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The Anti-Hubert Regulations

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THE ANTI-*HUBERT* REGULATIONS

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This article examines new regulations issued in response to the Supreme Court's decision in *Hubert*. The fundamental issue relates to the impact of administration expenses on the amount of a marital or charitable deduction. The regulations divide administration expenses into management expenses and transmission expenses. Management expenses burdening a marital or charitable gift will generally not result in a reduced charitable or marital deduction. Transmission expenses will. The article sets forth a policy rationale for this approach, considers the planning implications, and makes suggestions about the changes in drafting necessary to secure an optimal outcome.

Table of Contents

On December 3, 1999, Treasury took an important step toward conforming a portion of the federal estate tax system to the economic realities of estate administration. It issued final regulations[1] that deal sensibly with the effect of certain administration expenses on the amount of the estate tax marital and charitable deductions. The regulations were issued in response to the Supreme Court's decision in *Hubert*.[2] This article examines the new regulations against the backdrop of the Court's decision.

I. The Issue in *Hubert* and Its Resolution

In *Hubert*, the Supreme Court considered the impact of estate administration expenses on the marital and charitable deductions. The issue was whether the amount of the deduction allowed for a marital or charitable gift that bears the burden of administration expenses should be reduced to reflect this encumbrance. The executors of Hubert's estate and the Internal Revenue Service had agreed that those administration expenses that burdened the marital or charitable bequests under Hubert's will and that were chargeable to principal under state law would reduce the amount of the deductions. The question before the Court was whether a reduction was required for such an administration expense if, under the testamentary instrument, state law, or as a result of a discretionary act by the executor, the expense was charged to accounting income.[3]

Although the *Hubert* decision was splintered among four separate opinions, all of the Justices based their

[1]T.D. 8846, 64 *Fed. Reg.* 67763, corrected, in part by Announcement 2000-3, 2000-2 IRB 296, *Doc 2000-1976 (1 original page), 2000 TNT 11-11*.

[2]*Commissioner v. Estate of Hubert*, 520 U.S. 93, *Doc 97-7754 (51 pages), 97 TNT 53-13* (1997).

[3]Accounting income is the category of receipts that are distributable to the person who is entitled or eligible to receive trust accounting income from a trust. Although trust accounting income is primarily a local law concept, the Internal Revenue Code of 1986 as amended uses the concept for several purposes. For example, a trust qualifying for the marital deduction under section 2056(b)(5) or 2056(b)(7) must be required to distribute all of its accounting income to the surviving spouse. Throughout this article, the terms "accounting income" and income are used interchangeably.

analysis principally on the last two sentences in Treas. reg. section 20.2056(b)-4(a). The dispute was resolved, in large part, by a construction of these two sentences, which at the time provided:

> 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[4] 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 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 two opinions left the material-limitation concept intact as a weapon available to the Service in future cases.

The plurality opinion (by four Justices) concluded that the application of the estate's accounting income to the payment of administration expenses would reduce the deduction only if the use of such income to pay for administration expenses could be viewed as creating a material limitation on the spouse's right to receive income from the marital share. A concurring opinion (by three Justices) similarly concluded — although through somewhat different reasoning — that it was appropriate to reduce the deduction on account of such expenses if the material-limitation concept was violated. Although the plurality and concurring opinions did not reach agreement as to the contours of the material-limitation concept, both opinions concluded that, based on the record, the executor's use of estate income to pay for administration expenses did not create a material limitation on the spouse's right to receive income. As a result, the Hubert estate's marital deduction was not reduced on account of the administration expenses. But the two opinions left the material-limitation concept intact as a weapon available to the Service in future cases.

II. The Consequences of *Hubert*

Hubert created the potential for the economic equivalent of a double deduction, consisting of: (i) an inflated estate tax marital deduction (i.e., inflated in the sense that the deduction is not reduced even though administration expenses are paid from the marital share) and (ii) either a second estate tax deduction or an income tax deduction for these same administration expenses. Assume, for example, that a taxpayer dies with a gross estate of $2 million. Her will gives an amount equal to the maximum amount that can pass free of federal estate tax, after taking into account her remaining applicable exclusion amount of $600,000, to a trust for the benefit of her children. It gives the balance to a trust that qualifies for the marital deduction, from which the trust income must be paid each year to her husband. Her estate incurs administration expenses of $100,000, which the will requires be paid from the income otherwise allocable to the marital deduction bequest. With an estate tax exemption equivalent of $600,000 and the administration expenses deducted for estate tax purposes under section 2053, the marital deduction would be $1,300,000, leaving $700,000 for the children's trust. The administration expense deduction of $100,000, although paid from the income earned on the husband's share, would reduce the taxable estate to $600,000, leaving a tax liability of zero.

Because the marital deduction is designed to permit a deferral of the estate tax obligation until the surviving spouse dies rather than an exclusion, the amount of the deduction in the estate of the first spouse to die should be limited to the amount flowing into the surviving spouse's estate for later inclusion in his or her federal gross estate. In other words, for the marital deduction to carry out its purpose, the amount of the marital bequest, as well as any income generated by it, must form a part of the surviving spouse's estate. In this example, a marital deduction of $1,300,000 should be available only if that amount, together with all of the income it generates from the date of the decedent spouse's death, becomes part of the surviving spouse's estate. But, under *Hubert*, even though the administration expenses of $100,000 in effect reduces the amount available for inclusion in the surviving spouse's estate, the estate is permitted a marital deduction of $1,300,000, as long as no violation of the material-limitation concept occurs. In this example, the estate enjoys a marital deduction that is inflated by $100,000 and, as a result, the children's trust receives $100,000 more than that amount normally protected by the applicable credit amount.[5]

If, in this example, the estate had taken the administration expense as an income tax deduction instead, *Hubert* still permits an inflated marital deduction (assuming again the material-limitation concept were not violated). With the $100,000 expense deducted on the estate's income tax return, the marital deduction would be $1,400,000 (even though the bequest bears the economic burden of the administration expense). The taxable estate would again be $600,000, producing a tax of zero. In this case, the children's trust is not benefited by the inflated marital deduction. Instead, the administration expenses produce a $100,000 income tax deduction and a marital deduction that is inflated by $100,000.

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[4]Throughout the regulations, the surviving spouse is referred to as female.

[5]*See* Jonathan G. Blattmachr and Madeline J. Rivlin, "Drafting for Estate Administration Expenses After *Hubert*," 136 *Trust & Estates* No. 9, 57 (August 1997) at 64-65 (This article anticipated new regulations. *Id.* at 60.); Joseph M. Dodge, "Lifting the Shroud Obscuring *Estate of Hubert*: The Logic of the Income and Estate Tax Treatment of Estate Administration Expenses," 3 *Fla. Tax Rev.* 647 (1998).

The code contains three different rules that bear on the double-deduction issue. First, section 642(g) provides that administration expenses may be deducted either on the estate's income tax return (under section 212) or on its estate tax return (under section 2053), but not on both returns. Second, section 2056(b)(9) provides that no deduction for the same amount may be taken twice for estate tax purposes. Third, section 2056(b)(4)(B) requires that any expense or obligation burdening a marital bequest must be taken into account in the same manner as if it were an *inter vivos* gift. The Supreme Court had previously held that the third rule limits the marital deduction to the net economic amount received by the spouse.[6]

In *Hubert*, the administration expenses were deducted on the estate's income tax returns; the estate did not seek to deduct these expenses for federal estate tax purposes. All of the Justices were, therefore, able to agree that the prohibition contained in section 642(g) was not directly applicable, though the dissenting Justices found the section somewhat relevant.[7] And not having sought a double estate tax deduction, the estate obviously did not violate the prohibition contained in section 2056(b)(9). Consequently, none of the Justices found it necessary to discuss this section. That left the Court (the plurality, the concurrence, and the dissenting opinions) to focus its analysis largely on section 2056(b)(4)(B) and its implementing regulation, Treas. reg. section 20.2056(b)-4(a).

Although the four-Justice plurality did not express any discomfort with the double deduction its decision would permit, the other opinions did reveal a concern about this issue. Indeed, the concurrence explicitly acknowledged that the statute could accommodate new regulations precluding taxpayers from enjoying double deductions.[8] Moreover, in the view of the dissenters, the existing regulation could be construed as prohibiting double deductions.

What made the estate's argument in *Hubert* tenable, and ultimately successful, was the regulation's emphasis on state law. The underlying statute (section 2056(b)(4)) provides that obligations encumbering the marital gift must be taken into account, with the statute making no distinction between obligations chargeable to income and obligations chargeable to principal under state law. The statute can easily be read — indeed, is perhaps better read — as requiring a reduced deduction whenever the marital gift is made subject to an obligation or expense. Under the regulation, however, special treatment was provided for administration expenses charged to accounting income, triggering a reduced deduction only when the expense effected a material limitation on the right to that income.

This special treatment for expenses charged to income under state law is economically unjustifiable. The marital deduction will effectuate its deferral objective only if the deduction is not permitted to exceed the amount available for inclusion in the surviving spouse's estate. If the amount passing to the spouse is encumbered by an obligation, the encumbrance will have the effect of reducing the amount in the surviving spouse's estate, regardless of its characterization as an income or principal charge under state law. If the marital deduction is not to be inflated, any expense burdening the marital gift must reduce the amount of the deduction, unless, as discussed below, the expense is related to the investment or preservation of the marital gift rather than to its transmission.

Moreover, as is often the case when the tax law puts an overemphasis on state law, gaming opportunities are created.[9] In this case, the state law emphasis creates the opportunity to enjoy double deductions. In the aftermath of *Hubert*, many lawyers began drafting testamentary instruments to require that administration expenses be charged to the spouse's income interest, subject to the proviso that the charge not be made to

[6]*See United States v. Stapf*, 375 U.S. 118 (1963).

[7]520 U.S. at 137. *See also* Mitchell M. Gans, "Will Administration Expenses Charged to Income Reduce the Marital Deduction?" 71 *J. Tax'n* 90 (1989) (arguing that if a double deduction is permitted with respect to administration expenses, the spirit, if not the letter, of section 642(g) would be violated), cited by Tax Court Judge Beghe in his concurring in part and dissenting in part opinion in *Hubert*, 101 T.C. 314, 349, *Doc 93-10865 (57 pages), 93 TNT 215-7* (1993)).

[8]520 U.S. at 122. Tax practitioners have long been accustomed to the notion that regulations are entitled to deference when issued contemporaneously with the enactment of the underlying statute. *See, e.g., Bingler v. Johnson*, 394 U.S. 741, 750 (1969). From this perspective, one might anticipate that any regulations currently issued under the marital deduction section, which was enacted in 1948, would be entitled to little or no deference on any challenge to their validity. This mode of analysis with respect to regulations has, however, fallen into disfavor. Since the Supreme Court's decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the relationship between the agencies and the courts has been substantially reworked. In *Smiley v. Citibank*, 517 U.S. 735 (1996), for example, the Court applied *Chevron's* deferential standard of review in upholding a regulation issued more than 100 years after the enactment of the underlying statute and in response to litigation. Thus, the invitation to amend the regulations offered by the three Justices in the concurrence must be understood in light of the changing environment created under *Chevron*. Significantly, this alteration in the relationship between the courts and the agencies has not been lost on the Service. Recently, for example, perceiving a conflict between the Second and Eighth Circuits on a generation-skipping tax issue (*compare Simpson v. United States*, 183 F.3d 812, *Doc 1999-25088 (8 original pages), 1999 TNT 142-69* (8th Cir. 1999) *with Peterson Marital Trust v. Commissioner*, 78 F.3d 795, *Doc 96-7270 (16 pages), 96 TNT 49-9* (2nd Cir. 1996)), Treasury proposed regulations adopting the position it had advanced in the courts. *See* prop. reg. section 26.2601-1 (November 18, 1999). Under pre-*Chevron* practice, the Service presumably would have sought to resolve the conflict in the courts. Apparently, it now believes it is able to resolve the conflict simply by declaring victory in new regulations.

(Footnote 8 continued in next column.)

[9]*See* Mitchell M. Gans, "Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?" 48 *Emory L.J.* 871 (1999).

the marital share to the extent it would create a material limitation on the spouse's right to income.[10]

III. The New Regulations

The new regulations contain a few simple rules. They first divide all administration expenses into two categories, estate *management* expenses and estate *transmission* expenses. (Treas. reg. section 20.2056(b)-4(d)(1)(i) and (ii).) They then provide that 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 any estate *management* expenses paid from the marital share to the extent not attributable to the marital share; and (3) the amount of any estate *management* expenses attributable to the marital share that are deducted under section 2053. (Treas. reg. section 20.2056(b)-4(2) - (4).)

The third required reduction is necessary to prevent the use of a section 2053 deduction for management expenses paid from a marital bequest to protect bequests to others from estate tax. Consider the following example:

> D dies with a gross estate worth $2 million, $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 subject to estate tax at a rate of 55 percent. The state estate tax equals the state tax credit available under 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 inclusion of the life insurance proceeds in D's gross estate. 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, in the absence of the third required reduction described above, would have been $2 million ($1,910,000 marital and $90,000 administrative). As a result, in the absence of the third required reduction, no estate tax would have been imposed on the life insurance proceeds passing to the daughter.[11]

The new regulations eliminate the opportunity to create double estate tax deductions. They abandon the material-limitation concept by deleting from Treas. reg. section 20.2056(b)-4(a) the two critical sentences that had been the focus of the Court's attention in *Hubert*, and they make irrelevant the income or principal characterization of expenses supplied by state law or the testamentary instrument.

The fact that management expenses attributable to and charged against a marital bequest will not reduce the marital deduction permits the estate to take an income tax deduction for the expense without increasing the taxable estate. The failure to reduce the marital deduction by the amount of such expenses does not give the estate a double deduction. Because management expenses are the same kind of expenses the spouse or his or her trust would have paid for the management of the property if it had been distributed immediately rather than kept in the estate during the period of administration, it would be inappropriate to use these expenses to reduce the marital deduction.

This point is illustrated by the following example: Decedent spouse bequeaths property with a value of $1 million to surviving spouse and $25,000 in cash to enable surviving spouse to pay for the cost of managing the bequeathed property. The decedent's estate would be entitled to a marital deduction of $1,025,000, and the surviving spouse would be entitled to an income tax deduction (under section 212) of $25,000. No one would seriously maintain that this constitutes an impermissible double deduction: Whenever a transfer is made to a surviving spouse, a marital deduction is permitted; and when the surviving spouse subsequently expends the amount transferred on a tax-deductible item, the surviving spouse becomes entitled to an income tax deduction.

The new regulations are consistent with this example. They permit (i) the marital deduction and (ii) an income tax deduction to the estate in lieu of the income tax deduction the surviving spouse would ordinarily enjoy for a management expense.[12] The new regulations do not permit the same treatment for transmission expenses because, unlike management expenses, they are not incurred by or on behalf of the surviving spouse. Instead, they are incurred in the process of transferring wealth to the surviving spouse.

A. Illustrations and Drafting

To illustrate the treatment of *transmission* expenses under the new regulations, assume a gross estate of $2,075,000, estate transmission expenses of $100,000, which the governing instrument charges to the marital deduction bequest, and a typical tax-minimization marital formula clause. With an estate tax-exemption equivalent of $675,000 and assuming the expenses are taken as an estate tax deduction (under section 2053),

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[10]*See, e.g.*, Blattmachr and Rivlin, *supra* note 5; Stephen P. Lappert, David C. Jacobson and Adriane K. McIntyre, "How to Allocate Estate Expenses Under *Hubert*," *New York Law Journal*, Apr. 4, 1998. As indicated, because this allocation of expenses to income or principal may be controlled by the terms of the governing instrument, reliance on state law to effect the tax benefit is not even necessary — just clever or efficient drafting.

[11]There would have been a similar impact even in a nontaxable estate because a formula nonmarital bequest could have been increased by an amount equal to the section 2053 management expenses paid by the marital share.

[12]A deduction on the estate's income tax return, however, may not be the complete equivalent of an income tax deduction on the surviving spouse's personal income tax return. A personal income tax deduction for management expenses would presumably constitute a miscellaneous itemized deduction (*see* section 67), while a deduction on the estate's income tax return would probably not be so viewed. *See O'-Neill v. Commissioner*, 994 F.2d 302, *Doc 93-6321, 93 TNT 118-14* (6th Cir. 1993).

a marital deduction of $1,300,000 (together with the $100,000 administration expense deduction) would bring the taxable estate to $675,000 and reduce the federal estate tax to zero. Under the new regulations, transmission expenses burdening a *marital gift* reduce the amount of the *marital deduction*, a formula clause would produce a *marital gift* of $1,400,000 (converting into a *marital deduction* of $1,300,000 by virtue of the reduction the regulations require). On the other hand, if the expenses were deducted on the estate's income tax return, a marital deduction of $1,400,000 would be necessary to reduce the tax to zero. Thus, in that case, a formula clause would produce a marital gift of $1,500,000, converting into the requisite marital deduction of $1,400,000 once the reduction mandated by the regulations is taken into account. The estate in this example would have the following options: (1) enjoy an immediate tax savings from taking the $100,000 income tax deduction, at the cost of increasing the surviving spouse's estate by $100,000 (together with any income or appreciation the $100,000 sum generates over surviving spouse's life), or (2) forego the income tax savings and secure, instead, the benefit of excluding the $100,000 sum (with income or appreciation on that amount) from the surviving spouse's estate.

The same results would be achieved if the governing instrument charged the nonmarital bequest with the burden of the transmission expenses. To illustrate, if the expenses were charged to the nonmarital share and taken as an estate tax deduction, the formula would produce a marital deduction of $1,300,000. And because the expenses do not burden the marital gift, a marital gift of $1,300,000 would produce the requisite marital deduction of $1,300,000. As in the case when the expenses burden the marital gift, the amount flowing into the surviving spouse's estate is $1,300,000. On the other hand, assuming the expenses were taken as an income tax deduction, the amount flowing into the surviving spouse's estate would remain at $1,400,000 even if the marital gift were not burdened by the expense: With the deduction taken on the income tax return, the formula would call for a marital deduction of $1,400,000, which would be satisfied by a nonburdened marital gift of $1,400,000.

Whether estate transmission expenses are charged to the marital deduction bequest or the non-marital deduction bequest will not be significant, if the marital-formula clause self-adjusts (i.e., as long as the formula, after taking into account whether or not the marital gift is to bear the expense, will produce the optimal, or "reduce to zero," marital deduction).[13] If, however, the marital-formula clause does not self-adjust, the marital deduction could be underutilized if transmission expenses are borne by the marital deduction gift. For example, if the testamentary instrument specifies an amount for the marital deduction bequest of, say, $1,400,000 and charges the transmission expenses to that gift, the marital deduction would be only $1,300,000 and an estate tax liability would result unless the transmission expenses are deducted as administration expenses under section 2053.[14]

The regulations do not require a reduction in the marital deduction on account of an executor's power to reduce the marital share by the amount of estate transmission expenses. The estate transmission expenses must *actually* be paid from the marital share to cause a reduction in the marital deduction. Although this may be contrary to conventional marital-deduction thinking,[15] it is not contrary to *Hubert*. In *Hubert*, the estate and the Service had agreed that expenses charged to principal would reduce the amount of the marital deduction. The Service did not take the position that the deduction should be reduced on account of the discretion given to the executor to charge the expenses to principal. The absence of a penalty for broad discretion is also consistent with cases such as *Estate of Clayton v. Commissioner*,[16] in which the Fifth Circuit permitted a marital deduction for property that would not have passed to the surviving spouse if the executor had not made a qualified terminable interest property ("QTIP") election.[17]

In the case of estate *management* expenses, care must be taken in drafting formula clauses to ensure that

[13]*See* Treas. reg. section 20.2056(b)-4(d)(5), *Example 5* (where the formula clause self-adjusts to provide the appropriate marital deduction depending on whether the transmission expenses are taken as income or estate tax deductions). Although, based on *Example 5*, it would appear that the typical formula clause will self-adjust and that there is, therefore, no need for any drafting modification, it may be prudent to include language such as the following in the clause: taking into account management expenses, transmission expenses, and the manner in which these expenses are taken as deductions.

[14]For an article on drafting under the new regulations (written when the regulations were in proposed form), see Eileen Caulfield Schwab and Darcy M. Katris, "Administration Expense Regulations Proposed," *New York Law Journal*, Apr. 5, 1999.

[15]*See, e.g.*, *Wycoff v. Commissioner of Internal Revenue*, 506 F.2d 1144 (10th Cir. 1974) (holding that where the executor is given the discretion to apportion the burden of estate taxes to the marital share, section 2056(b)(4) requires that the deduction be reduced even if the executor chooses to apportion the tax to the nonmarital share). *But see* the Tax Court decision in *Hubert* (101 T.C. 314 (1993) (indicating that the rule established in *Wycoff* deals with the executor's discretion to apportion taxes between the marital and nonmarital share, not with an executor's discretion to allocate expenses between income and principal); *Patterson v. U.S.*, 181 F.3d 927, 930 at n.2 (8th Cir. 1999) (indicating that the Tax Court in *Hubert* limited the *Wycoff* principle in this fashion). On the other hand, it has been suggested that *Wycoff* has been implicitly overruled in its entirety by the Supreme Court decision in *Hubert*. *See* Richard B. Covey, *Practical Drafting*, July 1997 at 4885.

[16]*Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991).

[17]*See also Estate of Robertson v. Commissioner*, 15 F.3d 779, *Doc 94-1612, 94 TNT 26-16* (8th Cir. 1994), *rev'g* 98 T.C. 678 (1992); *Estate of Spencer v. Commissioner*, 43 F.3d 226 (6th Cir. 1995), *rev'g* T.C. Memo. 1992-579; and *Estate of Clack v. Commissioner*, 106 T.C. 131, *Doc 96-6201 (71 pages), 96 TNT 43-9* (1996). In 1998, Treasury changed the regulations to conform to these decisions. T.D. 8779, amending Treas. reg. section 20.2056(b)-7(d)(3).

management expenses attributable to the marital share are charged against that share. In addition, the formula defining the marital and nonmarital shares may have to be redrafted. To illustrate, assume a gross estate of $2 million, an estate tax-exemption equivalent of $600,000, $100,000 of management expenses attributable to the residuary estate that were taken as income tax deductions, and a will that gives everything to the decedent's husband other than the amount calculated by the following formula clause:

> ***Bequest of the Applicable Credit Amount.*** If my husband survives me, I give to my daughter an amount equal to the "applicable credit amount." The "applicable credit amount" is the largest amount, if any, that can pass free of federal estate tax (determined without regard to any renunciation or disclaimer that my husband may make) based on the credit allowable against such tax under section 2010 of the code, and no other credits, reduced by: (1) the value of all property includible in my gross estate that passes under any other Article or passes or has passed outside of this Will and that does not qualify for the marital or charitable deduction or any other deduction permitted under the federal estate tax law in effect at my death, (2) the amount of my adjusted taxable gifts, and (3) *the expenses and debts of my estate that are chargeable to principal and that are not allowed as federal estate tax deductions in my estate.*

The formula reduces the amount of the applicable credit bequest by the amount of the management expenses. As a result, the residue passing to the husband will be $1,400,000. The daughter will receive only $500,000. The remaining $100,000 will be used to pay the management expenses.

This formula, which was typical of the formulas used before the issuance of the final *Hubert* regulations, will overutilize the marital deduction and will diminish the amount passing to the daughter. Given the new regulations, the formula should be changed to prevent this overutilization from occurring. The following is an example:

> ***Bequest of the Applicable Credit Amount.*** If my husband survives me, I give to my daughter an amount equal to the "applicable credit amount." The "applicable credit amount" is the largest amount, if any, that can pass free of federal estate tax (determined without regard to any renunciation or disclaimer that my husband may make) based on the credit allowable against such tax under section 2010 of the code, and no other credits, reduced by: (1) the value of all property includible in my gross estate that passes under any other Article or passes or has passed outside of this Will and that does not qualify for the marital or charitable deduction or any other deduction permitted under the federal estate tax law in effect at my death, (2) the amount of my adjusted taxable gifts, and (3) *the expenses and debts of my estate (other than estate management expenses attributable to property passing under this will to my husband) that are not allowed as federal estate tax deductions in my estate. For purposes of this provision, the term "estate management expenses" shall have the meaning given to it in Treas. reg. section 20.2056(b)-(4)(d)(1)(i).*

Under this formula, the husband's residuary bequest would be $1,300,000, and the daughter would receive $600,000. The daughter would receive an additional $100,000 without incurring any estate tax.

A word of caution is in order about double deductions. Because the regulations do not permit a double estate tax deduction (i.e., an inflated marital deduction and an estate tax deduction under section 2053),[18] it will never be appropriate to take management expenses attributable to a bequest eligible for the marital deduction as an estate tax deduction under section 2053. Taking such a deduction would reduce the marital deduction by an equal amount. As a result, there will be no estate tax benefit derived from the deduction. In virtually all cases, it will be preferable to take an income tax deduction for such expenses.

One further comment is in order about drafting. Under *Hubert*, charging an expense to income could, in some cases, produce a double deduction. The final *Hubert* regulations, as indicated, have completely abandoned the income/principal distinction. As a consequence, it will no longer be necessary for the testamentary instrument to charge expenses to income or for the testamentary instrument to give the executor the discretion to do so.

B. Definition of Mgmt. and Transmission Expenses

The regulations define management expenses as those incurred in connection with investment, management, or preservation of estate assets during a reasonable period of administration. The regulations give the following examples of possible management expenses: investment advisory fees, stock brokerage commissions, custodial fees, and interest.[19] Transmission expenses are defined to include any administration expense that is not a management expense. The regulations go on to give further guidance, indicating that expenses incurred in collecting the decedent's assets, paying debts and taxes, and making distribution to the beneficiaries are all transmission expenses. They give the following as possible examples of transmission expenses: executor's fees, attorney's fees, appraisal fees, and expenses incurred in defending a

[18] *See* Treas. reg. section 20.2056(b)-4(d)(3) (providing that the marital deduction must be reduced by the amount of a management expense if it is taken as a section 2053 estate tax deduction).

[19] As a general matter, interest, though viewed as a management expense, will not generate a double deduction. Under section 163(h), interest cannot be deducted on the estate's income tax return (unless the interest is incurred in connection with an extension of time to pay the estate tax). And if the interest is instead deducted on the estate tax return (section 2053), this will result in a reduced marital deduction, thus precluding the estate from enjoying a double deduction.

probate contest or in a construction proceeding. In the case of executors' and attorneys' fees, however, the regulations do make an exception. When it can be shown that these expenses are specifically related to management functions (i.e., investment, management, or preservation of estate assets), they are treated as a management expense.

The regulations leave several unanswered questions.

The regulations do not indicate how such a showing can be made, and leave several unanswered questions: Will it be possible for an executor to use time records to establish what portion of his, her, or its compensation is attributable to management functions? Will the apportionment depend on whether, under state law, part of the executor's fee is chargeable to income or is determined based on the amount of income collected during administration? The answer to this question should be in the negative in view of the regulations' rejection of the income-principal distinction. Will the states adopt legislation apportioning the executor's fee between management and transmission functions? If, for example, a state were to enact legislation providing that 90 percent of the executor's fee represents compensation for management functions and 10 percent represents compensation for transmission functions, would the Service argue that 90 percent of the compensation is not specifically related to management functions? And what about the compensation paid to a trustee under a trust that was revocable during the decedent's lifetime and that is used as a testamentary substitute? Since transmission activities are generally reduced by the use of a revocable trust, arguably a major portion of the trustees' commissions should be treated as management expenses.

To minimize the impact of this uncertainty, the will or revocable trust could define management and transmission expenses by referencing the definition contained in the regulations (as illustrated by the formula clause set forth above). With this approach, the final characterization of the expense in any dispute with the Service will determine its treatment.

C. Must the Marital Share Participate in Income?

The question of whether the amount of the marital deduction must be reduced if the marital share is not entitled to share in the estate's income and gains earned during administration is closely related to the issue considered by the Supreme Court in *Hubert*. What is the effect on the marital deduction, for example, when the surviving spouse is to receive a pecuniary (fixed sum-of-money) bequest that does not entitle it to receive interest or to participate in estate income or gains? Although there is no unambiguous authority on the issue, there has been concern in the estate planning community that the marital deduction might be reduced if the surviving spouse were not given the right to receive income or interest during the period of estate administration.

There is cause for this concern. In *Hubert*, Justice Breyer, in his dissenting opinion, suggests that the amount of the marital deduction would be reduced to take into account a direction in the will that income generated by the marital share during estate administration be payable to a beneficiary other than the spouse (citing Treas. reg. sections 20.2056(b)-4(a), 20.2056(b)-5(f)(9), and *Estate of Friedberg v. C.I.R.*[20]). Although, in Justice Breyer's hypothetical, the will placed the marital gift in trust, the same question arises in the context of an outright pecuniary marital gift. In fact, the one case cited by Justice Breyer, *Estate of Friedberg*, involved an outright pecuniary marital bequest. The will authorized the executor to delay distribution to the spouse for a period of as much as five years (depending on how a specified contingency was resolved). The Service argued that a reduction in the marital deduction was required because of the possible delay in making distribution. Tax Court Judge Halpern rejected the Service's argument because the spouse was entitled to receive interest equal to no less than marital gift's share of estate income, but agreed with the Service that a reduction in the amount of the marital deduction would ordinarily be necessary if distribution of the marital gift could be delayed and if the spouse were not permitted to receive interest or income. Judge Halpern's reasoning was based on the last two sentences in Treas. reg. section 20.2056(b)-4(a), which were critical to the analysis made in the various *Hubert* opinions. Because the new regulations omit these two sentences, it is uncertain whether the conclusion reached by Judge Halpern in *Friedberg* remains viable.[21]

The new regulations contain an example that supports the conclusion that no reduction of the marital deduction is required by the failure to give a marital bequest interest or a share of the estate's income or gains during the period of estate administration. The will described in the example (Treas. reg. section 20-2056(b)-4(d)(5) *Example 7*), contains a pre-residuary pecuniary marital bequest of $3 million and gives the residue to the decedent's child. Even though the spouse is not entitled to participate in estate income or gains (i.e., the income and gains inure to the benefit of the residuary legatee), the example concludes that the estate is entitled to a $3 million marital deduction. The new regulations seem to have implicitly adopted the position that it is unnecessary to reduce the amount of the marital deduction simply because the spouse is prevented from participating in estate income or gains. If, in fact, this understanding of the example is correct, estate planners should consider making the marital bequest pecuniary without the right to participate in income or gains during the estate-administration period. Under such an approach, less will flow into the

[20]63 TCM 3080 (1992).

[21]In this regard, it should be noted that the *Friedberg* court, in n.48, also cited Treas. reg. section 20.2056(b)-4(b) and indicated that this regulation, which has not been amended, provided additional support for its conclusion.

surviving spouse's estate than if the spouse were permitted to participate in income (or to receive interest on the bequest).

The example in this regulation, however, does not indicate whether a reduction in the marital deduction would be necessary if the will explicitly called for a postponed distribution to the spouse (or if the will called for a postponement but only during a reasonable period of administration). The implication, may be that as long as the governing instrument does not provide for an explicit postponement, no reduction is necessary (it remaining unclear whether a reduction would be necessary if the testamentary instrument called for a postponement but only during a reasonable period of administration). Perhaps the underlying premise of the regulation is that, if the testamentary instrument does not mandate a postponement, state law will prevent the executor from unduly delaying the distribution.

In the absence of a provision in the will authorizing a delay in distribution to the spouse, state law would likely give the spouse a claim against the executor should he or she fail to make prompt distribution. This claim would become part of the spouse's estate (or would trigger a taxable gift if the claim were not asserted), just as a right to participate in estate income and gains would produce an inclusion in the spouse's estate.[22] This kind of tacit reliance on state law could prove, however, as it often does, to be problematic.[23] Consider, for example, the possible enactment of state legislation denying the beneficiary of a pecuniary bequest any claim against the fiduciary (or any claim to interest or to participate in estate income or gains) unless the testamentary instrument affirmatively required distribution within a specified time — or perhaps legislation setting a nominal interest rate to compensate for any delay unless the testamentary instrument established a higher rate. To the extent such legislation is enacted, or to the extent statutes presently permit a delay in distribution without requiring compensation,[24] the regulation's premise fails to hold.

The fact that the regulations do not require that the marital share participate in estate income or gains leads, inevitably, to economically inconsistent treatment between a marital bequest that is entitled to share in income and gains and one that is not. Assume, for example, that the surviving spouse in *Example 7* was entitled to the income earned by the property that was distributed to him in satisfaction of his pecuniary bequest, that such income amounted to $300,000, and that $100,000 of the income was used to pay estate transmission expenses. The marital deduction, in this case, will be reduced by $100,000, even though the surviving spouse will actually receive a greater amount than the surviving spouse in *Example 7* (who received none of the income).

The flaw that leads to this anomalous result is not a flaw in the *Hubert* regulations. The problem is that the regulations do not reflect the economic reality that a bequest of a fixed dollar amount to be satisfied at some time in the future is worth less than the fixed dollar amount. A similar issue arises whenever it is necessary 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. The issue is essentially a "time value of money problem." Treasury has resolved this issue in the context of the generation-skipping transfer 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.[25] It should consider the same approach in connection with the marital deduction.

D. The Charitable Deduction

Before the issuance of the new regulations, the impact of administration expenses on the charitable deduction was less clear than their impact on the marital deduction. In fact, in *Hubert*, after beginning its analysis with section 2056(b)(4) (indicating that obligations burdening the marital gift must be taken into account) and then focusing on the implementing regulation (Treas. reg. section 20.2056(b)-4(a)), the plurality acknowledged the absence of any counterpart in the charitable deduction provision (section 2055) or in the charitable deduction regulations. The plurality then alluded to the parties' agreement that the impact on both deductions should be determined in the same way and chose the marital deduction as its framework for resolving both issues. The concurrence and dissent similarly used the marital deduction as the controlling framework.

The regulations follow the approach taken by the Court in *Hubert*, adopting the identical framework in the charitable deduction regulations as they do for the marital deduction. Therefore, as in the marital deduction context, management expenses burdening a charitable

[22]*See Estate of de St. Aubin v. Commissioner of Internal Revenue*, 76 T.C.M. (CCH) 409, *Doc 98-27999 (54 pages), 98 TNT 178-11* (1998) (holding, among other things, that the widow's so-called "minimum worth" hybrid pecuniary marital deduction bequest was not entitled to share in appreciation in her husband's estate under local, (New York) law even though more than 15 years passed after the husband's death before the marital deduction bequest was funded and the value of his estate increased by a factor of 10 during that time); *compare Matter of Abrams*, 242 A.D.2d 450, 662 N.Y.S.2d 760 (1st Dept. 1997) (permitting the spouse to participate in appreciation in the particular circumstances presented).

[23]In section 2704, for example, the concept "applicable restriction" is determined by reference to the default rule under state law. As a consequence, various states have enacted legislation changing the default rule to make their partnership law friendlier to taxpayers concerned about running afoul of section 2704. The decision to allow state law to govern in this fashion can be viewed as an inappropriate overemphasis on state law. *See* Gans, note 8 *supra*.

[24]*See* Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* (U.S. Trust Co. 1984), Appendix B for a list of state law rules on the payment of interest or income on pecuniary and residuary dispositions.

[25]*See* Treas. reg. sections 26.2642-2(b)(3) and 26.2654-1.

gift do not reduce the amount of the charitable deduction, whereas transmission expenses so burdening a charitable gift do result in a reduced deduction. See Treas. reg. section 20.2055-3(b). The effect is to permit the same income tax deduction for estate management expenses that are attributable to and paid from charitable gifts that marital gifts are permitted. Remaining faithful to the marital deduction framework, the regulations do not permit a double deduction in the form of a double estate tax deduction (i.e., an inflated charitable deduction and an estate tax deduction under section 2053). See Treas. reg. section 20.2055-3(b)(3). Since the charitable deduction regulations on this issue are identical to the marital deduction regulations, the considerations in terms of drafting are the same: As in the case of a marital gift, the charitable gift should be required to bear the burden of management expenses to secure an income tax deduction without a reduction in the estate tax charitable deduction.[26]

The wholesale adoption of the marital deduction framework for charitable deduction purposes, while superficially attractive, may not be justified.

The wholesale adoption of the marital deduction framework for charitable deduction purposes, while superficially attractive, may not be justified, in terms of either the code sections the regulations seek to implement or the underlying policy objectives. In terms of the code, the marital deduction (section 2056) and charitable deduction (section 2055) provisions are not parallel. Two provisions in section 2056 critical to the framework adopted in the regulations are missing from section 2055: section 2056(b)(9),[27] prohibiting a marital deduction for an item otherwise deducted on the estate tax return, and section 2056(b)(4), providing that obligations encumbering a marital gift must be taken into account. These two provisions obviously serve, in the marital deduction context, as the statutory predicate for the rules prohibiting a double deduction for transmission expenses and a double estate tax deduction for management expenses. Given the fact that section 2055 contains neither of these provisions, the statutory basis for the double-deduction prohibitions in the charitable deduction regulations is uncertain. Indeed, Treas. reg. section 20.2055-3(b)(3), in requiring a reduction in the amount of the charitable deduction when the expense is deducted under section 2053, explicitly invokes section 2056(b)(9) as its statutory authority — not, most significantly, any provision in section 2055.

If the focus were strictly on the code, the conclusion might well be reached — given the absence of any double-deduction prohibition in section 2055 — that double deductions should be permitted. In fact, in *Hubert*, the Court permitted the estate a double deduction.[28] At the same time, one might also conclude that the code could be interpreted to preclude taxpayers from enjoying double deductions. After all, the four-Justice concurrence was of the view that the code could accommodate new regulations that would bar double deductions entirely, not to mention the two dissenters who would have barred double deductions based on the regulations then existing. It is, however, difficult to find any basis in the code for the compromise approach actually adopted in the regulations.[29]

Finally, in some circumstances, it will not be appropriate to permit an estate to take an income tax deduction for management expenses charged against a charitable bequest without reducing the amount of the charitable deduction. In the marital deduction context, the deduction seems appropriate since the spouse, had he received an immediate distribution of his bequest and had he incurred the same management expense, would have been allowed to claim that deduction. In the charitable deduction context, the income tax deduction will also be justified if the deduction would have inured to the tax benefit of a noncharitable beneficiary. If, however, the deduction would not have inured to the tax benefit of a noncharitable beneficiary, it seems inappropriate to permit the deduction.

Nonetheless, it is not likely that the validity of the regulations could be successfully challenged given the willingness of the Court in *Hubert* to analyze the charitable deduction under a marital deduction framework; given the fact that the compromise is more generous to taxpayers than the approach six Justices thought either appropriate under existing regulations or permissible under new regulations; and given the increasing deference that regulations enjoy in the courts.[30]

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[26]Of course, if the entire estate passes to charity, the income tax deduction will be of no value as a general rule. *See* Blattmachr and Rivlin, note 5 *supra*, at 62.

[27]Although contained in the marital deduction section (section 2056), the language, perhaps, is broad enough to cover double estate tax deductions, regardless of whether one is the marital deduction.

[28]*Cf. Hartwick College v. U.S.*, 611 F. Supp. 400 (N.D.N.Y 1985) (holding that the amount of the charitable deduction under section 642(c) need not be reduced on account of the burden of income tax liability imposed on the charitable gift).

[29]Similarly, one might take the position that section 2056 could be construed as denying double deductions entirely or as permitting them, but not as contemplating the compromise adopted in the regulations. As the concurrence indicates, however, the direction in section 2056(b)(4) that obligations encumbering the marital deduction gift be taken into account is somewhat ambiguous: The section does not say how they should be taken into account. *See* 520 U.S. at 113. Moreover, as indicated in text, the compromise approach in the marital deduction context is supported by the theory that the estate receives the benefit of the income tax deduction that would have been available to the spouse.

[30]*See* note 8 *supra*.