Marital Deductions

Related Tax Issues in Trust and Estate Administration

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A. ***Impact of Management vs. Transmission Expenses on the Marital Deduction***

The Service adopted the so-called "Hubert regulations" in connection with marital and charitable deduction issues relating, in part, to "swing item" expenses, and the chargeability of such expenses to estate income or principal. In issuing those regulations, the government avoided cumbersome distinctions and analytical nuances being considered at the time, and instead focused on, what was then, a new classification concept. This effort resulted in the creation of two broad classifications, within which every administrative expense is presumed to fall: an estate management expense or an estate transmission expense.

The Hubert regulations appear to sort administration expenses that were traditionally charged to income from those that were a proper charge to principal. However, the categories of estate management expenses and estate transmission expenses are defined without income and principal distinctions. Instead, the Hubert regulations distinguish administration expenses that are incurred in consequence of the death of a transferor from those that are not. Treas. Reg. §§ 20.2055-3(b)(1); 20.2056(b)-4(d)(1)(i).

In particular, Treas. Reg. § 20.2056(b)-4(d)(1)(ii) provides:

> "Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense. Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees."

For a table illustrating the effect of administration expenses on the marital deduction, see Exhibit C, attached.

B. ***Section 67(e) Expenses and the Two Percent Miscellaneous Floor***

In an effort to alleviate extensive and complicated record-keeping, particularly with respect to relatively minor expenditures of an estate or non-grantor trust, Congress enacted section 67 of the Internal Revenue Code. In Treasury Regulations section 1.67-4 (made final on May 9, 2014), the Service has set forth a new classification approach with respect to expenses of administration, influenced in part by the U.S. Supreme Court decision in *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181 (2008). These classifications are in addition to those set forth in 1999 under the

Hubert regulations, dealing with the treatment of similar expenses in the context of marital and charitable deductions and the section 2013 credit.

The final regulation under § 67(e) attempts to distinguish between those expenses "that are paid or incurred in connection with the administration of an estate or a [non-grantor trust] and which would not have been incurred if the property were not held in such estate or trust," and those which would "commonly or customarily . . . be incurred by a hypothetical individual holding the same property." Treas. Reg. § 1.67-4 (2014). The tax effect is as follows: an expense of a trust or estate that would be *common or customary to an individual* is subject to the miscellaneous two percent floor for trust and estate expense deductions, whereas an expense that would be *unique to an estate or trust* is not subject to the two percent floor. The regulation specifically provides that "[i]n analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered to the estate or non-grantor trust . . . , rather than the description . . . , that is determinative." *Id.* (emphasis added). The common or customary expenses of an individual would include such things as ownership costs and investment advisory fees in general. Examples given in the proposed regulation of expenses unique to estate or trust administrations are tax preparation fees (other than those associated with a decedent's final individual return) and the incremental costs (*i.e.*, special, additional charges) for "investment advice beyond the amount that normally would be charged to an individual investor." The unbundling of fees charged by a corporate trustee-investment advisor is generally required to sort the unique expenses from the others. *Id.*

C. ***More IRD Planning***

1. Swap Power. As indicated previously, property that constitutes either IRD or a right to receive IRD does not get a new basis at death; rather the person receiving the IRD gets a carryover basis. If an Internal Revenue Code section 675(4)(C) swap power is included in an irrevocable grantor trust instrument (where the trust assets are not subject to estate tax inclusion in the settlor's estate), the settlor may wish to consider moving a low basis (non-IRD) asset out of the irrevocable grantor trust and into the settlor's estate or revocable trust, which will allow that asset to get a stepped-up basis on the settlor's death, in exchange for an IRD asset of the settlor of equivalent value (which will not receive a basis step-up in any event).

2. Qualified Retirement Plans and Accounts. Special issues arise in the context of qualified retirement plans and accounts. For instance, if an estate is a named or default beneficiary, and if the estate distributes the beneficial interest of the IRA (i.e., the right to receive the IRA distributions) to an individual entitled thereto, or if under a Will that beneficial interest in the IRA is distributed as a specific bequest (but not in satisfaction of a cash bequest or a non-IRA in-kind bequest), the distributee will be taxed on the income (as determined for income tax purposes). See Treas. Regs. §§ 1.691(a)-2(b), Ex. (1) and (2); 1.691(a)-4(b).

If the benefits are paid out to the estate or a trust before the estate assigns the IRA beneficial interest, those benefits are probably taxable to the estate/trust, unless the governing instrument expressly requires the beneficial interest (or its benefits) to be distributed to a particular beneficiary. See Treas. Regs. §§ 1.691(a)-4(b); 1.663(c)-2(b)(3). (One commentator opines that probably the same answer holds for a distribution of the IRA beneficial interest (or benefits) pursuant to a discretionary power to distribute principal.)

On August 23, 2006, the IRS ruled in three related PLRs involving an IRA of an individual who died after his required beginning date, that the segregation of certain estate beneficiaries' (children of the decedent) fractional interests in an IRA into separate "inherited" IRAs, where each inherited IRA would independently meet minimum distribution requirements based on the remaining life expectancy of the decedent, would not constitute a distribution nor an attempted (improper) rollover. Previously some practitioners questioned whether this result was possible based Treasury Regulations § 1.401(a)(9)-4, which indicates that the "separate account" rules are not available to beneficiaries of an estate (or a trust) with respect to the estate's (or trust's) interest in an employee plan or IRA interest. Subject to the usual caveats surrounding PLRs, these rulings give some assurance of flexibility in the postmortem (or clean up) context, where an estate is the named (or default) beneficiary. See PLRs 200646025, 200646027, and 200646028.

	(A) The interest rate applicable under section 7520 at the death of the transferor; and (B) The period between the date of the transferor's death and the date the pecuniary amount is paid. (ii) Special rule for residual transfers after pecuniary payments payable in kind. The denominator of the applicable fraction with respect to any residual transfer after satisfaction of a pecuniary payment payable in kind is the date of distribution value of the property distributed in satisfaction of the residual transfer, unless the pecuniary payment must be satisfied on the basis of the value of the property on— … (B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.	(ii) Other pecuniary amounts payable in kind. The denominator of the applicable fraction with respect to any property used to satisfy any other pecuniary payment payable in kind is the date of distribution value of the property.

Minimum Worth	(Not viable.)	(Not viable.)

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