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# Will Administration Expenses Charged to Income Reduce the Marital Deduction?

An apparent change of position by the Tax Court opens planning possibilities. However, back-up positions are advisable.

BY MITCHELL M. GANS

**U**nder Section 2056(b)(4), the marital deduction must be reduced for any obligation or burden placed upon the marital gift by the decedent. In *Estate of Roney*, 33 TC 801 (1960), the Tax Court had held that the marital deduction was so reduced for administration expenses. Recently, however, in *Estate of Richardson*, 89 TC 1193 (1987), and *Estate of Street*, TCM 1988-553, the court found such a reduction unnecessary because the expenses were chargeable to income under state law.

## Tax Court's Analysis

In *Richardson*, the decedent's will provided that his spouse was to receive a fraction of the residue as her marital bequest. Unlike the Federal and local estate taxes, which the will charged to the nonmarital share of the residue, the interest on taxes would be borne by the entire residue, including the marital share. The issue was whether the marital deduction had to be reduced by the interest chargeable to the marital share of the residue. The Tax Court held that a reduction in the marital deduction was not required.

The court's basic premise was that interest chargeable against income will not reduce the value of the surviving spouse's share in the estate. Concluding that state law was not

clear on whether the interest was chargeable to income or principal, the court focused on the will to ascertain the decedent's intent. The will emphasized the decedent's objective to maximize the marital deduction. Given this, the Tax Court determined that the decedent could not have intended to cause a reduction in the marital deduction through a charge of the interest to principal.

In reaching its conclusion, the court emphasized that interest on taxes is not an obligation due as of the date of death, but rather an obligation that accrues from day to day after death. The court distinguished *Roney*, which involved administration expenses claimed on a fiduciary income tax return. *Roney* held that those expenses reduced the amount available to the surviving spouse, and therefore reduced the marital deduction. *Roney* was distinguishable, according to the court in *Richardson*, for two reasons: (1) unlike administration expenses, interest accrues after death, and (2) administration expenses (which the will in *Roney* did not charge to any particular source) usually are chargeable to principal.

Given the court's discussion of the administration expenses in *Roney*, it would seem that its holding in *Richardson* could not be extended beyond the context of post-death interest. But in *Street*, the Tax Court appears to have extended *Richardson* to administration expenses other than post-death interest. In *Street*, the will contained a pre-residuary bequest of

the exemption equivalent of the unified credit. The residue was placed in a trust that would qualify for the marital deduction. The issue was whether the administration expenses (i.e., interest and other types of administration expenses) incurred by the estate reduced the marital deduction.<sup>1</sup>

The Tax Court concluded that it was not illogical to extend the treatment afforded interest in *Richardson* to other administration expenses. Thus, according to the court, if the administration expenses were chargeable to income under state law, they would not reduce the marital deduction. The court noted that although in this case state law was unclear, it did permit testators to direct in their wills whether administration expenses should be charged to principal or income. Here, the will conferred discretion upon the fiduciary to allocate these expenses. The court determined that the expenses were chargeable to income because state law mandated that a fiduciary take appropriate action to protect the marital deduction and because the will revealed the testator's desire to maximize the marital deduction. The Tax Court again distinguished *Roney*, pointing out that in that case state law required that the expenses be charged to principal and there was no contrary provision in the will.

**Planning opportunities.** *Richardson* and *Street* create interesting planning opportunities. When the marital be-

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quest is to share in the income earned by the estate during administration, it would seem advisable to direct that administration expenses be borne by the marital portion of the estate and that the expenses be charged to income. If this is done, the surviving spouse will receive less from the estate than if the marital share were exonerated from the burden of these expenses, thereby producing an estate tax savings upon the death of the surviving spouse. And, of course, the administration expenses still could be deducted, as they were in *Street* and *Richardson*, on the fiduciary income tax returns.

In effect, by taking this approach, the estate enjoys a double deduction—a reduction in the amount to be included in the surviving spouse's estate, and an income tax deduction. One might well have thought, before the decisions in *Richardson* and *Street*, that such a double-deduction effect would violate the spirit, if not the literal language, of Section 642 (g). It might even be possible to secure, in effect, a double estate tax deduction.

**EXAMPLE:** The gross estate is \$2 million, and \$100,000 in administration expenses are taken as a Section 2053 deduction.<sup>2</sup> A \$600,000 bequest is committed to a credit-shelter trust. The marital deduction could equal \$1.3 million without generating any tax. By contrast, to keep the estate tax at zero if the administration expenses are not deducted under Section 2053, the marital deduction would have to be \$1.4 million. Thus, if the income produced by the marital portion of the estate bears the burden of the administration expenses, a double estate-tax deduction is obtained since (1) the amount included in the surviving spouse's estate is reduced by \$100,000 and (2) the surviving spouse is deprived of the income from the \$1.3 million fund to the extent it is used to pay administration expenses.<sup>3</sup>

## Validity of *Richardson* and *Street*

Although *Richardson* and *Street* offer grist for planning, the approach taken by the court in both of these cases may be somewhat questionable.

The conclusion reached by the court in *Street* may be inconsistent with Reg. 20.2056(b)-4(a). That Regulation appears to require that the marital deduction be reduced where income earned by the estate prior to the creation of the marital trust is burdened with the payment of administration expenses. The Regulation provides, in part:

"The marital deduction may be taken only with respect to the net

**The surviving spouse could disclaim the exoneration clause and obtain the double-deduction effect.**

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 the spouse were being determined. 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."

It seems surprising that the court did not even cite the Regulation in *Street*, where the marital bequest was placed in trust. After all, the portion of the estate income attributable to the marital share that was earned prior to the creation of the marital trust was not available for distribution to the spouse. Instead, it was required to be used for administration expenses.

Unlike *Street*, the marital bequest in *Richardson* was outright in nature. Thus, Reg. 20.2056(b)-4(a) may arguably be irrelevant in the context of *Richardson*. Nevertheless, it would seem that the third sentence in the portion of the Regulation quoted above is illustrative of the second sentence. It would also seem that the

principle established in the second sentence may well extend to outright bequests, as well as to bequests made in trust.

Indeed, the first sentence in the quote would appear to confirm this. It, as well as the Code, requires that the principles applicable in determining the value of a gift be used to ascertain the net value of the bequest passing to the surviving spouse. If this were done, one would likely conclude that the value of the marital bequest must be reduced where a portion of the income attributable to it earned during estate administration is committed to the payment of administration expenses.

Consider, for example, an inter vivos gift of \$100,000 subject to a reservation that the income earned by this \$100,000 fund for one year be used to pay the donor's living expenses. The value of this gift would not be \$100,000, but rather the present value of the right to receive \$100,000 one year hence.<sup>4</sup> Similarly, in computing the net value of an outright marital bequest it would seem appropriate to take into account the fact that the income that is generated by the marital bequest is unavailable to the surviving spouse for some period of time after the decedent's death.<sup>5</sup>

In addition, the legislative history underlying the marital deduction, though not explicitly addressing the question of estate income being used to pay administration expenses, suggests an approach different from the one taken by the Tax Court in *Richardson* and *Street*. The Senate Report<sup>6</sup> provides that the interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the will leaves the residue of the estate to the surviving spouse, and either the surviving spouse or the estate's income pays claims against the estate, any resulting 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 marital deduction. In *Roney*, the Tax Court quoted the Senate Report in concluding that the marital deduction was reduced by the

administration expenses burdening the marital bequest.

## Marital Deduction Trusts

An additional difficulty with *Richardson* and *Street* exists when the marital share is placed in trust. By depriving the surviving spouse of some portion of income earned during estate administration, the instrument violates the requirement that all trust income be payable to the surviving spouse. This would perhaps taint the marital trust and, therefore, result in the marital deduction being diminished by an amount greater than simply the administration expenses.

The Service, however, appears to be precluded from making this argument by Reg. 20.2056(b)-5(f)(9), which provides that the requirement that income be payable to the surviving spouse is not violated merely because the spouse is not entitled to the income from estate assets for the period before distribution of those assets by the executor, unless the executor is authorized or directed by the will to delay distribution beyond the period reasonably required for administration of the estate. Thus, unless the will authorizes or directs such a delay, a will provision charging administration expenses to income attributable to the marital share should not cause a violation of the marital trust requirement that income be payable to the surviving spouse.

The question still remains whether, under Reg. 20.2056(b)-4, the value of the interest passing to the surviving spouse, and therefore the amount of the marital deduction, is reduced because of the deflection of income away from the surviving spouse toward the payment of administration expenses. Although Reg. 20.2056(b)-5(f)(9) states that the income requirement for marital trusts is not

violated by a deflection of income during a reasonable administration period, it does provide that such a deflection is to be considered in determining the value of the interest passing to the surviving spouse under Reg. 20.2056(b)-4.

Finally, as a matter of policy, it would seem that estates have a choice between two different types of deductions under the Code for administration expenses: a deduction on the estate tax return or a deduction on the fiduciary income tax return. Section 642(g) makes clear that estates are precluded from taking both for a single expenditure. As suggested previously, a double-deduction effect is created if administration expenses burdening a marital bequest do not affect the calculation of the marital deduction. Thus, the policy against double deductions would be frustrated by the approach taken in *Richardson* and *Street*.

Given these concerns about the validity of the *Richardson-Street* approach, some practitioners may well believe that it would be imprudent to incorporate in a will a direction that administration expenses be borne by the marital share. Indeed, in light of the third sentence from Reg. 20.2056(b)-4(a) quoted above, such a direction would seem particularly troublesome where a trust is the receptacle for the marital gift. Moreover, what would happen if the decisions in *Richardson* and *Street* are overruled?

The concern about the use of a marital trust is, of course, easily eliminated by making the marital bequest outright. As suggested above, however, this may not necessarily render the Regulation inapplicable (and in any event may be impractical or undesirable). With respect to the possibility that these cases may be overruled, it would be wise to draft flexibility into wills so that it

would be possible to decide after the death of the testator whether administration expenses should burden the marital bequest. In order to create such flexibility, the will could provide that administration expenses be charged to income but that the marital deduction bequest be exonerated from any obligation to contribute to the payment of these expenses. Under this approach, no reduction in the marital deduction would be required even if *Richardson* and *Street* are overruled, for the marital share would not be required to bear the burden of these expenses. On the other hand, if after the client's death *Richardson* and *Street* are still viable, the marital portion of the estate can be made subject to the burden of administration expenses by having the surviving spouse disclaim the benefits of the exoneration clause.<sup>7</sup>

There would appear to be no downside inherent in this technique. If the surviving spouse does not disclaim the benefit of the exoneration clause, the administration expenses will be paid from the nonmarital share, thus precluding any reduction in the marital deduction on account of the administration expenses. The technique offers an upside if the *Richardson-Street* approach remains viable. The surviving spouse could disclaim the benefit of the clause and obtain the double-deduction effect.<sup>8</sup>

## Conclusion

*Richardson* and *Street* offer planning opportunities. If, however, wills are drafted to take advantage of these cases and the cases are overruled or given a restrictive reading in the future, an under-utilization of the marital deduction could result. Consequently, one should be cautious in drafting wills that allocate the burden of administration expenses to the marital share. □

<sup>1</sup> This issue might not have arisen had the estate claimed the expenses as a Section 2053 deduction, which would have offset the reduction in the marital deduction. The estate, however, claimed the administration expenses as a deduction on its fiduciary income tax return, waiving the Section 2053 deduction.

<sup>2</sup> It may not be possible to take a deduction under Section 2053 for administration expenses chargeable to income under state law. See *Lewis v. Bowers*, 19 F. Supp. 745 (DC N.Y., 1937).

<sup>3</sup> But see Reg. 20.2056(a)-2(b)(2), which provides that if a deduction is allowed under Section 2053 by reason of the passing of a property interest from the decedent to the surviving spouse, such interest is, to the extent of the deduction under Section 2053, a non-deductible interest.

<sup>4</sup> See Regs. 25.2511-1 and 25.2512-9.

<sup>5</sup> See *Stapf*, 375 U.S. 118 (1963), where the Court noted that the appropriate reference is not to the value of the gift moving from the deceased spouse but rather to the net value

of the gift received by the surviving spouse.

<sup>6</sup> S. Rep't No. 1013, 80th Cong., 2d Sess. II-6 (1948).

<sup>7</sup> See *Boyd*, 819 F.2d 170 (CA-7, 1987), where the court held that a life insurance beneficiary could validly disclaim the benefits of a clause exonerating him from an obligation to pay estate tax attributable to the inclusion of the insurance proceeds in the gross estate.

<sup>8</sup> Assuming the disclaimer is recognized as valid under *Boyd*.