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Commissioner v. Estate of Hubert: How the I.R.S. Stole Hubert's Blessing

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Commissioner v. Estate of Hubert: How the I.R.S. Stole *Hubert*'s Blessing

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The Case

Commissioner v. Estate of Hubert[1] is a plurality opinion finding no reduction in an estate tax marital or charitable deduction when an estate administrator has undisputed discretion to (and does) pay certain administrative expenses using post-mortem income derived from an estate's marital and charitable shares. The expenses allocated to income were not considered a "material limitation" on the spouse's/charity's right to receive income such that the expenses affected the valuation of those interests and consequently the associated deductions.[2] The estate thus received a $1.5 million income tax deduction without any attendant reduction in the marital and charitable deductions. Since the administrative expenses at issue were not taken into account in valuing the date-of-death marital or charitable deduction assets, the estate essentially received two deductions for the price of one.

Mr. Hubert died in 1986 as a resident of Georgia with an estate valued at more than $30 million. After his death, the estate incurred substantial litigation expenses, most of which related to the distribution of assets pursuant to claims of undue influence, fraud and related causes of action. In 1987, the executors filed the federal estate tax return. In 1990, the Commissioner issued a notice of deficiency claiming underreporting of approximately $14 million. The major challenge was to the estate's claimed entitlement to marital and charitable deductions. The estate petitioned the Tax Court for a redetermination of the deficiency.[3] Within days of that petition, the litigation settled, with the settlement dividing $26 million of the date-of-death residue assets between trusts for decedent's widow and charities. The Commissioner conceded that the charitable and marital gifts agreed to in the settlement qualified for deductions under Code sections 2055 and 2056, respectively.[4]

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1 520 U.S. 93 (1997).

2 *Id.* at 107.

3 *Id.* at 98.

4 *Id.*

Consistent with decedent's last will and Georgia law, the settlement provided discretion to pay administration expenses from principal or income. Actual administrative expenses were on the order of $2 million. The executors allocated $500,000 to principal and the remaining $1.5 million to income. The estate recalculated its marital and charitable deductions, reducing those values only by the expenses allocated to principal.

In considering the recalculated deductions taken pursuant to the underlying settlement agreement, the Commissioner contended that the use of post-mortem income to pay administration expenses also required a dollar-for-dollar reduction of the marital and charitable deductions paying those expenses.[5] The estate disagreed. The Tax Court rejected that position "on the facts before [it],"[6] noting that it had resolved the same issue against the Commissioner in *Estate of Street v. Commissioner*,[7] and acknowledging that the Sixth Circuit reversed this aspect of *Estate of Street.*[8] The Eleventh Circuit affirmed, noting the resulting conflict with *Estate of Street* and with *Burke v. United States.*[9]

For Supreme Court review, the parties agreed that interpretation of the regulations requires the same result with respect to both the marital deduction and the charitable deduction, notwithstanding the more specific provisions of the marital deduction regulations.[10] The Court agreed with this approach; the holding applies to valuing assets for both deductions.[11]

For the plurality, Justice Kennedy, joined by Chief Justice Rehnquist, Justice Stevens and Justice Ginsburg, analyzed the issue as one of date-of-death valuation of the deductible assets under the controlling regulation, versus qualification for the deduction under the controlling statute.[12] The plurality relied on the language of Treasury Regulation

5 *Id.* at 99.

6 Estate of Hubert v. Comm'r, 101 T.C. 314, 325 (1993).

7 *Id.* at 326; *see* Estate of Street v. Comm'r, T.C. Memo. 1988-553, 56 T.C.M. (CCH) 774, 777 (1988) (administration expenses chargeable against income do not reduce amount of principal eligible for marital deduction).

8 *Estate of Hubert*, 101 T.C. at 326; s*ee* Estate of Street v. Comm'r, 974 F.2d 723, 728-29 (6th Cir. 1992).

9 994 F.2d 1576 (Fed. Cir. 1993). *See* Estate of Hubert v. Comm'r, 63 F.3d 1083, 1083 (11th Cir. 1995).

10 Comm'r v. Estate of Hubert, 520 U.S. 93, 100 (1997). The then-regulations read in part, "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." Treas. Reg. § 20.2056(b)-4(a) (1994) (emphasis added) (superseded by 1999 amendment).

11 *Estate of Hubert*, 520 U.S. at 100.

12 *Id.* at 104-06.

20.2056(b)-4(a).[13] Turning then to valuation principals, the plurality reasoned that the materiality of a limitation providing that income is to be used throughout administration to pay expenses is a factual determination.[14] Factors relevant to materiality include how much income is likely to be earned during administration versus the amount of anticipated administrative expenses, whether the deductible gift and its income-earning potential is large or small relative to the estate, whether the deductible gift is in trust, etc.[15] Weighing this slim record, the Court concluded that discretion to pay administrative expenses out of income was not a material limitation on the right to receive income and, therefore, allocation of administrative expenses to income did not trigger a reduction in the claimed deductions.[16] The plurality did not reach the more challenging question of what reduction would be applicable if a limitation were material.[17]

Justice O'Connor's concurrence, joined by Justice Souter and Justice Thomas, harshly criticizes the Commissioner for regulations which do not clearly define "material limitation" and for not arguing or putting forth a record in this case as to what level of expenses would qualify as material.[18] Justice O'Connor also found significant Revenue Ruling 93-48,[19] which provides that the marital deduction is not ordinarily reduced when an executor allocates interest payments on deferred federal estate taxes to the spouse's post-mortem income.[20] Because interest payments do not reduce the marital deduction per the Commissioner's admission, Justice O'Connor reasoned that the Court could not adopt the Commissioner's argument that every financial burden on a marital bequest's post-mortem income is a material limitation warranting a reduction in the deduction.[21]

Justice Scalia's dissent, joined by Justice Breyer, argued that the marital and charitable deductions must be reduced whenever post-mortem income from those shares is used to pay administrative expenses because, unlike anticipated future income, the gross estate for

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13 *Id.* at 105.

14 *Id.*

15 *Id.* at 106-07 (analyzing factors impacting materiality in Treas. Reg. § 20.2056(b)-(4)(a)).

16 *Id.* at 107.

17 The Commissioner's request for a dollar-for-dollar reduction in the gross date-of-death value is not consistent with normal valuation principals. The gross estate includes a discounted value of anticipated post-mortem income earned during administration. *See id.* at 108-09.

18 *See id.* at 121-22 (O'Connor, J., concurring).

19 Rev. Rul. 93-48, 1993-2 C.B. 271.

20 Comm'r v. Estate of Hubert, 520 U.S. 93, 118 (1997).

21 *Id.* at 119 (O'Connor, J., concurring).

federal estate tax purposes does not take account of anticipated administrative expenses.[22] A deduction for actual administration expenses, not a reduction in the estate's gross value, is provided under section 2053(a)(2).[23] In Justice Scalia's view, if income from a spousal bequest is used to pay administrative expenses, the spouse then receives less income than was projected in valuing the bequest resulting in an inflated deduction.[24]

The Aftermath – Treas. Reg. § 20.2056(b)-4 and Treas. Reg. § 20.2055-3

In describing the Supreme Court many years ago, Justice Robert H. Jackson wrote in an opinion not long before his own death, "We are not final because we are infallible, but we are infallible only because we are final."[25] Not so in the arena of tax regulation interpretation. It is the I.R.S. that has the final say. As Justice O'Connor's concurring opinion observed:

> There is no reason why this labyrinth should exist, especially when the Commissioner is empowered to promulgate new regulations and make the answer clear. Indeed, nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation.[26]

In direct response to *Estate of Hubert*, the Commissioner promulgated new regulations removing any distinction between paying with income or principal in favor of an inquiry into the nature of the expense and whether the expense has been deducted. For decedents dying on or after December 3, 1999, the marital deduction is to be reduced by: (1) the amount of "estate transmission expenses" paid from the marital share, whether from income or principal; (2) the amount of "estate management expenses" paid from the marital share where such expenses were not attributable to the marital share; and (3) the amount of "estate management expenses" attributable to the marital share that are deducted from the gross taxable estate as administrative expenses under section 2053."[27] "Management expenses" are defined as expenses "incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administra-

22 *Id.* at 122-23 (Scalia, J., dissenting).
23 *Id.* at 125 (Scalia, J., dissenting).
24 *Id.* at 123 (Scalia, J., dissenting).
25 Brown v. Allen, 344 U.S. 443, 540 (1953) (Jackson, J., concurring).
26 Comm'r v. Estate of Hubert, 520 U.S. 93, 122 (1997) (O'Connor, J., concurring).
27 Treas. Reg. 20.2056(b)-4(d)(2), (3); s*ee also* Treas. Reg. § 20.2055-3(b) (applicable to charitable deduction).

tion."[28] "Transmission expenses" are expenses that "would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it."[29] Examples of transmission expenses are executor and attorney fees, probate fees, expenses incurred in construction proceedings and will contests, and appraisal fees. Unlike transmission expenses, management expenses could be avoided or managed by a sale or distribution of the asset. Consequently, management expenses generally do not reduce the value of the marital deduction property as of the decedent's date of death.

The Conclusion

As observed by Justice Kennedy, "[i]n consequence of life's two certainties a decedent's estate faced federal estate tax deficiencies, giving rise to this case."[30] The Supreme Court then interpreted "any material limitation upon her right to income from the property" so as to reduce the consequences of the second certainty for Mr. Hubert's beneficiaries.[31] Perhaps spurred on by Justice O'Connor's harsh assessment of the lack of clarity and logic in the applicable law, the I.R.S. issued post-*Hubert* regulations compelling the dollar-for-dollar reduction of the marital/charitable deductions whether or not paid with income or principal. These new regulations moot the benefit of granting the trustee/executor discretion to allocate transmission expenses between income and principal.

Now, the value of property qualifying for the marital and charitable deductions is reduced by all administrative expenses incurred to transfer the property from decedent to the beneficiary, all asset management expenses related to non-deductible shares which are paid for by deductible shares, and all asset management expenses paid by the deductible shares which have been deducted for federal estate tax purposes under Section 2053. No more can one allocate expenses incurred in passing deductible property to income for purposes of taking an income tax deduction without a reduction in the date-of-death valuation of the transferred property.

Upon considering the post-*Hubert* regulatory changes and given the many issues of public importance vying for Supreme Court attention in a land of 200 million actual and potential taxpayers, one must consider whether interpreting I.R.S. regulations is a good use of the Court's valu-

[28] Treas. Reg. § 20.2056(b)-4(d)(i); *see also* Treas. Reg. § 20.2055-3(b)(i)-(iii).
[29] Treas. Reg. 2056(b)-4(d)(ii); *see also* Treas. Reg. § 20.2055-3(b)(ii).
[30] *Estate of Hubert*, 520 U.S. at 97.
[31] *Id.* at 105.

able time. It is tempting to argue that the split in the circuits justifies review so that federal law is applied uniformly. However, where the Commissioner can and does circumvent the Supreme Court's decisions for future taxpayers, what is the point? Perhaps the point of Supreme Court review is just what happened in and after *Estate of Hubert*; namely, where the federal tax law is so unclear as to take up multiple court resources leading to different results on similar facts, it will take a shaming by the Supreme Court to spur the Commissioner to change.