[4830-01-0]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 20

[REG-114663-97]

RIN 1545-AV45

Marital Deduction; Valuation of Interest Passing to Surviving Spouse

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the effect of certain administration expenses on the valuation of property which qualifies for the estate tax marital or charitable deduction. The proposed regulations define estate transmission expenses and estate management expenses and provide that estate transmission expenses, but not estate management expenses, reduce the value of property for marital and charitable deduction purposes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by February 16, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 21, 1999, at 10 a.m., must be received by March 31, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-114663-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin

Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-114663-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Deborah Ryan (202) 622-3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On March 18, 1997, the Supreme Court of the United States issued its decision in Commissioner v. Estate of Hubert, 520 U.S. 93 (1997) (1997-32 I.R.B. 8), in which it considered the proper interpretation of §20.2056(b)-4(a) of the Estate Tax Regulations. On November 24, 1997, the IRS issued Notice 97-63 (1997-47 I.R.B. 6), requesting comments on alternatives for amending §20.2056(b)-4(a) in light of the Supreme Court's Estate of Hubert decision.

Section 2056(b)(4) provides that, in determining the value of an interest in property which passes from the decedent to the

surviving spouse for purposes of the marital deduction, account must be taken of any encumbrance on the property or any obligation imposed on the surviving spouse by the decedent with respect to the property. Section 20.2056(b)-4(a) of the Estate Tax Regulations amplifies this rule by providing that account must be taken of the effect of any material limitations on the surviving spouse's right to the income from the property. The regulation provides, for example, that there may be a material limitation on the surviving spouse's right to the income from marital trust property where the income is used to pay administration expenses during the period between the date of the decedent's death and the date of distribution of the assets to the trustee.

The facts in Estate of Hubert are similar to a common fact pattern wherein the decedent's will provides for a residuary bequest to a marital trust which qualifies for the marital deduction and also provides that estate administration expenses are to be paid from the residuary estate. Further, the will (or state law) permits the executor to use the income generated by the residuary estate (otherwise payable to the marital trust) to pay administration expenses, and the executor does so. The issue before the Supreme Court in Estate of Hubert was whether the executor's use of the income to pay estate administration expenses was a material limitation on the surviving spouse's right to the income which would reduce the marital deduction under §20.2056(b)-4(a).

The issue in Estate of Hubert also involved the estate tax charitable deduction, and the proposed regulations relate to the valuation of property for both marital and charitable deduction purposes. However, for simplicity and clarity, this discussion focuses on the provisions of the estate tax marital deduction.

In Estate of Hubert, the Commissioner argued that the payment of administration expenses from income is, per se, a material limitation on the surviving spouse's right to income for purposes of §20.2056(b)-4(a), and, therefore, the value of the marital bequest should be reduced dollar for dollar by the amount of income used to pay administration expenses. The Court agreed that the value of the marital bequest should be reduced if the use of income to pay administration expenses is a material limitation on the spouse's right to income. The Court found, however, that the regulation does not define material limitation and that the Commissioner had not argued that the use of income in this case was a material limitation. Thus, the Court held for the taxpayer.

In Notice 97-63 (November 24, 1997), the IRS requested comments on possible approaches for proposed regulations in light of the Estate of Hubert decision. Notice 97-63 suggested three alternative approaches for determining when the use of income to pay administration expenses constitutes a material limitation on the surviving spouse's right to income. One approach distinguished between administration expenses that are properly charged to principal and those that are properly charged to

income and provided that there is a material limitation on the surviving spouse's right to income if income is used to pay an estate administration expense that is properly charged to principal. A second approach provided a de minimis safe harbor amount of income that may be used to pay administration expenses without constituting a material limitation on the surviving's spouse's right to income. A third approach provided that any charge to income for the payment of administration expenses constitutes a material limitation on the spouse's right to income.

Notice 97-63 also asked for comments on whether the test for materiality should be based on a comparison of the relative amounts of the income and the expenses charged to the income; whether materiality should be based on projections as of the date of death rather than on the facts that develop afterwards; and whether present value principles should be applied.

In response to Notice 97-63, several commentators suggested that local law should be determinative of whether an expense is a proper charge to income or principal. If the testamentary document directs the executor to charge expenses to income, and the charge is allowed under applicable local law, then the charge to income should not be treated as a material limitation on the spouse's right to income.

This approach was not adopted because statutory provisions relating to income and principal may vary from state to state, and this would result in disparate treatment of estates that are

similarly situated but governed by different state law. Moreover, in states that have adopted some form of the Uniform Principal and Income Act, the definitions of principal and income, and the allocation of expenses thereto, can be specified in the will or trust instrument and given the effect of state law. Thus, simply following state law was thought to be too malleable to protect the policies underlying the marital and charitable deductions.

Several commentators agreed with the de minimis safe harbor approach whereby a certain amount of income could be used to pay administration expenses without materially limiting the surviving spouse's right to the income. Under this approach, the safe harbor amount is determined in two steps: first, the present value of the surviving spouse's income interest for life is determined using actuarial principles and, second, the resulting amount is multiplied by a percentage, for example, 5 percent.

The proposed regulations do not adopt this approach. Although a de minimis safe harbor approach would provide a bright line test for determining materiality in the context of the marital deduction, it is unclear how this approach would apply for charitable deduction purposes because there is no measuring life for valuing the income interest.

One commentator suggested that, consistent with the plurality opinion in Estate of Hubert, the test for materiality should be quantitative, based upon a comparison between the amount of income charged with administration expenses and the

total income earned during administration. The commentator, however, considered the requirement that projected income and expenses be presently valued to be impractical, complex, and uncertain. Another commentator considered a quantitative test to be impractical. A third commentator suggested that a quantitative test would require a factual determination in each case and, as a result, the period of estate administration would be greatly prolonged.

Because these tests for materiality appear to be complex and difficult to administer, the proposed regulations adopt neither a quantitative test nor a test based on present values of projected income and expenses.

Many commentators opposed an approach in which every charge to income is a material limitation on the spouse's right to income. Two commentators contended that adoption of this approach would effectively overrule the result in Estate of Hubert.

One commentator suggested the approach adopted in the proposed regulations, a description of which follows, and two commentators suggested similar approaches.

Explanation of Provisions

After carefully considering the comments, the Treasury and the Internal Revenue Service have determined that a test based on what constitutes a material limitation would prove too complex and would be administratively burdensome. For this reason, the proposed regulations eliminate the concept of materiality and,

instead, establish rules providing that only administration expenses of a certain character which are charged to the marital property will reduce the value of the property for marital deduction purposes. It is anticipated that these rules will have uniform application to all estates, will be simple to administer, and will reflect the economic realities of estate administration. These same rules will also apply for purposes of the estate tax charitable deduction.

Under the proposed regulations, a reduction is made to the date of death value of the property interest which passes from the decedent to the surviving spouse (or to a charitable organization described in section 2055) for the dollar amount of any estate transmission expenses incurred during the administration of the decedent's estate and charged to the property interest. Such a reduction is proper because these expenses would not have been incurred but for the decedent's death. No reduction is made for estate management expenses incurred with respect to the property and charged to the property because these expenses would have been incurred even if the death had not occurred. However, a reduction is made for estate management expenses charged to the marital property interest passing to the surviving spouse if the expenses were incurred in connection with property passing to someone other than the surviving spouse and a person other than the surviving spouse is entitled to the income from that property. Estate transmission expenses are all estate administration expenses that are not

estate management expenses and include expenses incurred in collecting estate assets, paying debts, estate and inheritance taxes, and distributing the decedent's property. Estate management expenses are expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration.

Proposed Effective Date

These regulations are proposed to be effective for estates of decedents dying on or after the date the regulations are published in the **Federal Register** as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments

(a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 21, 1999, beginning at 10 a.m. in Room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 31, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Deborah

Ryan, Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 20 is proposed to be amended as follows:

PART 20--ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §20.2055-1, paragraph (d)(6) is added to read as follows:

§20.2055-1 Deduction for transfers for public, charitable, and religious uses; in general.

* * * * *

(d) * * *

(6) For the effect of certain administration expenses on the valuation of transfers for charitable deduction purposes, see §20.2056(b)-4(e). The rules provided in that section apply for purposes of both the marital and charitable deductions. This paragraph (d)(6) is effective for estates of decedents dying on or after the date these regulations are published in the **Federal Register** as final regulations.

Par. 3. Section 20.2056(b)-4 is amended by:

1. Removing the last two sentences of paragraph (a).

2. Adding paragraph (e).

The addition reads as follows:

§20.2056(b)-4 Marital deduction; valuation of interest passing to surviving spouse.

* * * * *

(e) Effect of certain administration expenses--(1) Estate transmission expenses. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of estate transmission expenses incurred during the administration of the decedent's estate and paid from the principal of the property interest or the income produced by the property interest. For purposes of this subsection, the term estate transmission expenses means all estate administration expenses that are not estate management expenses (as defined in paragraph (e)(2) of this section). Estate transmission expenses include expenses incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property to those who are entitled to receive it. Examples of these expenses include executor commissions and attorney fees (except to the extent specifically related to investment, preservation, and maintenance of the assets), probate fees, expenses incurred in construction

proceedings and defending against will contests, and appraisal fees.

(2) Estate management expenses--(i) In general. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall not be reduced by the amount of estate management expenses incurred in connection with the property interest during the administration of the decedent's estate and paid from the principal of the property interest or the income produced by the property interest. For marital deduction purposes, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of any estate management expenses incurred in connection with property that passed to a beneficiary other than the surviving spouse if a beneficiary other than the surviving spouse is entitled to the income from the property and the expenses are charged to the deductible property interest which passed to the surviving spouse. For purposes of this subsection, the term estate management expenses means expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

(ii) Special rule where estate management expenses are deducted on the federal estate tax return. For purposes of

determining the marital deduction, the value of the deductible property interest which passed from the decedent to the surviving spouse is not increased as a result of the decrease in the federal estate tax liability attributable to any estate management expenses that are deducted as expenses of administration under section 2053 on the federal estate tax return.

(3) Examples. The following examples illustrate the application of this paragraph (e). In each example, the decedent, who dies after 2006, makes a bequest of shares of ABC Corporation stock to the decedent's child. The bequest provides that the child is to receive the income from the shares from the date of the decedent's death. The value of the bequeathed shares, on the decedent's date of death, is $3,000,000. The residue of the estate is bequeathed to a trust which satisfies the requirements of section 2056(b)(7) as qualified terminable interest property. The value of the residue, on the decedent's date of death, before the payment of administration expenses and estate taxes, is $6,000,000. Under applicable local law, the executor has the discretion to pay administration expenses from the income or principal of the residuary estate. All estate taxes are to be paid from the residue. The state estate tax equals the state tax credit available under section 2011. The examples are as follows:

Example 1. During the period of administration, the estate incurs estate transmission expenses of $400,000, which the executor charges to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the

federal and state estate taxes and by the estate transmission expenses. If the transmission expenses are deducted on the federal estate tax return, the marital deduction is $3,500,000 ($6,000,000 minus $400,000 transmission expenses and minus $2,100,000 federal and state estate taxes). If the transmission expenses are deducted on the estate's income tax return rather than on the estate tax return, the marital deduction is $3,011,111 ($6,000,000 minus $400,000 transmission expenses and minus $2,588,889 federal and state estate taxes).

Example 2. During the period of administration, the estate incurs estate management expenses of $400,000 in connection with the residue property passing for the benefit of the spouse. The executor charges these management expenses to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the federal and state estate taxes but is not reduced by the estate management expenses. If the management expenses are deducted on the estate's income tax return, the marital deduction is $3,900,000 ($6,000,000 minus $2,100,000 federal and state estate taxes). If the management expenses are deducted on the estate tax return rather than on the estate's income tax return, the marital deduction remains $3,900,000, even though the federal and state estate taxes now total only $1,880,000. The marital deduction is not increased by the reduction in estate taxes attributable to deducting the management expenses on the federal estate tax return.

Example 3. During the period of administration, the estate incurs estate management expenses of $400,000 in connection with the bequest of ABC Corporation stock to the decedent's child. The executor charges these management expenses to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the federal and state estate taxes and by the management expenses. The management expenses reduce the value of the residue because they are charged to the property passing to the spouse even though they were incurred with respect to stock passing to the child and the spouse is not entitled to the income from the stock during the period of estate administration. If the management expenses are deducted on the estate's income tax return, the marital deduction is $3,011,111 ($6,000,000 minus $400,000 management expenses and minus $2,588,889 federal and state estate taxes). If the management expenses are deducted on the estate tax return rather than on the estate's income tax return, the marital deduction remains $3,011,111, even though the federal and state estate taxes now total only $2,368,889. The marital deduction is not increased by the reduction in estate taxes attributable to deducting the management expenses on the federal estate tax return.

(4) Effective date. This paragraph (e) is effective on the

date these regulations are published in the **Federal Register** as final regulations.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue