OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated November 5, 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.

LEGEND:

Decedent
A
B
C

Date 1
Date 2
Date 3
Date 4

a
b
c
d
e
f

g
h
x
y

Administrative expenses

9608 Form 1041:

Fiduciary Fees

Executor fees
Bank fees
Property taxes
subtotal

Professional Fees

Attorney fees
Accountant fees

subtotal

Other

Abstract and Title
Administrative
Appraisal
Form K-1

TOTAL

9708 Form 1041:

Fiduciary Fees

Executor fees
Bank fees
subtotal

Professional Fees

Attorney fees
Accountant fees
subtotal
Other

Administrative

TOTAL

9808 Form 1041(Estimated):

Fiduciary Fees

Executor fees
Bank fees
subtotal

Professional Fees

Attorney fees
Accountant fees

Other

Administrative

TOTAL

ISSUE:

Whether the executors' discretionary authority to allocate the estate's administration expenses against the postmortem income earned by the estate is a "material limitation" upon the surviving spouse's right to the income from the property when the exercise of that discretionary authority results in $h of administration expenses being charged against the income of the estate.

CONCLUSION:

The determination of whether there is a “material limitation” upon the surviving spouse’s right to income depends on all the facts and circumstances. Based on the facts presented, there appear to be factors indicating that the payment of $h of administrative expenses from postmortem income represents a “material limitation” upon the surviving spouse’s right to the income in this case. However, further factual development would be necessary before a final determination can be made.

FACTS:

Decedent, died testate on Date 1. At the time of his death, Decedent was survived by his wife, A, and two children, B and C.

The relevant portions of Decedent's will are as follows:

> ITEM II.
>
> My Executor shall pay my debts and charges from my estate,
>
> ITEM IV.
>
> If my wife, A, shall survive me, I give, devise, and bequeath in trust to the Trustees hereafter named, and to its successor in trust, cash, securities or other property of my estate having a value equal to the maximum marital deduction as finally determined in my federal estate tax proceedings, less the aggregate amount of marital deduction, if any, allowed for such tax purposes by reason of property or interests in property passing or which have passed to my said spouse otherwise than pursuant to the provisions of this ITEM; provided, however, the amount of this bequest shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate tax purposes) to the largest amount that, after allowing for the unified credit against the federal estate tax, and the state death tax credit against such tax (but only to the extent that the use of such state death tax credit does not increase the death tax payable to any state), will not result in a federal estate tax being imposed on my estate. The term “maximum marital deduction” shall not be construed as a direction by me to exercise any election respecting the deduction of estate administration expenses, the determination of the estate tax valuation date, or any other tax election which may be available under any tax laws, only in such manner as will result in a larger allowable estate tax martial deduction than if the contrary election had been made.

ITEM V.

I direct that all inheritance, estate, succession, or other similar taxes against my taxable estate of [sic] the recipients thereof, including any taxes arising from the transfer or receipt of assets which are not part of my probate estate, shall be paid from the balance of my estate remaining after complying with the foregoing provisions of this Will. Such taxes shall not be charged against the respective beneficiaries, and my Executor shall not seek reimbursement from anyone therefor . . . .

ITEM VI.

I give, devise, and bequeath all the rest, residue and remainder of my estate to be known as the [Decedent] TRUST, which shall not be less that [sic] the equivalent exemption for the unified credit for federal estate tax, to the Trustee hereafter named, under the following terms and conditions of Trust: . . . .

A. During the life of my wife, A, my trustee, from time to time, shall pay to, or apply for the benefit of my wife all of the income and such sums from the principal of this Trust estate, as the Trustee, in the exercise of its sole discretion, deems advisable, in addition to any other funds known to it to be available to my wife, to provide for her support, maintenance, health and education.

. . . .

C. This Trust, except as hereinafter provided, will terminate upon the death of A.

ITEM VII.

The Trustee of the Trusts created hereunder shall have power and authority to do any act or thing reasonably necessary or advisable in a fiduciary capacity for the proper administration and distribution of each Trust created by this Will. No power granted by this ITEM shall be exercised with respect to the Trust created in ITEM IV if the effect of its exercise is to disqualify that Trust for the marital deduction. In extension but not in limitation of any power, right or discretion otherwise possessed by the Trustee, I grant to said Trustee, without the necessity of notice to or approval of any court or person, the following powers:

> . . . .
>
> (D) To determine what shall be charged or credited to income and what to principal, notwithstanding any determination by the courts or by any custom or statute; . . . .
>
> ITEM XI.
>
> It is my intention that the A TRUST hereinbefore created under ITEM IV of this Will shall meet the requirements of the Internal Revenue Code of the United States, so the marital deduction will be allowed with respect to that Trust. To accomplish this result, I specifically direct and provide that the provisions of this Will shall be construed and that the said Trust and my estate shall be administered so as to meet such requirements. Notwithstanding anything in this Will to the contrary, any power, duty or discretionary authority granted to my Executor or my Trustees shall be absolutely void to the extent that the right to exercise such power, duty or authority or the exercise thereof shall in any way affect, jeopardize or cause the disallowance to my estate of all or any part of the tax benefit afforded by the marital deduction provisions of the Internal Revenue Code of 1954, as amended from time to time.

Decedent's estate timely filed the United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706.

During the examination of the Form 706, a state income tax refund in the amount of $a was identified as an asset of the estate. Therefore, the corrected gross estate is $b. Line 2 of the Form 706 reports total allowable deductions of $c computed by adding funeral expenses, debts, mortgages and liens, and a marital deduction of $d.

The estate did not claim any executors' commissions, attorney fees, accountant fees or other administration expenses as estate tax deductions on Schedule J of the estate's Form 706.

The estate filed its U.S. Income Tax Return for Estates and Trusts, Form 1041, for the period ending Date 2. On that Form 1041, the estate reported total income of $e and claimed administration expense deductions as shown in the legend. The estate filed the Internal Revenue Code section 642(g) waiver electing to claim the “administrative expenses” as deductions from gross income and not as estate tax deductions.

The estate filed its U.S. Income Tax Return for Estates and Trusts, Form 1041, for the period ending Date 3. On that Form 1041, the estate shows total income of $f and the estate claimed administration expense deductions as shown in the legend. The estate has not filed the section 642(g) waiver electing to claim the expenses shown above as deductions from gross income and not as estate tax deductions.

The estate has not yet filed its U.S. Income Tax Return for Estates and Trusts, Form 1041, for the period ending Date 4. The estate is estimating total income of approximately $g. The estate is estimating expenses as shown in the legend. Because no return has been filed, the estate has not filed the section 642(g) waiver electing to claim the expenses shown above as deductions from gross income and not as estate tax deductions.

The administrative expenses of $h, claimed or to be claimed on the Forms 1041, equal approximately x percent of the corrected gross estate and approximately y percent of the income earned during the period in which the expenses were incurred.

LAW AND ANALYSIS

Section 2056(a) provides that for purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(4) provides that 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 -

> (A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and
>
> (B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

Treas. Reg. § 20.2056(b)-4(a) provides, in relevant part, as follows:

> The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of 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, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

Treas. Reg. § 20.2056(b)-4(a), quoted above, provides that the marital deduction may be taken only for the net value of the interest passing to the surviving spouse. In determining the value of the interest, account must be taken of the effect of any material limitations on the spouse's right to the income from the property. The regulation indicates that this rule may apply in the case of a bequest of property in trust for the benefit of the spouse, when income from the property is used to pay estate administration expenses prior to distribution. See Notice 97-63, 1997-47 I.R.B. 1.

Under the applicable state law, an executor may charge payments of administration expenses against either the income of the estate or its principal, if the will so provides.

The Commissioner's position that the marital and charitable deduction must be reduced by the amount of administration expenses charged to income of the residuary was rejected in a fully reviewed but divided Tax Court opinion that was upheld by the Court of Appeals for the Eleventh Circuit with one dissenting judge. Estate of Hubert v. Commissioner, 101 T.C. 314 (1993), aff'd, 63 F.3d 1083 (11th Cir. 1995). The Commissioner's position had previously been upheld in Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992) and Burke v. United States, 994 F.2d 1576 Fed. Cir.), cert. denied, 114 S.Ct. 546 (1993).

The United States Supreme Court affirmed the decision of the Eleventh Circuit, with four justices joining in the plurality opinion, three justices concurring with the plurality's result but disagreeing with the reasoning and two justices dissenting. 117 S.Ct. 1124 (1998). The issue in Hubert was "whether the amount of the estate tax deduction for marital or charitable bequests must be reduced to the extent

administration expenses were paid from income generated during administration by assets allocated to those bequests." 117 S.Ct. at 1127 (Kennedy, J., plurality opinion). Writing for the plurality, Justice Kennedy readily conceded that there are situations in which a provision requiring payment of administration expenses could be deemed material. 117 S.Ct. at 1131. However, the plurality concluded that there was no basis for reversing the Tax Court's factual finding that the trustee's discretion to pay administration expenses out of income was not a material limitation on the right to receive income.

The Supreme Court pointed out that the estate tax regulations do not define the term "material limitation." The plurality opinion indicates that where administration expenses are paid from income that would otherwise go to the surviving spouse, the marital deduction should "reflect the date-of-death value of the expected future administration expenses chargeable to income if they are material as compared to the date-of-death value of the expected future income." 117 S.Ct. at 1133. The concurring opinion in Estate of Hubert reasoned that the relevant sources point to a test of quantitative materiality, 117 S.Ct. at 1139, and that, therefore, "some financial burdens on the [beneficiary's] right to postmortem income will reduce the ...deduction; others will not." 117 S.Ct. at 1137 (O'Connor, J., concurring). Accordingly, when the payment of administration expenses from postmortem income crosses the threshold of materiality, the residuary bequest must be reduced. Justice Scalia pointed out in his dissenting opinion that "a 'material limitation' is a limitation that is relevant or consequential to the value of what passes." 117 S.Ct. 1142.

The Service has issued proposed regulations providing guidance for the treatment of administration expenses paid from income attributable to marital or charitable bequests. This guidance, however, if adopted, will only apply to estates of decedents dying on or after the date of adoption. See Prop. Treas. Reg. §20.2056-4(e)(4), 63 Fed. Reg. 69248, 69451 (December 18, 1998).

In this case, the estate incurred administration expenses of $h and the executors elected to charge this amount against postmortem income. $h represents approximately x percent of D's gross estate and approximately y percent of the income earned during the period in which the expenses were incurred. Based upon the facts presented, it appears that y percent of the postmortem income represents an absorption of a significant portion of A's right to the income from the property in this case and may constitute a material limitation on her right to the income. Further, a deduction of $h in administrative expenses from postmortem income may be quantitatively material under the facts of this case.

However, further factual development is necessary before a final determination can be made as to whether $h in administration expenses charged against postmortem income is a material limitation in this case. Pursuant to the Supreme Court's plurality opinion in Estate of Hubert, in determining whether there is a material limitation on the spouse's income interest, you will need to determine the date of death value of the projected future administration expenses chargeable to income and the date of death value of the projected future income. Accordingly, you should consider to what degree the estate could have anticipated administrative expenses and income in the amounts eventually incurred. You should also further develop facts with respect to the type of assets in the estate, the sources of the estate's income, and the actual nature of the administrative expenses claimed. For example, some of the expenses claimed as executors fees or administrative fees may have been incurred in the production of income and would be allowable deductions from the income of the estate. Those expenses would not be taken into account in determining if there has been a material limitation on the spouse's right to the income of the estate.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The materiality issue is a question of fact and we recognize that [redacted]. However, we believe there are factors indicating that there may be a material limitation on the spouse's right to income. As the Supreme Court's fractured resolution of Hubert reveals, legal standards for determining when the payment of administration expenses crosses the threshold of materiality are not clearly defined. [redacted].

Although the Supreme Court pointed out in Hubert that the Service did not present evidence or argue that $1.5 million of administration expenses were quantitatively material, electing instead to argue that any diversion of postmortem income was material, Hubert, 117 S.Ct. at 1138, a majority of the Supreme Court justices agreed that had the IRS advanced such an argument, they would have concluded that $1.5 million was material under the facts of the case under any standard. (O'Connor, J., concurring); (Scalia, J., dissenting); (Breyer, J., dissenting).

[redacted]

Taxpayer may also argue that in comparison to the facts in Hubert which had slightly fewer administrative expenses ($1.5 million) and a much smaller gross estate ($30 million), its deducted administration expenses were not material. [redacted]

[redacted]

By: _____

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