proceeds of such disposition was included in the gross estate) and the like and similar expenses incurred by trustees in connection with the termination of a trust at the death of its grantor. The value of such property shall not be reduced by any administration expense incurred in connection with the investment of such property and with its preservation and maintenance during the administration period, such as investment advisory fees, accountant fees and asset disposition costs relating to the estate's post-death income (including post-death appreciation as well as dividends, interest and the like), income taxes, custody fees, and the like (collectively "estate investment expenses"). Estate investment expenses shall not reduce the value of such property regardless of whether, under local law, such expenses are charged to income or principal.