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Lifting the Shroud Obscuring *Estate of Hubert*: The Logic of the Income and Estate Tax Treatment of Estate Administration Expenses

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I. INTRODUCTION

In *Commissioner v. Estate of Hubert*, the Supreme Court upheld a Tax Court decision that $1.5 million of estate administration expenses charged against the income of a marital deduction bequest did not reduce the marital deduction for estate tax purposes.[1] In *Hubert*, the marital deduction bequest was a residuary bequest, and estate administration expenses were payable out of the residue, but the executors had discretion to allocate such expenses between principal and income.[2] Pursuant to what is known as the "section 642(g) election," the expenses charged against income were deducted for purposes of computing the taxable income of the estate as a separate taxpayer,[3] and were not deducted for estate tax purposes.[4]

This comment both critiques *Hubert* on a doctrinal basis and explores what should be the proper income and estate tax consequences of estate administration expenses.[5]

A. *The Statutory Framework*

Property is included in the gross estate at its fair market value at the date of death.[6] In arriving at the taxable estate, a deduction is allowed under section 2053 for debts and claims against the decedent arising before death[7] and for estate administration expenses, the most important of which are fees for services provided by the estate personal representative, attorneys

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1. 520 U.S. ___, 117 S. Ct. 1124 (1997), aff'g 63 F.3d 1083 (11th Cir. 1995) (2-1 decision), aff'g 101 T.C. 314 (1993) (reviewed) (2 dissents on this issue).

2. *Hubert*, 117 S. Ct. at 1128.

3. See Estate of Hubert v. Commissioner, 101 T.C. 314, 348 (1993) (Beghe, J., dissenting). The estate is a separate taxpayer for income tax purposes that computes net income in essentially the same manner as an individual, except as otherwise provided in Subchapter J of the Code. See IRC § 641(b). Income tax deductions for administration expenses are allowed under IRC § 212(1), (2), dealing with expenses relating to the production of income and income-producing property.

4. The estate tax deduction for estate administration expenses is found in IRC § 2053(a)(2).

5. Some of the post-*Hubert* drafting and expense allocation options are explored in Scott H. Malin & Bennett S. Keller, Planning for the Allocation of Administration Expenses to Income under *Hubert*, 84 J. Tax'n 213 (1997).

6. See IRC § 2031(a). The gross estate can, at the executor's election, be valued on the alternate valuation date (subsequent to the decedent's death) as prescribed by IRC § 2032.

7. See IRC § 2053(a)(3) (providing for deduction "for claims against the estate."); Regs. § 20.2053-4 (specifying that claims may be deducted only if "existing at the time of" the decedent's death).

representing the estate, and other professional service providers such as appraisers, and court costs.[8]

Section 2056(a) allows a marital deduction for the "value of any interest in property which passes . . . from the decedent to the surviving spouse . . . ." This rule means that a deduction is allowed only for interests that the spouse actually receives, not for interests that she might have received (but didn't receive). The "passing" requirement is easily confused with the "terminable interest rule" of section 2056(b)(1), which disallows the marital deduction where the spouse actually receives interests that might have been cut off by conditions precedent or subsequent.[9] Nevertheless, both the passing requirement and the terminable interest rule have a common purpose, which is to preclude a deduction being taken, as of the decedent's death, for interests that will not, or might not, appear in the surviving spouse's transfer tax base. The terminable interest rule tends to operate on an all-or-nothing basis, whereas the passing requirement can operate to disallow a transfer in whole or in part.[10]

Under section 2056(b)(5) and (b)(7), a marital deduction is allowed for the entire value of trusts in which the surviving spouse has, *inter alia*, an income-only interest for life.[11] The marital deduction trusts in *Hubert* fell under these provisions. The regulations state that an income interest will not satisfy the qualification rules if the income interest is illusory.[12] An example of an illusory income interest is where the trust is locked into investments that do not yield income. The expenses charged to income in *Hubert* were less than the gross income of the estate, and the practice was sporadic. Also, *Hubert* involved an estate with a limited duration, as opposed to a trust. Hence, the government did not contend that the income interest was illusory so as to wholly disqualify the marital deduction. Nevertheless, the parties and the various opinions in *Hubert* discussed the illusory-income-interest

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8. See IRC § 2053(a)(2); Regs. § 20.2053-3(a)-(c).

9. This confusion is discussed in Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-To-Value Lines, 43 Tax L. Rev. 241, 345-49 (1988).

10. The passing requirement is also elaborated upon in IRC § 2056(c), mostly relating to non-probate property, where the focus is on the "from the decedent" aspect. Section 2056(b)(4), a key statutory provision in the *Hubert* litigation, focuses on the "to his surviving spouse" aspect.

11. Section 2056(b)(5) qualifies a trust for the marital deduction if it gives the surviving spouse both a lifetime income interest and a general power of appointment as to the corpus, a "GPA" trust. Section 2056(b)(7) permits an election to qualify a trust in which the surviving spouse has a lifetime income interest in the absence of a general power of appointment if the trust constitutes "qualified terminable interest property," a "QTIP" trust.

12. See Regs. § 20.2056(b)-5(f).

regulations as being potentially relevant.[13] In fact, they are not relevant in the sense that the value-passing issue, referred to in the preceding paragraph, is analytically distinct from the qualification issue.

Section 2056(b)(4) states that, in determining the value of the interest that passes to the surviving spouse, there shall be "taken into account" taxes, encumbrances, and "any obligation imposed by the decedent" on the marital bequest. Regulation section 20.2056(b)-4(a) on its face appears to be relevant to the facts in *Hubert*:

> **§ 20.2056(b)-4 Marital deduction; valuation of interest passing to surviving spouse.**
>
> (a) In general. The value, for purposes of the marital deduction, of any deductible interest which passes from the decedent to the surviving spouse is to be determined on 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 . . . . 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 the 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 during the administration of the estate. [Emphasis added.]

Paragraph (b) of Regulations section 20.2056(b)-4 deals with bequests subject to an "encumbrance" (such as a mortgage or lien) or an "obligation imposed by the decedent." The discussion of the latter refers to situations where the surviving spouse, as a condition of receiving the bequest, must give up a claim against the estate or some other property interest that she owns. Encumbrances and obligations reduce the net amount passing to the surviving spouse. Although paragraph (b) does not specifically mention administration expenses, nevertheless administration expenses charged against the marital

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13. See *Hubert*, 117 S. Ct. at 1130-31 (plurality opinion), 1135-36 (concurring opinion), and 1140 (Scalia, J., dissenting). The parties stipulated that qualification was not at issue. In theory, a restriction on an income right could result in "partial" disqualification. An example would be where the surviving spouse has a right to a fraction of the income. See Regs. § 20.2056(b)-5(b) and (f)(1); Rev. Rul. 69-56, 1969-1 C.B. 224; Charles Davenport, *Hubert* Fog Thickens after Supreme Court Decision, 75 Tax Notes 434, 436 (Apr. 21, 1997). However, *Hubert* did not involve a restriction on an ongoing income right, and the problem could have been adequately dealt with under the value-passing rubric.

bequest also reduce the net amount passing to the surviving spouse.[14] However, if (unlike *Hubert*) the personal representative has discretion to allocate such expenses to the marital bequest,[15] it might be argued that section 2056(b)(4) does not literally apply, because there is no "encumbrance" or "obligation imposed by the decedent."[16] On the other hand, section 2056(b)(4) is only illustrative of facts that can reduce the value of the marital deduction under the "passing" or "valuation" rubric.[17] As paragraph (a) of

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14. There is no reference to the effect of the payment of administration expenses on the marital deduction in the legislative history, although there is reference to the payment of claims:

> 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. See S. Rep. No. 80-1013, pt. 2, at 6 (1948) (emphasis added).

I take this passage simply to reiterate the basic point, stated in IRC § 2056(a), that the deductible amount cannot exceed the amount includible with respect to the same property interest, and that estate income is not separately included in the gross estate. The date-of-death value of the residue encompasses future income—including income received during estate administration—because the value of any asset is the present discounted value of all future returns (of principal and income). The passage correctly concludes that treating an increase in the residue resulting from the use of estate income to pay claims would result in counting estate income twice in calculating the marital deduction: once when included in the date-of-death value of the residue and again when it subsequently increases the residue by reason of discharging claims. Counting the income twice would be incorrect in any event because the increase in the residue attributable to the payment of claims is exactly cancelled out by the diversion of income from the residue to a non-marital use. It does not follow that a "real" diversion of estate income to a non-marital use (i.e., a diversion that does not indirectly augment the marital share) would fail to reduce the marital deduction: a marital deduction for the date-of death principal assumes that both principal and income passes to the surviving spouse; insofar as this assumption is incorrect, the value passing to the surviving spouse is less than the date of death value.

15. In *Hubert* the administration expenses were to be charged (in part) to the marital share; the executor's discretion related only to whether the expenses should be charged to the principal or the income of such share. See *Hubert*, 117 S. Ct. at 1128.

16. See IRC § 2056(b)(4)(B).

17. As originally enacted, the predecessor of IRC § 2056(b)(4) was not located within the terminable interest rule of IRC § 2056(b). See IRC § 812(e) (1939), as amended by Revenue Act of 1948, § 361(a), 62 Stat. 110. The text of § 2056(b)(4) begins with, "In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—." The Senate Report to the predecessor of § 2056(b)(4) states that it is offered for purposes of clarification. See S. Rep. No. 80-1013, pt. 2, at 6 (1948). In short, nothing in the structure or history of IRC

Regulations section 20.2056(b)-4 indicates, the specific items enumerated in section 2056(b)(4) (encumbrances and obligations) are not exhaustive.[18] Therefore, the failure of section 2056(b)(4) to specifically mention administration expenses is not important.[19] And indeed there is universal agreement that estate administration expenses actually charged against the principal of a marital bequest reduces the marital deduction.[20]

The parties and judges in *Hubert* focused intently on the above-quoted regulation, since it specifically refers to administration expenses that are charged to income. However, the last sentence of the regulation is not directly "on point" because it refers to a situation in which the income "is to be used" to pay administration expenses,[21] whereas in *Hubert* the fiduciary had discretion to charge administration expenses against the principal or income of the marital bequest.

Finally, section 642(g) states that estate administration expenses claimed as estate tax deductions under section 2053 cannot also be deducted for estate income tax purposes. In *Hubert*, the expenses were deducted for estate income tax purposes,[22] not for estate tax purposes under section 2053. Normally, if administration expenses are deducted for estate tax purposes, the marital deduction under section 2056 is reduced pro tanto, since otherwise the same expenses would yield a double estate deduction for the same dollars.[23]

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§ 2056(b)(4) suggests that it is the exclusive locus of rules pertaining to the value of interests passing to the surviving spouse. Section 2056(b)(4) is merely illustrative of general "passing" principles.

18. See also S. Rep. No. 80-1013, pt. 2, at 6 (1948) (stating that the predecessor to IRC § 2056(b)(4)(B) is based on principles generally applicable in valuing the net bequest).

19. See Ballantine v. Tomlinson, 293 F.2d 311, 313 (5th Cir. 1961).

20. See *Hubert*, 117 S. Ct. at 1131; Rev. Rul. 55-225, 1955-1 C.B. 460 (administration expenses chargeable to marital deduction principal do not "pass" to surviving spouse). The taxpayer in *Hubert* made this concession on the basis of its "symmetry" theory: since estate income is not separately included in the gross estate, reductions in such income must be ignored for purposes of valuing the gross estate and the marital deduction. (For the illogic of this argument, see supra note 14.) Conversely, argued the taxpayer, since inclusion and deduction refers to the principal of assets, reductions in principal must reduce the deduction. The logic of the symmetry theory would seem to dictate that reductions in the principal of the marital deduction would also reduce the amount included in the gross estate, but this issue was not argued in *Hubert*, and if it had been argued the inclusion value would not have been reduced. See Section E infra.

21. See Regs. § 20.2056(b)-4 (last sentence).

22. See supra note 3.

23. Suppose W dies leaving $200,000 to B and the residue to H. Assume that W's gross estate is $1 million and that administration expenses (charged against the principal of the residue) are $50,000. W's taxable estate is $200,000 (i.e., the bequest to B is fully taxable). If W's estate were to obtain a deduction of $50,000 for administration expenses *and* a marital deduction of $800,000, there would be a double deduction to the extent of $50,000. The double-deduction problem is solved by the "value passing" rule: only $750,000 passes to H,

A way of stating the holding of *Hubert* is that deducting the expenses for income tax purposes does not per se require a dollar-for dollar reduction in the estate tax marital deduction if the expenses are charged against income for trust accounting purposes pursuant to an executor's discretion. Professor Charles Davenport has shown that not reducing the marital deduction in *Hubert* allows the expenses to reduce both estate taxable income and the taxable estate, contrary to the spirit, if not the letter, of section 642(g).[24]

> **Example**: H's gross estate is $50 million. H's will leaves $10 million to B and the residue to W. Estate administration expenses, payable out of the residue, are $1 million. Estate income is $3 million, all of which eventually passes to the residue. Administration expenses are charged against the income of the residue and are deducted for income tax purposes. Under *Hubert*, the marital deduction of $40 million is unreduced, and produces a taxable estate of $10 million (the bequest to B). Thus, there is a $1 million income tax deduction and a $40 million estate tax deduction, despite the fact that both deductions derive from the same $40 million fund. If the income tax deduction were taken but the expenses were charged against the principal of the residue, the marital deduction would concededly be reduced to $39 million. Similarly, if the expenses were claimed for estate tax purposes and charged to the principal of the residue, there would be no income tax deduction and total estate tax deductions of $40 million ($1 million under section 2053 and $39 million under section 2056).

The effect of the holding in *Hubert* is that administration expenses that reduce the marital bequest income can be deducted elsewhere while not reducing the marital deduction. This result is out of sync with the result for near-identical scenarios.

B. *The Opinions in the Supreme Court*

There were four opinions in the Supreme Court. The plurality opinion of Justice Kennedy (joined by Chief Justice Rehnquist and Justices Stevens and Ginsburg) took the position that the values of both the gross estate and the marital deduction were to be determined solely as of the date of death on the basis of present-value analysis.[25] If this premise were carried through to

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and so the marital deduction is limited to $750,000. In addition, IRC § 2056(b)(9) expressly precludes double estate tax deductions for the same interest in property.

24. See Charles Davenport, A *Street* Through *Hubert's* Fog, 73 Tax Notes 1107 (Dec. 2, 1996).

25. *Hubert*, 117 S. Ct. at 1128-29.

its logical conclusion, then it would not matter whether administration expenses were charged to income or to corpus. Present-value analysis makes no distinction between income and corpus. Nevertheless, the plurality opinion homed in on Regulations section 20.2056(b)-4(a), quoted above, and discovered the phrase "*material* limitations upon her right to income" (emphasis added) in the third sentence and "a case in which this rule *may be applied*" (emphasis added) in the fourth sentence.[26] It was noted that the government argued for a per se rule that income actually used to pay administration expenses must reduce the marital deduction dollar for dollar.[27] The plurality noted that the trustee had discretion as to how to pay the administration expenses and that the trust income was quite large. Therefore, it could not be concluded, *as of the decedent's death*, that the mere *possibility* of allocating some expenses to income would necessarily amount to a "material" limitation on the wife's right to income.[28]

By way of comment, since the possible exercise of discretion cannot be valued,[29] the result should hinge on which party has the burden of proving value (or the lack thereof). The plurality seems to ignore the maxim that a person claiming a tax benefit (such as a deduction) has the burden of proof on such factual issues as value. It would seem to be up to the estate to prove immateriality, but the estate would not be able to establish immateriality *ex ante* where the executor has discretion to allocate administration expenses to the income or principal of the marital bequest.[30]

In addition, the alternative in *Hubert* to allocating expenses to the income of the marital bequest was to allocate them to the principal of the marital bequest (as opposed to a non-marital transfer), and an allocation to principal would concededly have reduced the marital deduction.[31] Thus, any

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26. Id. at 1131.

27. Id. at 1128.

28. See *Hubert*, 117 S. Ct. at 1132. For a similar, if more detailed, interpretation of the plurality opinion, see Jonathan G. Blattmachr & Madelin Rivlin, Drafting for Estate Administration Expenses After *Hubert*, Trusts & Estates, August 1997, at 57, 58-59.

29. See Holbrook v. United States, 575 F.2d 1288 (9th Cir. 1978) (an interest subject to discretion has no value for purposes of the § 2013 credit).

30. Although "immateriality" is itself a "legal" standard, the only "fact" relating to that standard is that the trustee had *discretion* to charge estate administration expenses against income. Thus, the percentage of income actually used to pay administration expenses would not be a relevant fact under the plurality's view of the case. See infra note 32. There is no mention in the plurality or concurring opinions of the possibility that Georgia law might have restrained the exercise of the executor's discretion.

31. See *Hubert*, 117 S. Ct. at 1139, 1140 (Scalia, J., dissenting) (noting agreement of the plurality, concurrence, and both parties). See also Estate of Roney v. Commissioner, 33 T.C. 801, 804 (1960), aff'd, 294 F.2d 774 (5th Cir. 1961).

exercise of discretion to charge expense against either income or corpus would necessarily reduce the value of the marital bequest.[32]

The plurality opinion dealt with Professor Davenport's double-deduction argument based on section 642(g)[33] by stating that section 642(g) does not expressly prohibit taking an income tax deduction that merely fails to reduce the estate tax marital deduction.[34] However, the no-double-deduction rule of section 642(g) makes sense only on the understanding that claiming the deduction for income tax purposes increases the taxable estate *pro tanto* either by foregoing an estate tax deduction or by reducing the marital deduction.[35] In response, the plurality makes the undisputed point

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32. As Judge Halpern's dissenting opinion in the Tax Court points out, the case of Estate of Wycoff v. Commissioner, 506 F.2d 1144 (10th Cir. 1974), aff'g 59 T.C. 617 (1973), would seemingly have led the lower courts to the contrary result in *Hubert*. Estate of Hubert v. Commissioner, 101 T.C. 314, 334-45 (1993) (Halperin, J., dissenting). In *Wycoff*, the executor had discretion to allocate death taxes to the principal of either the marital trust or the non-marital trust. *Wycoff*, 506 F.2d at 1147. It was held that the marital deduction was reduced by the amount of taxes that *could have been* charged to the marital trust. Id. at 1149-50. In *Hubert*, the administration expenses could also have been charged against the principal of the marital trust. *Hubert*, 117 S. Ct. at 1128. Although death taxes are explicitly referred to in IRC § 2056(b)(4)(A), there is no meaningful distinction between taxes and administration expenses. See *Estate of Roney*, 33 T.C. at 804. It is true that in *Hubert* the administration expenses were actually charged to income, *Hubert*, 117 S. Ct. at 1128, but that also should not have mattered. Cf. Horne v. Commissioner, 91 T.C. 100 (1988) (expenses chargeable to corpus but actually paid out of income reduced charitable deduction); Alston v. United States, 349 F.2d 87 (5th Cir. 1965). Since valuation is to be made as of the decedent's death, the mere possibility of being charged against principal should be fatal, as was the case in *Wycoff*. Similarly, the fact that the actual allocation to income was valid under state law would also be irrelevant. Having missed the point of *Wycoff*, and treating the charge against income as being controlling, the Tax Court and Eleventh Circuit majority opinions in *Hubert* seem merely to distinguish the rule pertaining to charges against principal, and various cases applying that rule, without really explaining why charges against income would not also reduce the value of the marital bequest. That, of course, is the ultimate issue since, even if *Wycoff* was properly decided, it could be avoided by giving the executor discretion to allocate expenses either to the principal of the nonmarital bequest or to the income of the marital bequest. Curiously, the government failed to cite *Wycoff* in its Supreme Court brief.

33. See supra note 24 and accompanying text.

34. *Hubert*, 117 S. Ct. at 1133.

35. See *Hubert*, 117 S. Ct. at 1146 (Scalia, J., dissenting). In seeming accord is Patricia A. Metzer, The Deduction of an Estate's Administration Expenses: Section 642(g) of the Internal Revenue Code and Its Impact, 21 Tax L. Rev. 459, 467-69 (1966). Section 642(g) was added to the Code by the Revenue Act of 1942, which also added the predecessor of § 212. Prior to the 1942 Act, administration expenses were not deductible for income tax purposes. See United States v. Pyne, 313 U.S. 127 (1941). Congress could (and should) have repealed the estate tax deduction for administration expenses, but instead it simply aimed to prevent a deduction under each tax. The 1942 legislative history is not illuminating. See H.R. Rep. No. 77-2333, at 75-76 (1942); S. Rep. No. 77-1631, at 136 (1942). Insofar as the

that the marital deduction does not include the post-death income itself;[36] therefore, payment of expenses out of such income does not reduce the deduction.[37]

That argument proves too much. The logic of the argument would lead to the conclusion that, if estate income was used to pay administration expenses, the estate could claim an *estate tax* deduction under section 2053 without reducing the marital deduction.[38] It is true that section 2056(b)(9)—a provision ignored by everyone in the *Hubert* litigation—states that "Nothing in this section or any other provision of this chapter shall allow the value of any interest in property to be deducted under this chapter more than once with respect to the same decedent." But the logic of *Hubert* is that a section 2053 deduction derived from using estate income to pay administration expenses is not a deduction for the same "interest in property" (i.e., the principal) that generated the marital deduction. Alternatively, the mandate against double deductions for the same interest in property would not apply, because failing to reduce the marital deduction would not in itself constitute a "deduction." Such a construction of section 2056(b)(9)—which exactly echoes the plurality's construction of section 642(g)—is too absurd to require comment.

Justice O'Connor wrote a concurring opinion (joined by Justices Souter and Thomas) in which she declined to join the plurality opinion's present-value theory.[39] Presumably, it would follow that the critical fact would be the allocation to income that was actually made. Nevertheless, the concurring opinion proceeded to ridicule the Treasury, the IRS, and government counsel for its inconclusive and confusing regulations,[40]

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enactment of § 642(g) was based on revenue concerns, that rationale is undermined by the holding in *Hubert.*

36. See *Hubert,* 117 S. Ct. at 1133. See generally Maass v. Higgins, 312 U.S. 443, 446-47 (1941).

37. See *Hubert,* 117 S. Ct. at 1133-34 (O'Connor, J., concurring). The concurring opinion ignored the no-double-deduction argument, except to note that the *Hubert* problem was not solved by the language of the Code. Id. at 1135. The nonresponsiveness of the plurality and concurring opinions to the argument based on IRC § 642(g) might perhaps be attributed to the government allegedly raising the point for the first time in its oral argument before the Supreme Court, see id. at 1133 (plurality opinion), except that the double deduction argument was actually set out in the government's reply brief, dated Sept. 11, 1996, well before the oral argument or the appearance of Professor Davenport's article. Reply Brief for the Petitioner at 17-18, *Hubert,* 117 S. Ct. (No. 95-1402).

38. It is clear that the crucial fact in *Hubert* to both the plurality and concurring opinions was that the expenses were charged against estate income, not that they were deducted for income tax purposes. See infra note 52.

39. *Hubert,* 117 S. Ct. at 1136 (O'Connor, J., concurring).

40. See *Hubert,* 117 S. Ct. at 1139. The "material limitation" sentence of Regs. § 20.2056(b)-4(a) makes perfect sense without the sentence that follows (referring to estate

rulings,[41] and litigation posture.[42] The concurring opinion, like the plurality opinion, focussed on the "material limitation" phrase in the regulation. The opinion ultimately sided with the taxpayer because the government eschewed any attempt to define "material" or to apply that concept to the facts of the case, so that the Tax Court's factual determination of immateriality controlled.[43]

By way of comment, the concurring opinion misses the point. On the record, the fact that the trustee had apparently unlimited discretion to charge administration expenses against either the income or corpus of the marital bequest easily satisfied the "materiality" test on its face. Indeed, viewed correctly as of the date of death, such discretion was the *only* relevant "fact" bearing on the value-reduction issue; the actual amounts of income so used were, at least in theory, immaterial.[44] It is true that the government treated the actual charges against income as being relevant, but the government's approach actually can be seen as a concession: the government could have argued that, in general, the marital deduction is to be reduced by the maximum amount of expenses that *could be* charged against income. However, in *Hubert*, such an approach would have been redundant, because

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income). Thus, if the marital trust is locked into a low-yield asset, such could constitute a material limitation for valuation purposes. The sentence referring to estate income would have been clearer if it had said that the material limitation rule "is to be applied" (instead of "may be applied"), but "may be applied" is susceptible to a construction that is to be applied when the circumstances so warrant. See *Hubert*, 117 S. Ct. at 1143 (Scalia, J., dissenting). In the present context, "may be applied" is not equivalent to "might be applied," which expression necessarily reflects contingency or permissibility. The taxpayer has no option or election as to whether the rule will apply, and regulations, which set forth rules of law, do not need to refer to the obvious fact that the Service has enforcement discretion.

41. See *Hubert*, 117 S. Ct. at 1136 (O'Connor, J., concurring) ("no matter how poorly drafted or ill conceived [Rev. Rul. 69-56] might be . . ."). For example, Rev. Rul. 69-56, 1969-1 C.B. 224, confuses the effect of certain administrative powers on the qualification of an interest for the marital deduction and the valuation of that interest. Even worse, in Rev. Rul. 93-48, 1993-2 C.B. 270, 271, the Service conceded that the marital (or charitable) deduction was not reduced by interest on death taxes allocated to income. As the concurrence points out, *Hubert*, 117 S. Ct. at 1137-38, this Ruling is inconsistent with the government's position in *Hubert*. For a discussion of the background of the Ruling, see infra note 58 (noting that the government lost the interest expense issue in the courts because of its untenable distinction between administration expenses that supposedly "accrue" at death (executor's fees, etc.) and those that don't (interest)).

42. See *Hubert*, 117 S. Ct. at 1138-39. The government made no attempt to define "materiality" or even to obtain a remand to the Tax Court on materiality as a factual issue.

43. Id.

44. See supra note 32. The *possibility* of using marital assets to pay expenses would harmonize the "passing requirement" with the "terminable interest rule"—or could even be seen as triggering the terminable interest rule—which disallows the marital deduction to the extent that the marital bequest, as of the date of death, is subject to contingencies.

amounts not charged to income would have been charged to principal.[45] Since the Tax Court also missed the boat on the importance of discretion, the Tax Court's decision was not supported by the "evidence" and should have been reversed without remand. In other words, there was no genuine factual dispute, and there was no point in treating the case as if it hinged on "materiality," which in any event is a legal concept, not a factual (or quantitative) one.

Justice Scalia (joined by Justice Breyer) dissented. The Scalia opinion relied principally on the statutory mandate of section 2056(b)(4)(B), which calls for valuation of the marital deduction with reference to what actually passes to the surviving spouse, net of encumbrances and the like.[46] Justice Scalia went on to argue that the Regulation's use of the term "material" can mean "a limitation that is relevant or consequential *to the value* of what passes."[47] For example, not every charge against income would reduce the value of the property, because the charge could already be "built into" the valuation. Examples would include capital gains taxes and other transaction costs of disposing of assets in the future and expected repairs on tangible property. The Scalia opinion noted that reading "material" to mean "substantial," an indeterminate quantitative test, would produce a case-by-case quagmire.[48] Finally, if one relies on present value theory, as did the plurality, using income to pay expenses affects value just as much as using principal.[49]

Justice Breyer's separate dissent relied on the spirit of the "net value" concept under the "passing" requirement of the marital deduction.[50] The opinion also cited the purpose of section 642(g) to prevent double income and estate tax deductions.[51]

Due to the fractured majority, it is hard to say what—other than the result—*Hubert* stands for. The plurality opinion's marital deduction present-value theory was rejected by five Justices. As mentioned earlier, since the critical fact in *Hubert* was charging the expenses against income (as opposed to claiming them as income tax deductions), *Hubert* could be expansively read to sanction the taking of an *estate tax* deduction for administration expenses allocated to income and which would not, after *Hubert*, reduce the

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45. Since amounts charged to principal would reduce the marital deduction, reducing the marital deduction by the amounts actually charged against income would produce the correct overall result.

46. *Hubert*, 117 S. Ct. at 1139 (Scalia, J., dissenting).

47. Id. at 1142.

48. Id. at 1142, 1145.

49. Id. at 1144.

50. Id. at 1147 (Breyer, J., dissenting).

51. Id.

marital deduction.[52] Thus, there would appear to be the possibility of a double estate tax deduction for the same amount.[53] On the other hand, it appears that the government would have won the case if it had been willing to treat "materiality" as the crucial issue to be won on the facts. It also appears that the government would have won if the regulations and rulings were more explicit and less confused.[54] Perhaps the government would have won if it had argued the economics and the structure of the Code rather than conduct exegeses of its own unclear regulations. But my purpose here is only partly to critique the *Hubert* opinions. I turn next to a "big picture" view of the estate and income tax treatment of estate administration expenses.

C. *Should Estate Administration Expenses Be Deductible for Estate Tax Purposes?*

Estate administration expenses can currently be deducted for income tax purposes or estate tax purposes, but not both.[55] This approach is incorrect. In a conceptually pure estate tax, administration expenses would not be deductible; deduction should be had, if at all, under the income tax.

An estate tax deduction should be allowed for debts and claims arising before death. The net estate is assets less liabilities at the time of death. Estate administration expenses arise after death, and should be ignored for purposes of computing the net estate.[56] This point is magnified in the

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52. The plurality opinion does not even mention that the expenses were deducted for income tax purposes. The concurring opinion labors under the misapprehension that the decision to take the deduction for income or estate tax purposes hinges on the trust accounting allocation of expenses. See *Hubert*, 117 S. Ct. at 1134. In fact, the choice of which tax to take the deduction against has nothing to do with the trust accounting allocation. See Regs. § 1.642(g)-1, -2. Thus, the concurring opinion does not appear to be aware of the possibility that, as a result of the outcome in *Hubert*, expenses can be allocated to income and yet be deducted for estate tax purposes. Professor Davenport's article did not raise the possibility of double estate tax benefits—probably because no one would have thought such a result to be possible—and the government's oral argument based on Professor Davenport's article did not raise this possibility either. See Davenport, supra note 24; Oral Argument Transcript, *Hubert*, 117 S. Ct. (No. 95-1402).

53. See Steve R. Akers, Planning for Post-Death Expenses in Light of *Hubert*, 75 Taxes 263, 264 (1997). That such a construction should be resisted is argued in the text. See supra text accompanying notes 23-24.

54. See *Hubert*, 117 S. Ct. at 1139 (O'Connor, J., concurring); see also supra notes 40-41 and accompanying text.

55. See IRC § 642(g).

56. A leading treatise argues that estate administration expenses should be deductible for both estate and income tax purposes. The argument for estate tax deductibility is simply that such expenses reduce the amount receivable by legatees. See M. Carr Ferguson, James J. Freeland & Mark L. Ascher, Federal Income Taxation of Estates, Trusts, and

case where estate administration expenses are charged against income: such expenses simply don't reduce the net estate but only reduce post-death accretion.[57]

The argument for estate tax deduction, cited by Professor Davenport, is that estate administration expenses entail a charge against the estate that attaches (if not "accrues" in the income tax sense) by reason of death.[58] It is true that a large estate is likely to incur estate administration expenses, but no liability is incurred until the estate representative is authorized to pay them. The expenses arise because services are performed for the estate after the decedent's death. The largest category of such expenses, commissions, can be waived. The amount of expenses can vary widely because of such factors as will contests and unique assets.

Getting rid of the estate tax deduction for estate administration expenses would offer the beneficial side effect of rendering irrelevant the

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Beneficiaries § 4.2.6, at 4:24 (2d ed. (1997)). It is true that there is no general principle against deducting the same thing for each tax, since the income and estate taxes are separate taxes. See Kleberg v. Com'r, 31 B.T.A. 95, 100 (1934). Indeed, deductions in respect of a decedent are allowed under both taxes. See IRC §§ 642(g) (last sentence), 691(b). (Deductions in respect of a decedent are certain deductions incurred by the decedent before death but not paid until after death; hence; they are a form of claim against the decedent as opposed to being an administration expense.) But the estate tax is a tax on what the decedent had at death, not on what the legatees might receive. See Knowlton v. Moore, 178 U.S. 41, 48-49 (1900) (historical antecedent of estate tax was the probate duty). The false logic of deducting administration expenses for estate tax purposes would dictate a deduction for losses incurred (whether realized or unrealized) during the period of estate administration. As a historical matter, deduction for estate administration expenses was not allowed for income tax purposes until the Revenue Act of 1942 enacted the predecessor of IRC § 212(1) and (2). See supra note 35. Prior to 1942, an estate tax deduction might have been thought to have been better than nothing.

57. There is nothing in the regulations under IRC § 2053(a)(2) that prevents the taking of an estate tax deduction where administration expenses are charged against income.

58. The Supreme Court accepted certiorari in *Hubert* due to a conflict between the decision of the Eleventh Circuit in that case and the Sixth Circuit's decision in Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992). *Hubert*, 117 S. Ct. at 1128. The latter case, in holding for the government on the *Hubert* issue, appeared to rely on the notion that estate administration expenses accrue at death. *Street*, 974 F.2d at 727-28. As argued below, whether or not an item accrues at death is irrelevant. What is crucial is that funds are diverted from the surviving spouse to other purposes in the course of estate administration prior to the actual funding of the bequest. *Street* also held that interest on estate taxes paid out of a marital bequest did not reduce the marital deduction, on the theory that such interest accrues after death. Id. at 729. This holding was accepted by the Service in Rev. Rul. 93-48, 1993-2 C.B. 270. It is my view that neither administration expenses nor interest accrues at the decedent's death, but that both, if paid out of marital bequest income, should reduce the marital deduction. Hence, I disagree with *Street* on the interest issue, as well as with Estate of Richardson v. Commissioner, 89 T.C. 1193 (1987), and I disagree with Prof. Davenport's contention that interest on deferred death taxes is distinguishable in any relevant sense from executor's fees. See Davenport, supra note 24, at 1111.

confusing doctrine surrounding which of such expenses are nondeductible because they benefit individual legatees rather than the estate.[59]

As an aside, the statutory alternate valuation date rule[60] is also not justified. As with estate administration expenses, post-death asset depreciation should be reckoned under the income tax, not the estate tax.

Of course, Congress is not required to operate under a pure model. Repeal of so much of section 2053 as pertains to administration expenses and the alternate valuation date election would not be high on anyone's tax reform priority list.

D. *Should Anticipated Administration Expenses Reduce the Value of the Gross Estate?*

It is an accepted principle of valuation that a reduction in the value of property by reason of death is to be taken into account, at least if the reduction in value (a) pertains to the asset itself, (b) is bona fide, and (3) is not a device to achieve a tax-free gratuitous transfer.[61] The theory behind the principle is that estate tax valuation looks to the future.[62] Valuation in general is based on reducing future returns to present value. It might be argued that estate administration expenses produce a real decline in value of the gross estate on account of death. However, current valuation doctrine would not allow estate administration expenses to be taken into account for gross estate valuation purposes.

First, valuation pertains to *particular* assets, not the gross estate as an entity. Although some administration expenses might pertain to particular assets, most of them (taking inventory, paying creditors, preparing tax returns,

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59. See Regs. § 20.2053-3(d)(2); Estate of Smith v. Commissioner, 510 F.2d 479 (2d Cir. 1975); Estate of Park v. Commissioner, 475 F.2d 673 (6th Cir. 1973); Estate of Jenner v. Commissioner, 577 F.2d 1100 (7th Cir. 1978).

60. IRC § 2032.

61. IRC §§ 2703 and 2704 make sense only because of the background rule that value is generally affected by restrictions, etc., that arise by reason of death.

62. See United States v. Land, 303 F.2d 170 (5th Cir. 1962); Goodman v. Granger, 243 F.2d 264, 269 (3d Cir. 1957) (restriction lapsing at death is ignored; value is that which survives death). This principle is usually cited in connection with the valuation of *assets* for estate inclusion purposes. The plurality opinion in *Hubert*, 117 S.Ct. at 1129-30, cites Ithaca Trust Co. v. United States, 279 U.S. 151 (1929), for this proposition as it pertains to deductible interests (as opposed to assets). *Ithaca Trust* held that actuarial tables were to be used in valuing a charitable remainder interest for purposes of the then charitable deduction, despite knowledge of the noncharitable lead beneficiary's actual (short) life span. 279 U.S. at 292. A commitment to use actuarial tables, which is codified in IRC § 7520, is not controlling with respect to matters of discretion, such as whether to charge estate administration expenses against income or principal. The possible exercise of discretion is incapable of actuarial valuation. See supra note 29.

and defending will contests) relate to the estate as a whole. Administration expenses are not the equivalent of liens or restrictions on particular assets.

Second, the core valuation rule, which is the hypothetical willing-buyer willing-seller test, looks to the value of the asset, not the net amount to be received by the estate or legatees. Thus, future sales commissions that would be owed under an agency contract, even if entered into before death, are ignored for valuation purposes.[63] Such items represent post-death economic loss apart from any valuation discount. Administration expenses are indistinguishable in this respect from sales commissions.

Third, the willing-buyer willing-seller test disregards the identity, characteristics, or predictable actions of the legatees, the mechanics of estate transfers, or even the fact that an estate transfer is involved.[64] Thus, the value of property subject to a specific legacy would not be reduced because the legatee is committed to a certain use of the property.[65] In contrast, facts that are specific to certain assets or types of assets are properly taken into account.[66] Thus, a rental property that is located in a high-property tax area

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63. See Estate of Smith v. Commissionerr, 57 T.C. 650, 659 (1972), acq., 1974-2 C.B. 4, aff'd on other issue, 510 F.2d 479 (2d Cir. 1975); Rev. Rul. 83-30, 1983-1 C.B. 224.

64. See John A. Bogdanski, Federal Tax Valuation 4-72 to 4-74 (1996); Ahmanson Found. v. United States, 674 F.2d 761, 768-69 (9th Cir. 1981) (no discount where control block was carved up into minority interests by act of making bequests to separate legatees); Estate of Curry v. United States, 706 F.2d 1424, 1427-29 (7th Cir. 1983) (same); Propstra v. United States, 680 F.2d 1248, 1251 (9th Cir. 1982) (family relationships ignored). The so-called blockage discount allowed by Regs. § 20.2031-2(f) is ambivalent: it would appear to apply regardless of whether a sale is to be made by an estate or another party, but the rule may be colored by an anticipation that the estate will in fact unload the property on the market all at once (and to that extent the rule is, in my view, incorrect). See *Estate of Smith*, 57 T.C. at 657-58 (blockage discount awarded on assumption that *ouvre* of deceased sculptor would be offered on the market at the same time). But see Estate of Prell v. Commissioner, 48 T.C. 67 (1967) (blockage discount denied where the asset could have been liquidated in an orderly fashion). The rule that the value of an enterprise is to be reduced on account of the death of the "key man" is conceptually proper, since the reduction in value is attributable to the loss of human capital, and the human capital of the deceased person was never an asset of the type subject to estate tax.

65. Section 2032A, which values certain real estate at its actual use committed to by family-member legatees, would be superfluous if normal valuation rules took into account legatee facts.

66. See United States v. Cartwright, 411 U.S. 546 (1973) (value of mutual funds is redemption price, not issue price); Worthen v. United States, 192 F. Supp. 727, 730 (D. Mass. 1961) (lack-of-marketability discount for closely-held stock); Rev. Rul. 59-60, 1959-1 C.B. 237, amplified by Rev. Rul. 77-287, 1977-2 C.B. 319 (treating valuation of restricted stock, including stock subject to S.E.C. restrictions on marketability). In *Ahmanson Foundation*, 674 F.2d at 768, the court stated that the value of an asset could be affected by directions in the will such as a recapitalization or a direction to destroy. This statement appears to be dictum. The only case cited in *Ahmanson Foundation* is Provident National Bank v. United States, 581 F.2d 1081 (3d Cir. 1978), which involved a post-death recapitalization,

should be discounted with reference to expected diminished future net rentals.[67] The existence and amount of administration expenses is essentially a fact relating to the legatees and the mechanics or fact of estate transfer, and therefore should be ignored for valuation purposes.

In sum, administration expenses would not be taken into account for purposes of valuing assets included in the decedent's gross estate, even if there were no estate tax deduction for such expenses.[68] If they were taken into account, it would be necessary to discount them to present value as of the decedent's death.[69]

E. *Is the Valuation of Marital Deduction Bequests "Symmetrical" with Valuation for Estate-Inclusion Purposes?*

The plurality opinion in *Hubert* seemed to operate under the assumption that valuation for both inclusion and deduction purposes must be

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actually dealt with the issue of valuation for purposes of the marital deduction, and the taxpayer argued that the recapitalization *increased* the value of the marital bequest. A recapitalization is distinguishable from a direction to destroy property because a recapitalization merely rearranges interests already dissolved in corporate solution into a new configuration. Moreover, the Third Circuit appeared to assume (erroneously) that the value for the marital deduction had to be equal to the value of the amount included. Finally, *Provident National Bank* is inconsistent with the later case of Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987), which held that a marital bequest of a controlling interest would increase the value of the marital bequest relative to the nonmarital minority-interest bequest. The important holding in *Ahmanson Foundation* is that gross estate valuation is not affected by the identity of the legatees. It is possible to distinguish the effect of the identity of the legatee from the effect of directions in the will, but I find the distinction wholly unconvincing, since the correct inquiry pertains to the asset as owned by the decedent at death, not the asset as it is processed through the decedent's estate. Cf. Rev. Rul. 81-286, 1981-2 C.B. 177 (claim owned by a decedent does not disappear from the gross estate where the will directs that the claim be cancelled by the executor). See generally, Ray D. Madoff, Taxing Personhood: Estate Taxes and the Compelled Commodification of Identity, 17 Va. Tax Rev. ___ (forthcoming May 1998). In any event, *Hubert* did not involve a change in an asset mandated by a will provision.

67. It is critical to this example that the property cannot be moved. In contrast, a car garaged in a high crime area would not be discounted because of the possibility of theft or vandalism.

68. Of course, it would be improper both to allow estate administration expenses as an estate tax deduction and to allow the same expenses to reduce asset values. For a case in which the estate succeeded in obtaining a double tax benefit with respect to the underwriters' commissions pertaining to specific securities, see Estate of Joslyn v. Commissioner, 566 F.2d 677 (9th Cir. 1977), rev'g 63 T.C. 478 (1975), but in that case the IRS improperly allowed the valuation discount and then tried unsuccessfully to bar the deduction of estate administration expenses.

69. It might be argued that the payment of debts and claims are not discounted back to death, but these items have accrued as of the decedent's death, and are likely to be paid off in a short period of time. Moreover, if the creditor charges market interest, the present value of the claims equals the face amount thereof.

as of the decedent's death, determined by present value terms, and, therefore, identical.[70] As a matter of both the statute and doctrine, this assumption is partly correct and partly incorrect. It is correct insofar as valuation is to be determined as of the date of death; also, the amount deductible cannot exceed the corresponding amount includible. It is incorrect insofar as to what post-death facts are to be taken into account in determining such value. As noted above, in valuing assets for purposes of inclusion in the gross estate, legatee-specific and estate-specific facts are ignored. In contrast, the value of the marital deduction depends on what the surviving spouse is, viewed at the date of death, actually to obtain.[71] A leading "pure" valuation case (i.e., one not involving section 2056(b)(4)) concerning deductible bequests of closely-held stock imposed a minority interest discount upon the deductible bequest although no such discount was available for estate-inclusion purposes.[72] Similarly, the leading case under section 2056(b)(4), *United States v. Stapf*,[73] reduced the value of the marital deduction, but not the value of included assets, on account of an obligation imposed by the decedent's will upon the surviving spouse to transfer the latter's property to a third party as a condition for receiving the bequest.

The fact that valuation for inclusion and deduction purposes may be asymmetrical is not inconsistent with the proposition that valuation for both purposes should be "as of" the decedent's death. Thus, if the facts that reduce the bequest are triggered by a post-death event, the reduction in the deduction should, in theory, be figured on the basis of present value.[74] This point perhaps explains why section 2056(b)(4) states that encumbrances, etc., be "taken into account" in valuing the deduction (as opposed to mandating a dollar-for-dollar reduction). However, if the encumbrance, etc., and the amount thereof can be determined as of the date of death, and the only

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70. The taxpayer's brief in *Hubert* principally relies on this argument. Brief for Respondent at 16, *Hubert*, 117 S. Ct. (No. 95-1402). At least one commentator also makes this assumption. Farhad Aghami, Payments Out of Post Mortem Income: Impact on Estate Tax Marital and Charitable Deductions, 49 Tax Law. 707, 737-40 (1996).

71. See Provident Nat'l Bank v. United States, 581 F.2d 1081, 1086-87 (3rd Cir. 1978).

72. Ahmanson Found. v. United States, 674 F.2d 761, 771-72 (9th Cir. 1981) (charitable bequest). Accord, Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

73. 375 U.S. 118 (1963).

74. The *amicus* brief of the Tax Section of the Florida State Bar erroneously argued that the government's position in *Hubert* would demand reduction of the marital deduction by post-death depreciation or reductions in net income. Brief for Amicus Curiae the Tax Section of The Florida Bar in Support of Respondent at 8 n.9, *Hubert*, 117 S. Ct. (No. 95-1402). The possibility of post-death depreciation or reductions in net income is already factored into the asset values. In contrast, post-death charges of administration expenses to income are not taken into account in asset values. See supra pp. 629-31.

uncertainty is the time of discharge, transfer, or payment with respect to the encumbrance, etc., it would not be unreasonable to require a dollar-for-dollar reduction in the deduction. Administration expenses are a close call; those that are determinable as a percentage of the estate principal might be deemed to reduce the deduction dollar for dollar; those that are not determinable as a precentage of the estate principal should be reduced to the present value as of the date of death.

In any event, the present-value norm dictates that the reduction in the deduction should occur regardless of whether the charge is mandatory or discretionary or whether it is made against the corpus or income of the marital bequest. In *Hubert* the parties agreed, and the Court (without elaboration) endorsed the view that the marital deduction would indeed be reduced if the estate administration expenses were in fact (pursuant to the exercise of the executor's discretion) charged to principal, regardless of whether deducted for estate tax purposes or income tax purposes.[75] This "rule" is compatible with only one principle, namely, that the marital deduction is to be reduced when the legatee of the qualifying bequest in fact obtains less than the gross bequest due to payments or distributions incurred in the estate transmission process.[76] This concession should have been fatal to the taxpayer in *Hubert.*

Another version of the symmetry argument is as follows: (1) the amount included in the gross estate is the "principal" of assets, i.e., excluding post-death income; the deduction is for the same principal included in marital bequests; therefore, charges against *income* per se cannot reduce the deduction.[77] Basically, the argument is a non sequitur: the date-of-death principal for inclusion purposes is the present value of all future returns, both "principal" and "income";[78] the marital deduction assumes that the surviving spouse will be the transfer tax owner of both principal and income;[79] therefore, the possibility of diverting principal or income to a non-marital use should reduce the marital deduction. Valuation for inclusion purposes refers to specific assets. In valuing assets, the future income stream is considered, since the value of any asset is determined by reducing future returns (of

75. See supra notes 20 and 31.

76. Asset depreciation to the date of funding the marital bequest due to market forces would not result in reduction of the marital deduction because the value of the deductible assets is determined as of the decedent's death.

77. See Brief for Respondent at 13-14, 20, *Hubert*, 117 S. Ct. (No. 95-1402); Brief Amici Curiae of the American Council on Education and United Way of America in support of Respondnet at 4-6, *Hubert*, 117 S. Ct. (No. 95-1402).

78. Therefore, including actual post-death income in the gross estate would amount to including the same income twice.

79. See infra note 90.

principal and income) to present value. However, in valuing assets for inclusion purposes, charges against income or principal that are specific to the estate transmission process are, as described in the preceding section, ignored. For purposes of valuing the marital deduction, what is valued is the "interest" that "passes" to the surviving spouse, not specific assets. The "value passing" requirement mandates consideration of predictable charges against that interest. Charges against either the income and principal of the marital deduction bequest reduce the value of the interest passing to the surviving spouse.

A principal purpose of the section 2056(b)(4) value-reduction rule is to deny qualification for amounts which will escape the surviving spouse's gross estate.[80] Stated differently, failing to reduce the marital deduction would violate the core purpose of the marital deduction that deductible amounts appear in the surviving spouse's gross estate (unless consumed by the surviving spouse).[81] For example, assume H, the decedent, has a gross estate of $2 million, and $200,000 of administration expenses are incurred, to be charged against the residue. H leaves a specific bequest of $1 million to C and the residue to W. If the marital deduction is *not* reduced, H's taxable estate is reduced by $1 million but only $800,000 is includible in W's gross estate.[82]

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80. See S. Rep. No. 80-1013, pt. 1, at 28 (1948) (referring to "estate splitting," which means shifting tax base from decedent or donor spouse to surviving or donee spouse); Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 387 U.S. 213, 221 (1967). In Estate of Alexander v. Commissioner, 82 T.C. 34 (1984), aff'd 760 F.2d 264 (4th Cir. 1985) (unpublished table decision), the decedent created a trust in which the widow had the right to all of the income plus a general power of appointment over a specific dollar amount. The deduction was allowed in the amount of the specified dollar amount. The government argued that this arrangement violated the "specific portion" requirement of § 2056(b)(5). The effect of this decision was to exclude corpus appreciation from the widow's gross estate. Arguably, the government should have only tried to reduce the value of the marital deduction, but valuation under the estate and gift tax assumes that all economic return takes the form of "income" (rather than appreciation). Stated differently, the reduced value of the corpus component would have been made up for by the income component. *Estate of Alexander* is also distinguishable in that there were no charges against income or corpus, and the potential appreciation was not limited to the period of estate administration. Reaffirming the basic norm that the marital deduction should result in deductible interests being fully included (net of consumption) in the surviving spouse's transfer tax base, Congress in 1992 overturned *Northeastern Pennsylvania National Bank* and *Estate of Alexander* by enacting IRC § 2056(b)(10).

81. Id.

82. This argument is distinguishable from the argument based upon a purpose of the passing requirement to prevent a marital deduction for amounts that pass to a third party. Thus, the government's position is not weakened by a showing that no third party benefits from charging administration expenses to marital-bequest income. A third party would benefit where there is a nonmarital bequest that could have borne the burden of administration expenses, but not if the entire net estate is the subject of marital-deduction transfers.

It might be argued that economic waste is a legitimate form of estate tax avoidance. That argument raises the issue of whether a charge of estate administration expenses against a marital bequest is the equivalent of economic waste by the surviving spouse. Administration expenses are "caused" by the fact that the decedent has left an estate subject to administration, not by the independent consumption decisions of the surviving spouse. This point, incidentally, is not the equivalent of arguing that estate administration expenses "accrue" at death, an argument that has caused the government grief in both *Hubert*[83] and elsewhere.[84] It is sufficient to distinguish transmission-at-death-related expenditures from consumption by the surviving spouse. Although, in a vacuum, it would not be irrational to treat the two categories of waste the same, the distinction is clearly made by the structure of the marital deduction within the estate tax, as embodied in: (1) estate inclusion valuation principles, (2) the passing requirement,[85] (3) section 2056(b)(4), (4) the acknowledged rule reducing the marital deduction by estate charges against corpus,[86] (5) the terminable interest rule (and its exceptions),[87] and (6) the bar against deducting administration expenses for both income tax and estate tax purposes.[88]

A more subtle argument directed to the *Hubert* situation would be that, if expenses are charged against the *income* of the marital bequest, the amount included in the surviving spouse's gross estate (the corpus) under section 2041 or 2044—which apply by reason of the form of the marital trust—will not be reduced.[89] Thus, in the hypothetical set forth in the

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83. The government's brief in *Hubert* unfortunately relied heavily on this argument. Brief for the Petitioner at 14, 16, 24, 26-27, *Hubert*, 117 S. Ct. (No. 95-1402).

84. See *Hubert*, 117 S. Ct. at 1134-35 (O'Connor, J., concurring). This theory was adopted by the Sixth Circuit with the consequence that the government lost on the issue of the effect of interest on death taxes. Estate of Street v. Commissioner, 974 F.2d 723, 729 (6th Cir. 1992); see also supra note 58.

85. See IRC § 2056(a).

86. See supra notes 20 and 31.

87. See IRC § 2056(b)(1), (3), (5)-(8). The marital deduction qualification rules are designed to assure that deductible transfers will, because of their form, appear in the surviving spouse's tax base, see supra note 81, but there is no principle that the deductible amount appear dollar-for-dollar in the surviving spouse's tax base. The amount actually to be included in the surviving spouse's tax base is a function of actual (as opposed to estimated) economic return and consumption by the surviving spouse. See supra note 10.

88. See IRC § 642(g).

89. This appears to underlie the argument made by the American College of Trust and Estate Counsel in its *amicus* brief. See Motion for Leave to File Amicus Curia Brief of the American College of Trust and Estate Counsel Urging Affirmation and Brief of the Amicus Curiae in Support of Respondent at 4, *Hubert*, 117 S. Ct. (No. 95-1402) ("If, however, there is sufficient estate income to pay those expenses and the corpus is kept intact, then the surviving spouse or charity will eventually receive not only the full bequest, but also will have

preceding paragraph, if the income on the residue during administration is greater than $200,000, and administration expenses are charged against income, the corpus included in W's gross estate will be $1 million. The trust income—which will augment the surviving spouse's potential section 2033 gross estate as and when distributed to her—will be reduced. The marital deduction is allowed "on condition" that the surviving spouse be deemed the transfer tax owner of *both corpus and income*.[90] Not to reduce the deduction when expenses are charged against income would allow the surviving spouse in such case a free deduction against her own estate (actually, a reduction in her section 2033 gross estate) not available to surviving spouses who are beneficiaries of marital trusts in which corpus was so charged; at that point, equal consumption by the income-reduced spouse as by her corpus-reduced counterparts would leave the income-reduced spouse ahead of the transfer tax game.

To restate the foregoing more succinctly, the deductible value as of the decedent's death is the *present value* of that same amount as of the surviving spouse's death as augmented by income accrued to the surviving spouse's death, all of which (as it actually exists at the surviving spouse's death) is to be includible (net of consumption) in the surviving spouse's gross estate. Estate income used for administration expenses reduces the amount includible in the surviving spouse's gross estate and should (perhaps as reduced to present value) also reduce the amount deductible.[91]

Thus, the rule of section 2056(b)(4) is conceptually sound, and the principle that it embodies should, contrary to *Hubert*, be applied regardless of whether administration expenses are charged against the income or corpus of marital bequests. The principle, however, is the "passing" requirement itself. It is not necessary to attempt—as the government did in *Hubert*—to fit estate administration expenses into the "encumbrance or obligation" language of section 2056(b)(4)(B).[92]

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a larger investment base that can generate more gross income, using the assumptions stated in the Appendix.").

90. The marital deduction is allowed for outright bequests, IRC § 2056(a), single-life annuities, IRC § 2039, marital remainder trusts, Regs. § 20.2056(b)-4(d), power-of-appointment trusts, IRC § 2056(b)(5), QTIP trusts, IRC § 2056(b)(7), and estate trusts, Regs. § 20.2056(c)-2(b)(1)(iii). A "marital remainder trust" is a trust providing income to a nonspouse beneficiary for life or for a term of years and vested remainder in fee simple to the surviving spouse or the surviving spouse's estate. An "estate trust" is a trust in which income can be accumulated, but no income can be paid to a third party, and both the corpus and accumulated income must be paid to the surviving spouse's estate. In all of these forms, the income with respect to the deductible interest is actually owned, or is deemed for transfer tax purposes to be owned, by the surviving spouse.

91. See Davenport, supra note 24, at 1110.

92. See supra notes 17-18 and accompanying text.

At this point, estate administration expenses charged against the marital bequest would reduce the marital deduction without (under the ideal regime) being deductible independently under section 2053. In effect, an amount equal to estate administration expenses would be treated as a taxable bequest, even though it is never acquired by a legatee. Although this result seems counter-intuitive, it would be consistent with the fact that death taxes are also included in the tax base despite the fact that they reduce bequests. Taxing the economic waste attendant upon the transmission of property at death fulfills the logic of an estate tax, as opposed to alternative tax modes, such as an inheritance tax, an accessions tax, or including gratuitous receipts in income. Of course, in the vast majority of estates, the taxable "bequest" of estate administration expenses would not generate estate tax, due (mainly) to the unified transfer tax credit. And, of course, under current law the estate can obtain an estate tax deduction for such expenses. Also, the estate tax is not the only tax in the picture. There is the income tax.

F. *Income Tax Treatment of Estate Administration Expenses*

Estate administration expenses should be taken into account under the income tax, since such expenses represent fees for services performed over time after the death of the decedent.

Under current law, estate administration expenses are deductible for purposes of computing the taxable income of the estate as a separate taxpayer under the income tax. This result flows from the Supreme Court decision in *Trust of Bingham v. Commissioner*,[93] which imposed an expansive construction upon the language of section 212(2) ("management . . . of property held for the production of income"). The expenses in *Trust of Bingham* related to litigation and the distribution of assets in termination of a trust, but these functions were held to be connected with the management of income-producing property. The result has been incorporated into the regulations, where it is extended to estate administration expenses,[94] despite the fact that the estate's personal representative generally has no duty to invest.

Estates should be thankful for this result because estate administration expenses are, from the vantage of the legatees, capital expenditures in whole or in part.[95] The possibility of capitalization was not raised in *Trust of Bingham*—perhaps because trusts are distinguishable from estates—but presumably capitalization is a moot issue even for estates given the regulations under section 212. Nevertheless, if the capitalization issue were

93. 325 U.S. 365, 373-74 (1945).

94. See Regs. § 1.212-1(i).

95. See Estate of Davis v. Commissioner, 79 T.C. 503 (1982) (concerning outlays to establish heirship in order to obtain an inheritance from the estate of Howard Hughes).

to to be squarely faced as a matter of first impression, it would be hard to ignore the fact that estate administration expenses are incurred on behalf of legatees principally so that the latter may acquire possession and marketable title to estate assets and cash.[96] The "caretaking" aspect of estate administration is derivative of the fact that it takes time to collect assets and pay creditors (including tax collectors). Acquisition costs are capital expenditures.[97] Ergo, estate administration expenses are capital expenditures.

And how would such costs be actually treated? The conventional treatment of acquisition costs would be to add them to the cost basis. However, the basis in this case is not cost but, thanks to section 1014, fair market value at the date of death. In an analogous situation involving a part-gift part-sale transaction, the regulations under section 1015 provide in part that the taxpayer obtains the greater of (a) the "free" (here, the transferor's) basis or (b) the cost basis.[98] Since in the death-transfer situation, the free (section 1014) basis would normally exceed the cost basis (estate administration expenses), the latter would usually vanish without a trace. In other words, capitalization of estate administration expenses would (usually) produce no income tax benefits whatsoever.

This result is correct. Estate administration expenses relate to the acquisition of cash and property. Those that relate to cash are simply a non-deductible offset to cash that is tax free under section 102. Outlays relating to tax-exempt income are not deductible.[99] Therefore, no tax benefit would adhere to administration expenses allocable to cash. The same analysis applies to estate property because the section 1014 basis is the medium in which the section 102 exclusion is carried.[100] To add acquisition costs to the section 1014 basis of property would produce the equivalent of allowing a deduction for obtaining tax-free income.

The foregoing does not preclude the possibility that *some* estate administration expenses might be viewed as being properly deductible, sooner or later. Thus, expenses allocable to the management and conservation of income-producing property, or for the production or collection of (includible) income, might be allowed. Also, since income in respect of a decedent (IRD)

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96. See generally Jesse Dukeminier & Stanley M. Johanson, Wills, Trusts, and Estates 38, 48 (5th ed. 1995).

97. See Woodward v. Commissioner, 397 U.S. 572 (1970).

98. See Regs. § 1.1015-4(a)(1).

99. See IRC § 265(a)(1); Regs. § 1.212-1(a)(1).

100. The § 1014 basis preserves the integrity of the § 102 exclusion. If the property had a zero basis, the exclusion would disappear when the property is sold or realized. The estate situation is distinguishable from that of acquisition costs in obtaining § 103 bonds, which costs should be capitalized. In the § 103 bond situation, a true cost basis exists for the assets; it is the interest income from the asset (not the gain) that is tax free. Any costs relating to the tax-free interest should produce no tax benefits.

does not take a section 1014 basis, estate costs of acquiring and securing such property might, to the extent such costs exceed the carryover basis (which is often zero), be allowable. However, if the "origin test" were applied in the estate situation,[101] it would follow that *all* estate administration expenses are capital expenditures on the theory that they have their origin, or *raison d'etre*, in the fact of acquiring property and cash from a decedent.[102]

In any event, the threat of full capitalization, or at least the problem of allocating estate administration expenses among the categories of section 1014 asset acquisition costs, IRD acquisition costs, costs allocable to includible income, and costs allocable to excludable income, is finessed by the expedient of constituting the estate as a separate taxpayer apart from the legatees. Thus, everything the estate does is viewed as "management and conservation," and none of it as "acquisition" because it is the legatees who are actually doing the acquiring. The analogy is to a business which obtains property for others, such as a broker: the costs of operating the brokerage business are deductible expenses to the broker. The fees paid by the clients individually are capital expenditures to them. That is true of legatees who personally incur expenses to acquire their legacies or inheritances, but this rarely happens because that is precisely the job of the estate. The acquisition expenses incurred by the estate are not attributed to the legatees.

There is nothing inevitable about treating estates as separate taxpayers. Estates could be ignored, and the legatees treated as direct owners of their bequests. A variation of this approach would be to treat the estate as a pass-through vehicle so that accounting would occur at the estate level but items of income, expense, and capital expenditure would be allocated among the legatees according to their interests in the estate.[103] This approach is probably better than the current approach on both conceptual and simplicity grounds.

G. *Is an Estate Tax Deduction for Estate Administration Expenses a Practical Necessity?*

To sum up the foregoing, estate administration expenses should be reckoned under the income tax, not the estate tax. Despite this conclusion, it might be thought that allowing the estate tax deduction (as an option) is a

101. The origin test has been held to apply in the context of acquisition costs. See *Woodward*, 397 U.S. at 572.

102. Indeed, the origin test was applied in *Davis*, 79 T.C. at 503 (1982).

103. See Sherwin Kamin, A Proposal for the Income Taxation of Trusts and Estates, Their Grantors, and Their Beneficiaries, 13 Am. J. Tax Pol'y 215, 254-63 (1996); Joseph M. Dodge, Simplifying Models for the Income Taxation of Trusts and Estates, 14 Am. J. Tax Pol'y 125 (forthcoming 1997).

practical necessity to prevent possible loss of at least some of the deductions. Such loss would occur where estate administration expenses for the year exceed estate income for the year because the resulting net loss is not an NOL—since the deductions are not "business" deductions.[104] Only NOLs (and capital loss deductions) can be carried over to other taxable years of the estate.

In addition, unused NOL and capital loss carryforwards, plus excess (non-NOL and non-capital loss) deductions in the year of termination, can be carried over from the estate to the legatees.[105] However, excess deductions in the year of termination (resulting from estate administration expenses) can only be used by a legatee in her taxable year in which the estate terminates; such excess deductions do not create carryforwards at the legatee level.[106]

In short, under current income tax law (and assuming no estate tax deduction), the income tax losses attributable to estate administration expenses could be lost to some extent. Estate representatives would lie under a tax inducement to generate income to absorb the deductions, space the deductions to match income, or postpone the deduction to the year the estate terminates in hopes that the excess deductions in that year could be absorbed by high-bracket distributees.

The solution is to treat estate administration expenses as business deductions so as to allow the creation of NOLs that can be carried over to other years of the estate and of its distributees who bear the economic burden of such expenses. Although, as noted above, administration expenses at the legatee level might best be treated as capital expenditures, that problem would be cured by a statutory rule that treated NOL carryovers from an estate as NOL carryovers at the distributee level.

I do not personally favor the NOL approach. I am merely conceding that Congress would likely be disposed to allowing the deduction of estate administration expenses somewhere in the tax system. Assuming this to be the case, it is more appropriate to allow them for income tax purposes than for estate tax purposes.

H. *Administration Expenses and the Charitable Deduction*

In *Hubert* there was also a charitable bequest under the residue, and a portion of total administration expenses were chargeable against the income or corpus of the charitable bequest in the executor's discretion. Thus, the issue was raised as to whether a charge against charitable bequest income

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104. See IRC § 172(d)(4) (nonbusiness deductions in excess of nonbusiness income not included in NOL computation).

105. See IRC § 642(h).

106. See Regs. § 1.642(h)-2(a).

would reduce the charitable deduction. Both the parties and the Supreme Court agreed that (1) an actual charge to the corpus of the charitable bequest would reduce the charitable deduction and (2) an actual charge to the income of the marital bequest would raise the same issue (and would call for the same answer) as under the marital deduction.[107] In short, the result of *Hubert* is equally applicable to the marital and charitable deductions.

My conclusion is this conflating of the marital and charitable deductions is correct, notwithstanding the fact that there are some differences between the two deductions.

One such difference is that there is no charitable deduction analogue to section 2056(b)(4)(B), which refers to "encumbrances" and the like, although section 2055(c) is a charitable deduction counterpart to section 2056(b)(4)(A), which takes into account death taxes charged against a marital bequest.[108] As stated earlier,[109] section 2056(b)(4)(B) merely provides clarification with respect to certain aspects of the "passing" requirement of section 2056(a). Therefore, the omission from section 2055 of a similar encumbrance-related provision has little or no significance.

Potentially more serious is the fact that the charitable deduction has no explicit "passing" requirement. On the other hand, the charitable deduction is allowed only for bequests, etc., "to or for the use" of a charity.[110] The Regulations provide that a deduction is allowed only for interests that can be presently valued and which are not subject to meaningful contingencies.[111] If there is a will contest, the charitable deduction is the amount actually passing to the charity under the will contest.[112] Indeed, if the charitable interest cannot be ascertained at the decedent's death, the fact that it is ultimately fixed pursuant to a court order will not be sufficient to save the deduction.[113] Contingent bequests to charity are not deductible unless the

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107. *Hubert*, See 117 S. Ct. at 1129.

108. See IRC § 2055(c). This provision is the successor to IRC § 812(d) (1939) which overturned the result of Edwards v. Slocum, 264 U.S. 61 (1924). *Slocum* denied the government's effort to require "deducting from the exempted estate the amount of the tax to be paid, or in other words, adding the amount of the tax to the taxable estate" under prior law, Revenue Act of 1924, ch. 18, § 401, 40 Stat. 1057, 1096. See also Harrison v. Northern Trust Co., 317 U.S. 476 (1943) (upholding application of IRC § 812(d) (1939).

109. See supra notes 17-18 and accompanying text.

110. IRC § 2055(a)(2).

111. See Regs. § 20.2055-2(a). Compare Ahmanson Found. v. United States, 674 F.2d 761, 771 (9th Cir. 1981), (charitable deduction won't be disallowed on account of a greater-than-negligible possibility of a reduction pursuant to a will compromise).

112. See Toulmin v. United States, 462 F.2d 978, 982 (6th Cir. 1972).

113. See Merchants Nat'l Bank of Boston v. Commissioner, 320 U.S. 256 (1943); Estate of Marine v. Commissioner, 990 F.2d 136 (4th Cir. 1993), aff'g 97 T.C. 368 (1991) (charitable bequest subject to discretionary invasion for private individuals).

contingency is susceptible to actuarial valuation.[114] No reason can be conceived for allowing a charitable deduction for property or an interest therein that does not, or might not, pass to a charity on account of the exercise of an election provided for in the governing instrument. In sum, the passing requirement—as well as a mild common-law version of the terminable interest rule[115]—is implicit in the charitable deduction.[116]

Thus, in an outright residuary bequest to charity,[117] the deduction should be reduced by administration expenses charged to principal or residual income. As in the marital deduction context, an estate tax or income tax deduction can be obtained for such expenses, and the same expenses should not produce a second tax benefit in the form of a failure to reduce the charitable deduction.

In the case of split-interest charitable transfers (charitable lead or remainder interest with the other interest being noncharitable), the structure of the charitable deduction differs from that of the marital deduction. In the marital deduction, the surviving spouse is the deemed transfer tax owner of both the income and remainder interests. The charitable deduction does not treat the charity as the owner of all interests. But this point only suggests that the charitable-deduction situation is easier to analyze than the marital deduction situation. The charitable deduction is "final," and there is no concern with what ends up in the potential tax bases of either the charitable beneficiary (which is nontaxable in any event) and the noncharitable beneficiary. In other words, the problem is simply that of valuing what passes to the charity, and the guiding principle should be that the charitable deduction not be allowed for amounts that may be diverted to noncharitable purposes pursuant to the exercise of discretion. In applying that principle,

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114. See Humes v. United States, 276 U.S. 487 (1928); Griffin v. United States, 400 F.2d 612 (6th Cir. 1968); Rev. Rul. 59-143, 1959-1 C.B. 247; Rev. Rul. 68-336, 1968-1 C.B. 408.

115. The charitable deduction version disallows deduction for a charitable interest only if it is subject to contingencies that cannot be actuarially ascertained. See supra note 114. Conditions subsequent are disregarded where the chance of divestiture is remote. See Rev. Rul. 67-229, 1967-2 C.B. 335. Thus, the charitable deduction terminable interest rule is significantly milder than the marital deduction version, which is statutory.

116. See Harrison v. Northern Trust Co., 317 U.S. 476, 480 (1943) (charitable deduction reduced by tax payable out of charitable residue).

117. In a residuary bequest, the legatee is usually entitled to the net income. In the case of a specific monetary (i.e., pecuniary) bequest, there is usually no income right. In effect, such a bequest creates an immediate dollar claim in favor of the pecuniary legatee that is unaffected by estate income and expenses. Hence, a pecuniary charitable bequest would be reduced (for charitable deduction purposes) only if expenses, etc., were actually charged against the amount of such bequest.

administration expenses that reduce what the charity receives should reduce the charitable deduction to an appropriate extent.

I. *The Next Step*

Hubert did not construe the Code to preclude reduction of the marital or charitable deduction for administration expenses allocated to income pursuant to an executor's discretion. Because section 2056(b)(4) was viewed as not speaking directly to the facts of *Hubert*, the plurality and the concurring opinions relied on the regulations purporting to interpret the passing requirement as embellished upon by section 2056(b)(4).[118] Neither the parties nor the Court suggested that the regulations were invalid. Basically, the plurality and concurring opinions construed the regulations in a way that raised a factual issue of "materiality" that the government refused to explicitly address, although in fact any burden on the government was satisfied because all administration expenses had to reduce the income or principal of the marital and charitable bequests.

The government is now faced with two alternatives. It can try to live with the "materiality" test and apply it on a case by case basis. Or it can revise the regulations in a way that makes it clear that any estate charge against the income or corpus of a marital or charitable bequest reduces the deduction.[119] The amended regulation should eliminate the "materiality" test because the administrative discretion of the IRS can deal with *de minimis* situations. The marital or charitable deduction should be reduced by expenses and charges incurred during the estate transmission process that are not already factored into valuation for gross estate inclusion purposes. Since administration expenses are not properly factored into the valuation of assets for gross estate inclusion purposes, administration expenses chargeable to a marital bequest always reduce the value passing to the surviving spouse. Moreover, the deduction should be reduced by the maximum amount of estate administration expenses that *can* be charged against the income or principal of the marital or charitable bequest pursuant to an executor's discretion, although the IRS should be allowed to use hindsight where appropriate (i.e., all the administration expenses have been accounted for when the estate tax return is filed). Executors should be allowed to enter into agreements with the IRS in which the executor undertakes not to allocate charges against the marital or charitable share (assuming the executor has a choice).

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118. See supra text accompanying notes 25 and 43.

119. See *Hubert*, 117 S. Ct. at 1139 (O'Connor, J., concurring) (open invitation for the government to revise regulations to accord with litigating position).

The amended regulation should address the issue of whether the charges should be taken into account on a present-value or dollar-by-dollar basis. The charges should be reduced to present value only where the actual date of payment is known. Otherwise, the reduction should be on a dollar-for-dollar basis, on the theory that the estate cannot satisfy its burden of proving when the future charges will be paid.

The IRS should revoke Revenue Ruling 93-48,[120] which allows interest on deferred estate taxes to be deducted for income tax purposes without reducing the marital deduction. Interest on deferred estate taxes is an estate administration expense[121] and not a category of consumption by the surviving spouse. All costs relating to the estate transmission process that are charged to the income or principal of a marital or charitable bequest should reduce the marital or charitable deduction.

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120. 1993-2 C.B. 270. As discussed earlier, the ruling was prompted by government litigation reverses brought about by the government's own faulty theory. See supra note 58. The IRS can acquiesce in the result of cases without embracing the rationale.

121. See Rev. Rul. 79-252, 1979-2 C.B. 333 (interest on estate tax is deductible for estate tax purposes under IRC § 2053).