OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated August 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE(S):

Whether interest on the fraud penalty, which runs from the due date of the return with extensions, may be deducted as an administrative expense under § 2053(a) of the Internal Revenue Code,.

CONCLUSION:

Interest on the fraud penalty actually paid or accrued is deductible provided it is allowable as an expense of the estate under local law and the expense is incurred for the benefit of the estate.

FACTS:

The estate was assessed the fraud penalty for willful failure to disclose assets of the estate on the estate tax return.

LAW AND ANALYSIS

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2053(a)(2) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for administration expenses as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

Section 20.2053-3 of the Estate and Gift Tax Regulations provides that deductible administration expenses are those expenses that are actually and necessarily incurred in the administration of the decedent's estate. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.

Section 6663 provides that, if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

Revenue Ruling 81-154, 1981-1 C.B. 470, holds that the failure to pay or failure to file penalties are not deductible as a necessary administration expense under section 2053 of the Code even if the expense is allowable under local law. The willful failure to file the estate tax return is a breach of the executor's fiduciary duty and the resulting penalty would not be an expense necessarily incurred in the administration of the decedent's estate. Similarly, the filing of a fraudulent estate tax return is a breach of the executor's fiduciary duties and cannot be considered a necessary expense of administration of the estate.

Revenue ruling 81-154, however, does not address the question of the deductibility of interest on the penalty. It does address the deductibility of interest on the late payment of the tax itself and holds that the interest is deductible as an expense of administration of the estate. It cites Estate of Bahr v. Commissioner, 68 T.C. 74, (1977), acq., 1978-1 C.B. 1, for the proposition that interest expense is allowable under section 2053 without regard to the manner in which it was incurred. "It has been consistently recognized by this and other courts that 'interest on a tax is not a tax, but something in addition to a tax.' Capital Building & Loan Association v. Commissioner, 23 B.T.A. 848, 849 (1931)." Similarly, interest on a penalty is not a penalty, but something other than a penalty. Thus, even though the penalty may not be deductible for purposes of determining the taxable estate, the interest on the penalty is a separate item and must be evaluated on its own merits.

To be deductible, interest must be allowed by the laws of the jurisdiction under which the estate is being administered, that is, it must be allowable as a charge against the probate estate. Generally, interest on an obligation of an estate is allowed as an expense of administration under the laws of the jurisdiction in which

this estate is being probated. We have found nothing to indicate that there is an exception to the general rule for interest on penalties.

Additionally, to be allowed as a deduction the interest must be for the benefit of the estate, that is, the interest must have been actually and necessarily incurred for the benefit of the estate. Expenses that are not necessary to the settlement of the estate, but instead, are incurred for the benefit of heirs, legatees, or devisees are not deductible. This does not mean, however, that there can be no benefit to heirs, merely that there must be benefit to the estate. See Estate of Reilly v. Commissioner, 76 T.C. 369 (1981) and Porter, Transferee v. Commissioner, 49 T.C. 207, 225 (1967).

As explained by the Tax Court, "a given expense associated with the administration of an estate may be incurred for several reasons. This is, the sale may have been initiated for the benefit of the heirs, but at the same time it may have been necessary to acquire cash to pay expenses, preserve the estate, or to effect a distribution. In such a situation it may be more appropriate to ignore the personal aspects of the transaction and allow the executor to deduct the incurred expenses." Park's Estate v. Commissioner, 57 T.C. 705, (1972). It should be noted that in Park's Estate the court disallowed the claimed deduction of selling expenses because the estate had sufficient cash available to pay all of the expenses of administration that it was claimed necessitated the sale of estate assets. The court concluded that the sale was solely for the benefit of the heirs.

It is our understanding that here the estate did not have sufficient cash or liquid assets to pay the tax, penalty, and interest assessed against it and had to wait until other assets could be sold. In addition, the estate contested the penalty in the Tax Court. Even though it conceded the omission and undervaluation of many of the assets that generated an underpayment of Federal estate tax, it did not concede that the underpayment was with fraudulent intent. Thus, the estate can argue that its delay in payment of the penalty and the incurring of interest on the penalty pending a judicial determination were for the purpose of preserving the assets of the estate and, therefore, was for the benefit of the estate.

You note that the allowance of interest on the penalty as an administrative expense will reduce the amount of the taxable estate and, thereby, reduce both the amount of the tax and the penalty (which is computed on a percentage of the underpayment attributable to fraud). In Estate of Bahr, the Tax Court "fail[ed] to see the significance of the fact that the interest, if deductible, would reduce the taxable estate and thus the ultimate amount of estate tax paid. The result is the same when interest is paid to a private lender as in Estate of Huntington v. Commissioner, 36 B.T.A. 698 (1937), and Estate of Todd v. Commissioner, 57 T.C. 288 (1971). A deductible administration expense, by definition, reduces the taxable estate. To deny an administration expense deduction upon the mere basis that it would otherwise reduce the amount of estate taxes paid would result in the

disallowance of all administration expenses." We agree that a reduction in both the amount of tax and any addition to the tax computed as a percentage of the tax is inherent in the allowance of deductions from the taxable estate.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call (202) 622-7840.

By: _____
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