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Tax Law: Administrative Expenses and the Charitable and Marital Deductions—The Potentially Painful Surprise of a 642(g) Election

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TAX LAW: ADMINISTRATIVE EXPENSES AND THE CHARITABLE AND MARITAL DEDUCTIONS—THE POTENTIALLY PAINFUL SURPRISE OF A 642(G) ELECTION—*Estate of Hubert v. Commissioner*, 1993 T.C. LEXIS 63 (Oct. 19, 1993)

I. INTRODUCTION

In 1986, Otis C. Hubert died testate with a $30 million estate.[1] Mr. Hubert's estate filed both an estate tax return and an estate income tax return.[2] Mr. Hubert's estate executor[3] paid administration expenses from estate income and deducted these expenses on the estate income tax return rather than deducting them on the estate tax return.[4] The Commissioner of the Internal Revenue Service reduced the amounts claimed as the marital and charitable deduction on the estate tax return in order to reflect these administration expenses.[5] The Commissioner reasoned that the use of the marital and charitable trust income to pay administration expenses reduced the amount of the marital and charitable property passing to the beneficiaries. These reductions resulted in an estate tax deficiency.[6] On appeal by Mr. Hubert's estate of the resulting estate tax deficiency, the Tax Court upheld the estate's position.[7]

This Note focuses on the disagreement between the Tax Court and the United States Court of Appeals for the Sixth Circuit[8] concerning three estate tax issues. This Note first addresses whether net income earned during the administration of the estate is part of the gross estate valuation.[9] The second issue addressed is whether estate income used to pay estate administration expenses and deducted on the estate income tax return affect the amount of the marital deduction on the estate tax

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1. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63, at *4 (Oct. 19, 1993).

2. *Id.* at *18.

3. "The term 'executor' wherever it is used . . . in connection with the estate tax imposed . . . means the executor or administrator of the decedent, or . . . any person in actual or constructive possession of any property of the decedent." I.R.C. § 2203 (1988).

4. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *18.

5. *Id.* at *7.

6. *Id.*

7. *Id.* at *36.

8. The Sixth Circuit's position on these issues is articulated in Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992). For a discussion of *Estate of Street*, see *infra* notes 171-218 and accompanying text.

9. *See infra* notes 40-79 and accompanying text.

return.[10] The final issue addressed is whether estate income used to pay estate administration expenses and deducted on the estate income tax return affects the amount of the charitable deduction on the estate tax return.[11] These issues are considered through a discussion of Otis Hubert's estate.[12]

Section II of this Note discusses general taxation principles by focusing on both the estate tax and income tax imposed on a decedent's estate.[13] Section III examines these issues in view of the Sixth Circuit's opinion in *Estate of Street v. Commissioner*.[14] Section IV discusses the facts and holding of *Estate of Hubert v. Commissioner*.[15] Finally, Section V concludes that (1) income earned by the estate during administration may be included at its net present value in determining the fair market value of income producing property in the gross estate;[16] (2) the marital deduction may be affected by the payment of administrative expenses from estate income;[17] and (3) the same principles are applicable to the charitable deduction.[18]

II. BACKGROUND

Understanding the issues involved in *Hubert* requires a thorough comprehension of applicable estate taxation principles. Following the death of an individual, the estate executor must determine the value of the gross estate.[19] Subtracting various deductions from the gross estate yields the net estate.[20] These deductions include the administrative expenses,[21] the charitable deduction,[22] and the marital deduction.[23] State law[24] and the testator's intent[25] may influence the allocation of deduc-

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10. *See infra* notes 80-128 and accompanying text.
11. *See infra* notes 129-70 and accompanying text.
12. *See infra* notes 219-346 and accompanying text.
13. *See infra* notes 33-170 and accompanying text.
14. *See infra* notes 171-218 and accompanying text.
15. *See infra* notes 219-346 and accompanying text.
16. *See infra* notes 352-74 and accompanying text.
17. *See infra* notes 375-447 and accompanying text.
18. *See infra* notes 448-56 and accompanying text.
19. See *infra* notes 33-79 and accompanying text for a discussion of the gross estate.
20. See *infra* notes 80-120 and accompanying text for a discussion of authorized deductions.
21. See *infra* notes 80-92 and accompanying text for a discussion of administrative expenses.
22. See *infra* notes 116-20 and accompanying text for a discussion of the charitable deduction. Establishing the value of the net estate also requires consideration of various other deductions and credits. These deductions include claims against the estate and any indebtedness, as well as the unified tax credit.
23. See *infra* notes 93-115 and accompanying text for a discussion of the marital deduction.
24. See *infra* note 155 and accompanying text for a discussion of state laws regarding income and principal allocations.
25. See *infra* note 155 and accompanying text for a discussion of testator intent.

tions and thus affect the net estate.[26] The amount of estate tax payable is based upon the net estate.[27] The income produced by estate assets may also influence the estate tax payable.[28] The Tax Court considered the issue of allocation of deductions in *Estate of Hubert v. Commissioner*.[29] The U.S. Court of Appeals for the Sixth Circuit addressed the same issue in *Estate of Street v. Commissioner*.[30]

Because an estate does not complete distribution of estate assets on the date of the decedent's death, it often earns income during administration. The federal government taxes this income in a manner similar to the taxation of individuals.[31] The decedent's estate can elect to deduct the administrative expenses incurred during the settlement of the estate either on the estate tax return or on the estate's income tax return.[32]

A. Federal Estate Tax Liability

The value of the gross estate is the starting point for determining federal estate taxes.[33] The Internal Revenue Code defines the gross estate as "the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated" to the extent provided by Sections 2033 through 2046 of the Code.[34] "Value" refers to fair market value, which is "the price at which the property changes hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge

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26. See *infra* notes 122-28 and accompanying text for a discussion of the net estate.

27. See *infra* notes 122-28 and accompanying text for a discussion of net tax payable.

28. *See infra* notes 122-28 and accompanying text.

29. No. 22333-90, 1993 T.C. LEXIS 63 (Oct. 19, 1993); *see infra* notes 219-346 and accompanying text.

30. 974 F.2d 723 (6th Cir. 1992); *see infra* notes 169-217 and accompanying text.

31. The Internal Revenue Code states that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual." I.R.C. § 641(b) (1988); *see also* Estate of Hubbard v. Commissioner, 41 B.T.A. 628 (1940). *See infra* notes 129-68 and accompanying text.

32. See *infra* notes 147-53 and accompanying text for a discussion of administrative expenses deducted on the income tax return.

33. Treas. Reg. § 20.0-2(b)(2) (as amended in 1992). Section 2001 of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. I.R.C. § 2051 (1988). The tax is based on the value of the gross estate less certain deductions. *Id.* §§ 2051-2056. After subtracting the deductions, the net taxable estate is established. Under the current Internal Revenue Code, there is no estate tax due on taxable estates under $600,000 because of the unified tax credit available pursuant to I.R.C. § 2010. "A credit of $192,800 shall be allowed to the estate of every decedent against the tax imposed by section 2001." *Id.* § 2010(a). The unified tax credit equals the amount of tax due on a $600,000 estate. *Id.* § 2001(c). Thus, no estate tax is imposed on the vast majority of estates.

34. I.R.C. § 2031(a). I.R.C. §§ 2033-2046 concern valuing different interests in the gross estate. For a discussion of the alternate valuation date, see *infra* notes 66-79 and accompanying text.

of relevant facts."[35] "Brief as is the instant of death, the court must pinpoint [the estate's] valuation at this instant—the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins."[36] Thus, valuation looks ahead[37] or has a "look[s] forward" approach as opposed to a "wait and see" approach.[38] When valuing the gross estate, however, the executor may not look so far ahead that amounts reflect the value of property in the hands of designated beneficiaries.[39]

1. Determining the Value of the Gross Estate

a. Personal Property Valuation

Internal Revenue Service Treasury Regulations provide detailed methods for valuing property on the date of death.[40] Most items in the decedent's estate are easily valued. Secured and unsecured notes are valued as the sum of unpaid principal and the interest accrued prior to the date of death.[41] The executor values cash as the amount of the decedent's money in the decedent's possession, in another's possession,

35. Treas. Reg. § 20.2031-1(b) (as amended in 1988) (noting that this is general rule). The value of the gross estate includes the value of all property in proportion to the decedent's interest either at the time of death or six months after death. I.R.C. § 2033. Fair market value is a question of fact. United States v. Simmons, 346 F.2d 213, 217 (5th Cir. 1965); *see also* Burnet v. Logan, 283 U.S. 404, 405 (1931). The executor may not value the estate item at a forced sale price or in a market in which the property would not usually be sold. Treas. Reg. § 20.2031-1(b) (as amended in 1965).

36. Land v. United States, 303 F.2d 170, 172 (5th Cir.), *cert denied*, 371 U.S. 862 (1962); *see also* Ahmanson Found. v. United States, 674 F.2d 761 (9th Cir. 1981).

37. *Land*, 303 F.2d at 173 (valuing property passing at death as reflection of changes brought by death).

38. Lloyd v. United States, 650 F.2d 1196, 1198 (Ct. Cl. 1981); *see also* Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). In *Ithaca Trust*, Ms. Stewart inherited a right to the income for life from a trust created from her deceased husband's estate. *Id.* at 154. The trust provided that Ms. Stewart could not only use income, but also the trust principal, if necessary for her support. *Id.* Anything remaining in the estate following Ms. Stewart's death went to designated charities. *Id.* The executor determined the value of Ms. Stewart's life estate using mortality tables. *Id.* Ms. Stewart, however, died six months prior to filing the estate tax return, which was well in advance of the mortality table prediction. *Id.* The Court held that the proper time for valuing Ms. Stewart's life estate occurred at the decedent's death, not when the future event—Ms. Stewart's premature death—occurred. *Id.*; *see also* Shriner's Hosp. for Crippled Children v. United States, 602 F.2d 302, 309 (Ct. Cl. 1979) (holding that Commissioner properly valued life estate based on actuarial tables even though beneficiary died prior to filing of estate tax return).

39. Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1583 (1987); *see also The Ahmanson Found.*, 674 F.2d at 772 (noting that to value assets in hands of beneficiaries would allow testator to produce artificially low valuation by manipulatively disbursing complimentary assets into hands of different beneficiaries, only to have those assets recombined into more valuable arrangements later).

40. *See infra* notes 41-53 and accompanying text.

41. Treas. Reg. § 20.2031-4 (as amended in 1974) (noting that valuation may be different if executor establishes worthless bonds or bonds lower in value).

or on deposit with a bank.[42] The estate values household and personal effects at their fair market value.[43] For items such as artwork, jewelry, or antiques, the Regulations require expert appraisal.[44]

Other items are more difficult to value. The estate should value stocks and bonds based on their selling price on listed exchanges.[45] Closely held corporate stocks provide special problems, however, because they are not traded on public exchanges.[46] Thus, the Code requires stocks and securities not listed on an exchange to be compared with the value of stock of similar lines of business that are listed on an exchange.[47] The Regulations also recognize the problem of valuing a block of stock that represents a controlling share.[48] To address this problem, the Regulations require the appraisal of this stock based on the company's net worth, its prospective earning power and dividend-paying capacity, and other relevant factors.[49] These factors include the goodwill of the business, the economic outlook in the particular industry, and the degree of control represented by the block of stock.[50]

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42. *Id.* § 20.2031-5 (noting timing problems concerning outstanding checks for bona fide debts).

43. *Id.* § 20.2031-6(a). The Regulations provide for a room-by-room itemization with a separate value for each item. *Id.* The Regulations also provide an alternative to itemization if numerous articles are worth less than $100 and the estate obtains competent appraisal of the aggregate value. *Id.*

44. *Id.* § 20.2034-6(b).

45. Treas. Reg. § 20.2031-2 (as amended in 1992) (giving more detailed instructions for valuing stocks and bonds when not traded on date of death, when listed on competing exchanges at different prices, or when selling prices do not reflect market prices). In *Collins v. Commissioner*, the court held that the estate needed to value the inherent "bundle of rights" contained in United States savings and defense bonds in an estate. 216 F.2d 519, 523-24 (1st Cir. 1954). The court identified some of these value components, including the ability of the owner to retain the bonds until maturity, the capability to present the bonds within six months of maturity, and the interest the bonds earn until maturity. *Id.* at 523.

46. Estate of Righter v. United States, 439 F.2d 1204, 1207 (Ct. Cl. 1971). The absence of a ready market severely restricts capital gain possibilities, requiring a willing purchaser to look to dividends for his return. *Id.* Closely held stock under the majority control of a single family may freeze dividends, thus placing the minority position in an unenviable position. Estate of Katz v. Commissioner, 27 T.C.M. (CCH) 825 (1968) (holding that value stock sold for $290 was more accurate than Commissioner's $600 per share or expert's $800 per share).

47. I.R.C. § 2031(b) (1988); *see Righter*, 439 F.2d at 1217 (attacking comparison of companies noting different types of products and other factors severely limiting analyses of experts).

48. Treas. Reg. § 20.2031-2(f)(2) (as amended in 1974); *see Righter*, 439 F.2d at 1218 (minority interest in controlling block worth less than proportionate share of assets to which interest is attached).

49. Treas. Reg. § 20.2031-2(f)(2) (as amended in 1974).

50. *Id.* In *Newell v. Commissioner*, the decedent owned not only a majority interest in the Ingalls Stone Company, he also had complete dominion and control over its operation. 66 F.2d 102, 102 (7th Cir. 1933). The court noted that the Tax Board should have looked past the book value of the common stock and ascertained the effect on the stock's fair market value occasioned by the loss to the company of the decedent. *Id.* at 104.

Similar difficulties arise in valuing interests in partnerships or sole proprietorships.[51] The Regulations require valuation based on a fair appraisal of the business' assets, including goodwill and the business' demonstrated earning capacity.[52] The Regulations further require the executor to assess the company's net worth, prospective earning power, and dividend-paying capacity.[53]

b. Real Property Valuation

The basic principles affecting the fair market value appraisal of real property are varied and interrelated.[54] The primary consideration

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51. *See* Estate of Maddock v. Commissioner, 16 T.C. 324 (1951). In *Estate of Maddock*, the decedent was a partner in a mill and industrial supply store. *Id.* at 324. The Commissioner valued the decedent's partnership interest at $567,000, although a witness for the Commissioner valued the interest at only $457,000. *Id.* at 332. In contrast, witnesses for the estate valued the interest at $234,000 and $225,000. *Id.* The court noted that the Commissioner received a ten year earning period that contained a seven year period of abnormally high activity. *Id.* at 331. The court determined that Maddock & Company had no unique characteristics and little goodwill. *Id.* at 330. The court held that the amount determined by the partnership agreement of $256,085 represented the most accurate value for the decedent's partnership interest. *Id.* at 332. The court further suggested that if the decedent sold his interest, he could not have received more than the price fixed under his partnership buy-out agreement. *Id.*

52. Treas. Reg. § 20.2031-3(a), (b) (as amended in 1974). In *United States v. Land*, a closely held company lost two of its operating partners within a few months of each other. 303 F.2d 170, 171 (5th Cir. 1962). A partnership agreement provided that at the death of a partner, the surviving partner could purchase the deceased partner's interest at its full value. *Id.* Although the remaining partners could buy out a partner at two-thirds of the full value of the partner's interest, a partner's death foreclosed this option. *Id.* at 175. Therefore, the court held that the gross estate must value the partnership interest at its full value. *Id.* To support this holding, the court pointed out that a potential purchaser will subtract from his bid the loss to the company occasioned by the death of an important partner. *Id.* at 173; *see also Maddock*, 16 T.C. at 330 (noting that loss of dominate partner would impact business ability and goodwill attributable to partner's presence).

53. Treas. Reg. § 20.2031-2(f)(2) (as amended in 1974). The Regulations also include other relevant factors, such as:

> the economic outlook in the particular industry; the company's postion in the industry and its management; the degree of control of business represented by block of stock to be valued; and values of securities of corporations engaged in same or similar lines businesses which are listed on a stock exchange.

Id. The regulations also require the executor to consider prospective earning power, dividend-earning capacity, and life insurance policies payable to the company. *Id.*

54. MARTHA R. WILLIAMS & WILLIAM L. VENTOLO, JR., FUNDAMENTALS OF REAL ESTATE APPRAISAL 53 (6th ed. 1994). These principles include substitution, highest and best use, externalities, supply and demand, conformity, progression and regression, anticipation, balance, and contribution. *Id.* at 53-59; *see also* Estate of Huntington v. Commissioner, 36 B.T.A. 698, 704 (1937) (noting that transcript testimony on value of real estate in gross estate contained real estate description, location, size, boundaries, contours, state of improvements or lack thereof, water supply and transportation facilities or lack thereof, highest and best use, sales of adjoining properties, trends of sales prices in real estate, and salability or lack thereof).

is the highest and best use—the property's most profitable function.[55] In making this determination, property appraisers consider whether the property's use is physically possible, legally permissible, economically feasible, and maximally productive.[56] For example, commercial property may be underimproved if used for residential purposes.[57] Conversely, the property might be overimproved if used for commercial purposes after the area has been rezoned for private residences.[58] If property could be used for other purposes, the appraiser must consider its highest estimated financial return.[59]

To arrive at the highest estimated financial return, the appraiser may use the income capitalization approach. This approach recognizes that for rental property, the potential future net rental income is the main benefit to the owner.[60] Under this approach, the appraiser first estimates the gross income from all the property's potential sources.[61] Market rent is a property's rent potential or the amount for which the property should rent.[62] This estimate may be higher or lower than the actual rent the owner receives.[63] Specific income approaches, such as the direct capitalization approach and the yield capitalization approach, convert expected property income into a value estimate.[64]

c. Date of the Estate's Valuation

An estate can be valued on either the date of the decedent's death or on an alternative date up to six months after the date of death. For

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55. WILLIAMS & VENTOLO, JR., *supra* note 54, at 54; *see also* ALFRED A. RING, THE VALUATION OF REAL ESTATE 32 (2d ed. 1970) ("[A] site can have only *one* highest and best use at any given time.") (emphasis in original).

56. WILLIAMS & VENTOLO, JR., *supra* note 54, at 200; *see also* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, GUIDE FOR THE USE OF REAL ESTATE APPRAISAL INFORMATION 6 (1987).

57. WILLIAMS & VENTOLO, JR., *supra* note 54, at 201. The property would be nonconforming, but usually legal, if used for residential purposes prior to the enactment of the ordinance. *Id.*

58. WILLIAMS & VENTOLO, JR., *supra* note 54, at 201.

59. WILLIAMS & VENTOLO, JR., *supra* note 54, at 202; *see also* Estate of Huntington v. Commissioner, 36 B.T.A. 698, 716 (1937) (noting testimony that best potential use of platted real estate was for service stations, bungalow courts, or apartment houses).

60. WILLIAMS & VENTOLO, JR., *supra* note 54, at 263. This approach is based on the premise that a relationship exists between the income property can earn and the property's value. *Id.* Thus, this approach is most useful for income-producing investments. *Id.*

61. WILLIAMS & VENTOLO, JR., *supra* note 54, at 264.

62. WILLIAMS & VENTOLO, JR., *supra* note 54, at 267.

63. WILLIAMS & VENTOLO, JR., *supra* note 54, at 267. For instance, contractual rental agreements may bind the landlord to lower rent than he could otherwise receive. RING, *supra* note 55, at 208.

64. WILLIAMS & VENTOLO, Jr., *supra* note 54, at 302. The direct capitalization approach converts income for a single annual period into a value estimate. *Id.* The yield capitalization approach reviews the expected income flow for a number of years plus the expected gain or loss to be realized upon the sale of the property to arrive at value. *Id.*

an estate choosing the alternate valuation date, the Code provides guidance for income earned by the estate subsequent to the date of the decedent's death.[65] For leased property, Regulation § 20.2032-1(d)(2) includes in the gross estate value both the value of the leased property and the rents accrued to the date of death.[66] The Regulations direct the estate to exclude any rent accrued after the date of death and the subsequent valuation date.[67] The estate may also exclude interest income accrued after the date of death and before the alternate valuation date.[68] If a company declares ordinary dividends out of its earnings and profits after the decedent's death, the estate may exclude the dividends from the gross estate value.[69]

In *Maas v. Higgins*,[70] the estate executor elected to value the gross estate on the alternate valuation date.[71] The Internal Revenue Service Collector added to the gross estate valuation accrued income from rents, dividends, and interest earned by the estate after the decedent's death.[72] The Collector contended that this income consisted of payments on account of principal and that the income payments reduced this principal.[73] Because the estate values the capital assets at the end of the period, the Collector argued that the income amount must be added to the corpus to reflect its true value.[74] The Collector modified this argument before the Supreme Court, contending that an asset consists of two elements: "one the right of ownership the other the right to receive income."[75]

The Supreme Court recognized that rent or interest accrued at the date of death is properly treated as a capital asset, but rent collected

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65. The executor, at his election, may value the gross estate as of six months after the date of death. I.R.C. § 2032(a) (1988). In the case of election, property sold, distributed, exchanged or otherwise disposed of within six months of death shall be valued as of the date of distribution, date of exchange, or date of disposal. *Id.* § 2032(a)(1). Property retained by the decedent shall be valued six months after the date of death. *Id.* § 2032(a)(2). For interest bearing obligations, such as bonds or notes, both principal and interest are subject to the tax. Treas. Reg. § 20.2032-1(d)(1) (as amended in 1984). For purposes of the charitable and marital deduction, any interest passing shall be valued as of the date six months after the date of death. I.R.C. § 2032(b). The alternate valuation date can be taken only if it decreases the value of the gross estate and the sum of the estate tax. *Id.* § 2032(c). The executor must make the election in a timely fashion or potentially lose the alternate valuation date. *Id.* § 2032(d).

66. Treas. Reg. § 20.2032-1(d)(2) (as amended in 1984).

67. *Id.*

68. *Id.* § 20.2032-1(d)(1).

69. *Id.* § 20.2032-1(d)(4).

70. 312 U.S. 443 (1941).

71. *Id.* at 444.

72. *Id.*

73. *Id.* at 446-47.

74. *Id.* at 447.

75. *Id.*

from the same sources after death is treated as income.[76] The Court noted that living persons do not treat income as principal, nor does the promise to pay income have a market value apart from the asset.[77] Instead, the estate values the asset in its entirety, considering future income as one of many elements.[78] The Court, therefore, held that an estate need not add income earned after the decedent's death to the gross value of the estate.[79]

2. Administration Expenses

Because a decedent's estate remains open following the decedent's death, one of the first duties of an estate executor is to prevent the waste of estate assets during administration.[80] The Regulations define the period of administration as "the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests."[81] The Code allows a deduction for administration expenses that "are allowable by the laws of the jurisdiction . . . under which the estate is being administered."[82] The Regulations de-

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76. *Id.* (noting that, had Congress chosen, it could have easily directed different property valuation methods between date of death and alternate valuation date).

77. *Id.*

78. *Id.*

79. *Id.* (noting that Constitution does not forbid double taxation, but intent to impose it is not presumed).

80. Brown v. Commissioner, 74 F.2d 281, 285 (10th Cir. 1934) (holding estate taxes are administration expenses because they are incurred to prevent accrual of penalties and interest against estate); *see also* Brewster v. Gage, 280 U.S. 327, 329 (1930) (noting that at common law, "title to personal property not specifically bequeathed, together with the possession, right to collect income therefrom and power to sell, passes to the [estate] executor or administrator and not to the residuary legatees").

81. Treas. Reg. § 1.641(b)-3 (as amended in 1960). For problems encountered in administration, *see* Estate of Warren v. Commissioner, 93 T.C. 694 (1989), *rev'd*, 981 F.2d 776 (5th Cir. 1993). In 1983, Ms. Warren died testate owning an undivided 50% interest in her former husband's oil and gas partnership. *Id.* at 697. The Warren estate had property and administrators in Texas, Louisiana, and Colorado. *Id.* at 700-01. Multiple third parties asserted $90 million in claims against the estate, making it difficult to determine if the estate was solvent. *Id.* at 704. Creditors of the partnership pressured the estate to issue notes and guarantees immediately or risk losing all estate assets. *Id.* at 700. Attempting to recover and protect assets, the estate fought sixteen suits, many involving cross-claims and counterclaims. *Id* at 704. The estate incurred substantial administrative expenses in fighting these lawsuits. *Id.* In 1987, the 32 competing parties entered a settlement agreement. *Id.* The court held that the estate had incurred reasonable administrative expenses in light of the difficulty in settling the estate. *Id.*; *see also* First Nat'l Bank of Topeka v. United States, 233 F. Supp. 19, 29 (D. Kan. 1964) (holding that attorney's fee of $100,000 was allowable and that seven years during which estate was open reflected administrative problems).

82. I.R.C. § 2053(a)(2) (1988). The Code does not define "administration expenses." *Id.* The 1954 Code replaced the 1939 Code wording of "as are allowed" with "allowable." When determining the deductibility of an administration expense, however, federal law sets the outside parameters of "reasonableness" and the meaning of "administration expense." Pitner v. United

fine administrative expenses as expenses "actually and necessarily incurred in the administration of the decedent's estate."[83] Administrative expenses include executor's commissions,[84] attorney's fees,[85] and miscellaneous expenses.[86] Courts also have allowed the deduction of underwriter fees,[87] special guardian services,[88] sales commissions,[89] brokerage

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States, 388 F.2d 651, 659 (5th Cir. 1967). If a state has no law regarding administration expenses or fails to adequately represent the interests of the federal government in collecting taxes, federal law controls the deductibility of the expense. *Id.* The Fifth Circuit stated:

> [I]t is not enough that the deduction be allowable under state law. It is necessary as well that the deduction be for an 'administration expense' within the meaning of that as it is used in the statute, and that the amount sought to be deducted be reasonable under the circumstances.

Id. In United States v. Stapf, 309 F.2d 592 (5th Cir. 1962), *rev'd*, 375 U.S. 118 (1963), the Fifth Circuit noted that federal law incorporates state law. *Id.* at 602. Similarly, in Morgan v. Commissioner, 309 U.S. 78 (1940), the Court noted that "state law creates legal interest and rights." *Id.* at 80. "The federal revenue acts designate what interests or rights, so created, shall be taxed." *Id.* In *Estate of Britenstool v. Commissioner*, a beneficiary advanced over $20,000 in personal funds to pay the testator's expenses before his death. 46 T.C. 711, 712 (1966). The Tax Court noted that before death the decedent had sufficient funds to reimburse the beneficiary. *Id.* The Tax Court held that the estate could deduct the payments as administration expenses, accepting the New York Surrogate Court's acceptance as establishing the allowability of the claim under state law. *Id.* at 717. The Tax Court also allowed the estate to deduct two months rent paid pursuant to the decedent's lease because the local court accepted the expense. *Id.* at 719.

83. Treas. Reg. § 20.2053-3(a) (as amended in 1988); *see* Estate of Love v. Commissioner, 923 F.2d 335, 339 (4th Cir. 1991) (holding that acquisition of one-half interest in horse fetus for foal-sharing agreement did not fit into sort of administrative expense contemplated by statute).

84. Treas. Reg. § 20.2053-3(b) (as amended in 1979). Executor's commissions include the amount actually paid or the amount reasonably expected to be paid. *Id.*

85. *Id.* § 20.2053-3(c). "The executor or administrator, in filing the estate tax return, may deduct such an amount of attorney's fees as has actually been paid or an amount which at the time of filing may reasonably be expected to be paid." *Id.; see* DeNiro v. United States, 561 F.2d 653, 658 (6th Cir. 1977) (holding that attorney's fees in estate tax refund suit were deductible although estate never administered because testator died intestate); *see also Pitner*, 388 F.2d 652 (5th Cir. 1967) (holding that attorney fees and related expenses in establishing right to estate without administration of written will were deductible as administrative expenses).

86. Treas. Reg. § 20.2053-3(d) (as amended in 1979). Miscellaneous expenses include court costs, surrogates' fees, accountants' fees, appraisers' fees, and clerk hire. *Id.*

87. Estate of Joslyn v. Commissioner, 566 F.2d 677, 679 (9th Cir. 1977) (holding that $366,500 in underwriter fees approved by probate court and used to sell particular asset for payment of administration expenses deductible as administration expense); *see also* Estate of Jenner v. Commissioner, 577 F.2d 1100 (7th Cir. 1978) (holding that $945,000 paid to underwriters for sale of stock deductible as administration expenses).

88. Estate of Ruxton v. Commissioner, 20 T.C. 487, 495 (1953) (holding $2,500 of special guardian services deductible for trusts prior to final accounting by executors).

89. Estate of Smith v. Commissioner, 510 F.2d 479, 482 (2d Cir.), *cert. denied*, 423 U.S. 827 (1975). In *Smith*, the co-executors faced liquidating an estate comprised of 425 sculptures created by the decedent, and accounting for over 93% of the value of his estate. *Id.* at 480. The co-executors opted to pay an art gallery $1,602,644 in commission fees to sell the art work over a long period, rather than flooding the market and reducing the value of the art. *Id.* at 482. The court found only $750,447 of the requested $1,602,644 commission fees deductible as necessary to pay the expenses and to conserve the estate. *Id.* The court noted that income generated by the $750,447 in sales commissions was sufficient to pay expenses, debts, and taxes and conserve the

fees,[90] and estate taxes.[91] An estate, however, may not deduct expenses incurred for the benefit of heirs, legatees, and devisees.[92] An estate can incur and deduct a large amount in administration expenses.

3. Marital Deduction

In addition to the deduction for administration expenses, a second important estate deduction is the marital deduction. In 1948, Congress enacted the marital deduction, recognizing that the difference between property rights in community property and non-community property states resulted in inequalities for estate tax purposes.[93] In community property states, couples have an undivided one-half interest in the community property.[94] In common-law states, neither spouse has an undivided interest in the property of the other spouse.[95] In 1942, Congress attempted to equalize the two systems.[96] Congress amended the estate tax to include all community property in the estate of the first to die,

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estate. *Id.* The court, therefore, held that $750,447 was all that was necessary, as required by the New York statute. *Id.*

90. Estate of Park v. Commissioner, 475 F.2d 673, 674 (6th Cir. 1973) (holding brokerage fees deductible as administrative expense when paid by administrator to sell unwanted cottage decedents); *see also* Scott v. Commissioner, 69 F.2d 444, 445 (2d Cir. 1934) (holding commissions paid to sell real estate allowable as administration deduction).

91. Brown v. Commissioner, 74 F.2d 281, 284 (10th Cir. 1934) (holding property taxes during estate administration deductible as administrative expense on estate return).

92. *Id.* In *Hibernia Bank v. United States*, Hibernia, as administrator of Celia Clark's estate, decided to liquidate the Hillsborough mansion owned by the testator. 581 F.2d 741, 742 (9th Cir. 1978). During the seven year period that Hibernia tried to locate a buyer, the mansion incurred $60,000 a year in maintenance costs. *Id.* In order to pay these expenses, Hibernia executed two loans to the estate, through itself, totalling $625,000. *Id.* The bank also executed two more loans for $150,000 and paid yearly interest of $196,210 on the four loans. *Id.* As long as Hibernia did not draw from the corpus of the estate to pay principle, the bank continued to receive interest for $133,241 on its loans. *Id.* at 742 n.1. The court found that the executor kept the estate open much too long and implied that the heirs wished to have cash rather than the mansion. *Id.* at 743. The court, therefore, did not allow the estate to deduct the interest on the loans. *Id.* at 747. *But see Estate of Park*, 475 F.2d at 674 (noting that Code § 2053(a) does not require distinction between beneficiary's benefit and estate's benefit and general dual benefit to both).

93. REVENUE ACT OF 1948, S. REP. NO. 1013, 80th Cong., 2d Sess. 24-26 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1163, 1222. "The marital deduction is a deduction allowed upon the transfer of property from one spouse to another. The deduction is allowed under the Federal gift tax for lifetime transfers and also under the Federal estate tax for testimemtary transfers." BLACK'S LAW DICTIONARY 968 (6th ed. 1990). Prior to 1948, residents in community property states enjoyed a tax advantage not available to residents of common law states. First Nat'l Exchange Bank of Roanoke v. United States, 217 F. Supp. 604, 607 (W.D. Va. 1963), *aff'd*, 335 F.2d 91 (4th Cir. 1964). When a wealthy man died in a community property state, the government would tax only one-half of his estate, because the other half belonged to his wife. *Id.* At his wife's death, the government would then tax the remaining one-half. *Id.* From a tax standpoint, splitting the estate resulted in two smaller estates and thus, a lower tax. *Id.*

94. REVENUE ACT OF 1948, S. REP. NO. 1013, 80th Cong., 2d Sess. 24-26 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1163, 1222.

95. *Id.* In these states, the wealth usually resides in the husband.

96. *Id.*

unless the surviving spouse could show that he or she owned the property separately.[97] This provision placed a heavy evidentiary burden on the surviving spouse to trace separate property.[98] The amendment also required that at least one-half of the value of the community property be included in the decedent's estate, regardless of its source.[99] This rule caused problems because the decedent could only dispose of one-half of the property, but was taxed on the entire estate.[100] The Revenue Act of 1948 repealed the 1942 amendments.[101]

The 1948 Revenue Act created a marital deduction that was the greater of $250,000, or fifty percent of the decedent's gross estate for property passing outright from the decedent to the surviving spouse.[102] In the Economic Tax Recovery Act of 1981, Congress enacted the unlimited marital deduction.[103] Congress increased the marital deduction in order to tax the husband and wife as one economic unit, thus not imposing a tax on transfers between husband and wife.[104]

With the advent of the marital deduction, the Code moved away from valuing the asset in the hands of a decedent and instead focused upon the destination of the asset and the nature and value of the interest passing to the beneficiary.[105] Code § 2056(a) provides that the executor shall reduce the gross estate by an "amount equal to the value of any interest which passes from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the

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97. *Id.* Even if the wife generated none of the community property, at least one-half would be included in her estate. *Id.*

98. *Id.*

99. *Id.* (noting that in community property states, at least one-half of value of community property is transferred on death of either spouse).

100. *Id.*

101. *Id.* at 27.

102. *Id.*

103. Economic Tax Recovery Act of 1981, Pub L. No. 97-34, § 403, 95 Stat. 299, 301 (1981).

104. *Id.*

105. Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1583 (1987). Dean A. Chenoweth died in 1982, leaving 51% of his stock to his wife and 49% of his stock to his daughter. *Id.* at 1579. The estate and the Commissioner did not dispute the value of the entire company stock because the decedent owned 100% of the stock. *Id.* The court assumed that the estate included an element of value because of this control, but the estate could not value the 51% controlling interest passed to the surviving spouse in a mechanical fashion. *Id.* at 1588. The court concluded that while the two beneficiaries could not receive more than the gross value included in the estate, the estate could consider the additional element of controlling value when calculating the marital deduction. *Id.* at 1589; *see also* Ahmanson Found. v. United States, 674 F.2d 761, 772 (9th Cir. 1981); Provident Nat'l Bank v. United States, 581 F.2d 1081, 1091 (3d Cir. 1978) (holding that estate can calculate only one equity interest in stock which must be used in calculating gross estate and marital deduction).

value of the gross estate,"[106] whether by trust[107] or bequest.[108] The

106. I.R.C. § 2056(a) (1988). If the decedent's estate distributes the property to a surviving spouse but does not include the value of that property in the gross estate, it may not deduct the amount of the property as a marital deduction. Treas. Reg. § 20.2056(a)-2(b)(1) (as amended in 1958). Also, an interest that the estate has already deducted as an expense or indebtedness cannot be added to the surviving spouse's property interest and deducted again in the marital deduction. *Id.* § 20.2056(a)-2(b)(2). For instance, if the estate pays the surviving spouse commissions for executor duties, the estate cannot deduct these costs as administration expenses and also add the payments to the property passing to the surviving spouse so that it might include the commissions in the marital deduction. *Id.* In *Stapf v. United States*, a decedent in a community property state authorized his surviving spouse to choose between a community property distribution of one-half of the estate, or a distribution pursuant to his will, in which case the will would negate her community interest. 375 U.S. 118, 120 (1964). If Mrs. Stapf chose to take under the will, she would receive one-third of the community property and one-third of her husband's estate. *Id.* Mrs. Stapf's one-half interest in the community property would then pass in trust for the Stapf children. *Id.* at 121. Further, if Mrs. Stapf chose to take under the will, the executors were to pay all and not merely one-half of the community debts and administration expenses. *Id.* at 121. Mrs. Stapf elected to take under the will and received approximately five thousand dollars less than she would have acquired under a community property distribution. *Id.* at 121-22. The executors of the estate claimed Mrs. Stapf's full community property share as a marital deduction, as well as all of the claims against the estate and all of the administrative expenses. *Id.* at 122. The Commissioner disallowed the full marital deduction as well as one-half of the claims against the estate and 35% of the administrative expenses. *Id.* The United States Supreme Court agreed with the Commissioner. *Id.* The Court found that Mrs. Stapf had taken a one-third interest in property and surrendered a one-half interest for the benefit of her children. *Id.* at 122 n.6. The Court noted that Mrs. Stapf received no net benefit from the estate because she acquired the full community property share only as a condition of giving a larger share of the estate to the children. *Id.* The Court focused on interpreting the valuation provision of § 812(e)(1)(A) of the Code. *Id.* at 123. Section 812(e)(1)(A) states that when considering the value of any interest in property passing to the surviving spouse any "obligation imposed by the decedent with respect to the passing of such interest, such incumbrance 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." I.R.C. § 812(e)(1)(A) (as renumbered § 2056(b)(4)(B) (1988)). The lower court noted that pursuant to an inter vivos gift analysis, the detriment incurred would not ordinarily reduce the amount of the gift taxable to the husband. *Stapf*, 375 U.S. at 124. The Supreme Court disagreed, holding that the lower court failed to apply the entire statute to the case. *Id.* at 125. The Court noted that the statute provided for a marital deduction for gifts passing to the spouse, not to other beneficiaries. *Id.* Therefore, the Court held that the important value is the net value of the gift received by the surviving spouse. *Id.* The Court also noted that the only thing the surviving spouse actually received was the interest bequeathed to her over and above the community property and this would be the amount qualifying as a marital deduction. *Id.* at 127.

107. The Regulations define a trust as a testamentary arrangement in which the trustee holds legal title to the property and conserves the title for the beneficiaries. Treas. Reg. § 301.7701-4(a) (as amended in 1958). A decedent may establish a testamentary trust that pays a sum of money at regular intervals to his spouse and, following the death of his spouse, distributes the remaining trust property to a charity or to another beneficiary. Florida Bank at Lakeland v. United States, 443 F.2d 467 (5th Cir. 1971). The Code provides that an estate may take a marital deduction for property in which the surviving spouse has only a lifetime income interest. I.R.C. § 2056(b)(5) (1988). According to the Regulations, this type of property interest has to meet five elements in order to be deductible: (1) the spouse must be entitled for life to all of the income from the entire estate; (2) income payable to the surviving spouse must be payable annually or more frequently; (3) the surviving spouse must have the ability to appoint the entire interest to herself or to her estate; (4) the power to exercise must be exercisable by her alone and in all situations; and (5) no one else must have the ability to appoint any part of the interest to any

Code further provides that, for an allowable deduction, the value of any property passing to the surviving spouse shall take into account any estate, succession, legacy, or inheritance tax.[109] The Code also requires that:

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other person. Treas. Reg. § 20.2056(b)-5(a) (as amended in 1958); *see* Estate of Smith v. Commissioner, 66 T.C. 415, 427 (1976) (holding that trust met all five elements and was therefore deductible).

108. A decedent may make four types of bequests to his surviving spouse. A specific bequest can be described with particularity, allowing it to be distinguished from all of the testator's other property. Hurt v. Smith, 744 S.W.2d 1, 4 (Tex. 1987); *see also* Kenaday v. Sinnott, 179 U.S. 606, 617 (1900) (holding $12,000 of $15,500 bonds as specific bequest); Matthews v. Matthews, 477 So. 2d 391, 393 (Ala. 1985) (finding that 150 shares of stock testator possessed at execution of will bequeathed to ex-wife described sufficiently to distinguish them from any other property, and therefore were specific bequest); Dabney v. Estes, 204 S.E.2d 387, 387 (S.C. 1974) (leaving specific bequest of automobile and bank account); Estate of Ehrenfels, 50 Cal. Rptr. 358 (Cal. Ct. App. 1966) (determining bequest of 150 shares of Standard Oil stock to be specific rather than general because stock was named specifically in will and included sufficient number of shares to cover bequest). A demonstrative bequest is property which cannot be described specifically, but which is to be charged primarily to a fund or piece of property. *Hurt*, 744 S.W.2d at 4 (describing sums of money intended to be charged primarily to fund or piece of property). A general bequest is described as a designated quantity or value of property or money that the testator wished to be satisfied out of general rather than specific assets. *Id.*

A residual bequest includes everything remaining in the estate following the payment of debts and legal charges, as well as the satisfaction of specific, general, and demonstrative gifts. *Id.*; *see also Dabney*, 204 S.E.2d at 387, 388-89 (holding that "[a]ny further real or personal property residual, I give, devise, and bequeath same to George W. Mosley" referred to remaining property after all debts and bequests have been made).

109. I.R.C. § 2056(b)(4)(A) (1988). For instance, if the surviving spouse inherits $100,000, but the spouse had to pay state inheritance taxes of $1,500, the tax reduces the amount the estate can deduct as a marital deduction to $98,500. Treas. Reg. § 20.2056(b)-4(c) (as amended in 1958).

In 1983, James Fine's will directed that all taxes should be paid out of his residual estate without apportionment. Estate of Fine v. Commissioner, 90 T.C. 1068, 1070 (1988), *aff'd*, 885 F.2d 879 (11th Cir. 1989). He also provided that as soon after death as practicable, his estate should pay his debts and funeral expenses. *Id.* He further directed that his estate executor could not reduce the marital deduction for any reason. *Id.* The executor, therefore, claimed the marital deduction without subtracting any administration expenses or taxes. *Id.* The Commissioner issued an estate tax deficiency notice requiring the executor to reduce the marital deduction by the amount of the administrative expenses and taxes. *Id.* With regard to estate taxes, the court noted that Virginia required the estate to apportion estate taxes between beneficiaries, and each person would then have the benefit of any deduction of the property passing to him. *Id.* at 1072 (citing VA CODE ANN. § 64.1-161 (1987)). The court recognized that the statute also gave the testator the ability to change the apportionment, and if he clearly did so, the testator's will controlled. *Id.* The court noted that the Virginia statute already protected the marital deduction from apportionment; however, the decedent's inartfully drawn will had removed the marital deduction residuary from this protection. *Id.* at 1075. The testator had also devised to his wife his residence free and clear of all debt. *Id.* at 1068. The court held this was a specific bequest that passed to Ms. Fine unreduced by taxes. *Id.* at 1075-76. The court, however, noted that the Virginia Supreme Court required the estate to pay all debts before distributing bequests, unless otherwise specified. *Id.* at 1077. Thus, the estate would have to pay administration expenses out of the residuary estate before distributing the marital property, thereby reducing the marital property by the administration expenses. *Id.*

> 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.[110]

The Treasury Regulations also require the estate to consider any material limitations upon the surviving spouse's right to income from the property when valuing the surviving spouse's interest.[111]

The Regulations require the estate to value the marital deduction "in the same manner as if the amount of a gift to such spouse of such interest were being determined."[112] Thus, estates look to gift tax law for direction. The Regulations address the availability of the marital deduction for gift tax purposes when a surviving spouse receives an income-producing trust.[113] These gift tax Regulations provide that the trust qualifies for the deduction if it provides the spouse with "substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trust accord to a person who is unqualifiedly designated as the life beneficiary of a trust."[114] The surviving spouse receives that "degree of enjoyment" if the trust produces income or gives the spouse use of the trust property consistent with the value of the trust corpus and with its preservation.[115]

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110. I.R.C. § 2056(b)(4)(B) (1988). The Regulations provide an example of this rule for an estate using trust income from the surviving spouse's property to pay administration expenses. Treas. Reg. § 20.2056(a)-2(b)(2) (as amended in 1958). The Regulations also give guidance when a mortgage encumbers property passed to a surviving spouse. *Id.* § 20.2056(b)-4(b). The Regulations provide a general rule that the mortgage value reduces the property interest passing to the surviving spouse. *Id.* If the executor, however, pays the debt out of other assets or reimburses the surviving spouse, the spouse adds the payment or reimbursement to her marital deduction. *Id.* For instance, if a decedent devises property worth $25,000 to his wife instructing her to pay his sister $5,000, the wife can only deduct $20,000 for the marital deduction. *Id.* The Supreme Court frequently gives great weight to interpretative regulations of the Treasury Department, especially when supported by declarations of Congressional intent. United States v. Stapf, 375 U.S. 118, 127 n.11 (1963).

111. Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958).

112. *Id.* § 20.2056(b)-4(b).

113. Treas. Reg. § 25.2523(e)-1(f) (as amended in 1961). Code § 2056(b)(5) defines a life estate with the power of appointment as an interest in property entitling the surviving spouse to receive income for life from the entire interest with no restriction on her ability to appoint it to herself or her estate. I.R.S. § 2056(b)(5)(1988); *see also* Treas. Reg. § 20.2056(b)-5(f) (as amended in 1958).

114. Treas. Reg. § 25.2523(e)-1(f)(1) (as amended in 1961). The testator can adequately meet this requirement by designating his spouse as sole income beneficiary for life or as beneficiary of a specific portion of the entire interest. *Id.*

115. *Id.*

4. Charitable Deduction

In contrast to the marital deduction, the method of determining the amount of the charitable deduction is easily calculated. Code § 2055 allows a deduction from the gross estate for bequests and other transfers to qualifying recipients for public, charitable, religious, and other comparable purposes.[116] To qualify for a deduction, the decedent must make a valid transfer during life or at death to a qualified recipient or for a qualified purpose.[117] Like the marital deduction, the amount of the charitable deduction shall not exceed the value of the transferred property required to be included in the gross estate.[118] Similarly, the estate must reduce the charitable deduction by any estate, succession, legacy, or inheritance taxes paid out of the property.[119] If the decedent created a trust and transferred the property for both private uses and charitable uses, the estate can take a deduction for the charitable portion only if it can value that portion.[120]

5. Estate Tax Payable

After determining the amount of the administrative expense deducation, the charitable deduction, and the marital deduction, the executor determines the taxable estate. As a final step, the executor determines the estate tax payable.[121] The Internal Revenue Code requires the estate executor to pay the estate tax.[122] The Code, however, does

116. I.R.C. § 2055(a) (1988). Deductible bequests, legacies, devises, or transfers include those made to the United States, any State, any political subdivision, or the District of Columbia if used exclusively for public purposes. *Id.* § 2055(a)(1). Also, bequests, legacies, devises, or transfers to "corporation[s] organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" are deductible. *Id.* § 2055(a)(2).

117. Treas. Reg. § 20.2055-1(a) (as amended in 1958); *see* Estate of Lamson v. United States, 338 F.2d 376, 378 (Ct. Cl. 1964) (holding that testator who left $20,000 to his son, a priest, who he knew would transfer money to religious order, did not constitute charitable bequest because charity had its contractual rights with son, not father).

118. I.R.C. § 2055(d) (1988); *see* Ahmanson Found. v. United States, 674 F.2d 761, 767-70 (9th Cir. 1981).

119. I.R.C. § 2055(c). In 1956, Charles Loridans died, leaving his residual estate to a qualified charitable foundation. Alston v. United States, 349 F.2d 87, 88 (5th Cir. 1965). Mr. Loridans did not specify from which source the estate should pay burial and cemetery upkeep, payments of debts, various legacies, or taxes. *Id.* Georgia law required that debts of the testator shall be paid out of the residue of the estate. *Id.* The executors charged administrative expenses against income earned by the estate during administration, not against principal. *Id.* The court held that Georgia law required the estate to pay administrative expenses out of the estate as a pre-residue deduction. *Id.* at 89. Further, the court held that whether the executors charged administrative expenses to income or principal was insignificant because of clear statutory language. *Id.*

120. Treas. Reg. § 20.2055-2(a) (as amended in 1986); *see* Fort Worth Nat'l Bank v. United States, 396 F. Supp. 337 (N.D. Tex. 1975), *aff'd*, 552 F.2d 158 (5th Cir. 1977).

121. Treas. Reg. § 20.0-2(b)(5) (as amended in 1958). The Code also allows the credits to be applied against the estate tax payable. *Id.* Credits, however, are beyond the scope of this Note.

122. I.R.C. § 2002 (1988).

not designate the source from which the estate tax shall be paid. Thus, most states have answered the issue statutorily, apportioning estate taxes between different beneficiaries.[123] The vast majority of states require that all distributees and legatees bear a share of taxes proportionate to their distribution.[124] These same statutes allow the testator the option of charging specific beneficiaries with the entire estate tax.[125] For example, Kansas provides an order of priority for property bearing the estate tax that becomes effective if the decedent fails to provide for a system of payment in the will.[126] In contrast, Alabama requires the executor to charge the entire estate tax against the residue[127] unless the testator has otherwise provided for payment by will.[128]

B. Federal Income Tax Liability

Code § 1(e) imposes a tax on the taxable income of every estate and trust.[129] An estate or trust is taxed in essentially the same manner as an individual.[130] Estates or trusts also receive essentially the same

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123. *See* ARK. CODE ANN. § 26-51-406 (Michie 1992); ALASKA STAT. § 13.16.610 (1985); CAL. PROB. CODE § 20110-20117 (Deering 1991 & Supp. 1994); COLO. REV. STAT. § 15-12-916 (1989); DEL. CODE ANN. tit. 12, § 2901 (1987); HAW. REV. STAT. § 236A-2 (1986); IDAHO CODE § 15-3-916 (1979 & Supp. 1994); IND. CODE ANN. §§ 29-2-12-2 to -7 (West 1994); LA. REV. STAT. ANN. § 9:2432 (West 1991); ME. REV. STAT. ANN. tit. 18-A, § 3-916 (West 1981 & Supp. 1993); MD. CODE TAX-GEN. ANN. § 7-308(b), (c) (1988); MICH. COMP. LAWS §§ 720.12-.13 (1993); MINN. STAT. § 524.3-916 (Supp. 1994); MONT. CODE ANN. §§ 72-16-603 to -604 (1993); NEB. REV. STAT. § 77-2108 (1990); NEV. REV. STAT. ANN. §§ 150.310-.330 (Michie 1993); N.H. REV. STAT. ANN. §§ 88-A:2 to -A:3 (1992); N.J. REV. STAT. § 3B:24-4 to -8 (1983 & Supp. 1994); N.M. STAT. ANN. § 45-3-916 (Michie 1993); N.C. GEN. STAT. § 28A-27-2 (1993); N.D. CENT. CODE § 57-37.1-09 (1993); OHIO REV. CODE ANN. § 2113.86 (Anderson 1994); OR. REV. STAT. §§ 116.313-.323 (1990); 20 PA. CONS. STAT. § 3702 (1993); R.I. GEN. LAWS §§ 44-23.1-2 to-3 (1988); S.C. CODE ANN. § 62-3-916 (Law. Co-op. 1987 & Supp. 1993); S.D. CODIFIED LAWS ANN. § 29-7-1 (1984); TENN. CODE ANN. § 30-2-614 (Supp. 1993); TEX. PROB. CODE ANN. § 322A(b)(1)-(2) (West Supp. 1994); UTAH CODE ANN. § 75-3-916 (1993); VT. STAT. ANN. tit. 32, §§ 7302-7303 (1991); WASH. REV. CODE §§ 83.110.020(1), 83.110.030 (Supp. 1994); W. VA. CODE § 44-2-16a(2) (Supp. 1994); WYO. STAT. § 2-10-103 (Supp. 1994).

124. See statutes cited *supra* note 123.

125. With the exception of North Dakota and West Virginia, see statutes *supra* note 123.

126. KAN. STAT. ANN. § 59-1405 (1984 & Supp. 1993). The order of priority for property bearing the estate tax is: "(1) [p]ersonal property not disposed of by will; (2) real estate not disposed of by will; (3) personal property bequeathed to the residuary legatee; (4) real estate devised to the residuary devisee; (5) property not specifically bequeathed or devised; and (6) property specifically bequeathed or devised." *Id.* Massachusetts provides that, in the absence of testamentary direction, the estate tax shall be paid from the general funds of the estate. MASS. GEN. LAWS ANN. ch. 65A, § 5(1) (West 1988).

127. Residue is defined as the "surplus of a testator's estate remaining after all the debts, taxes, costs of administration, and particular legacies have been discharged." BLACK'S LAW DICTIONARY 1310 (6th ed. 1990).

128. ALA. CODE § 40-15-18 (1993).

129. I.R.C. § 1(e) (1993).

130. Treas. Reg. § 1.641(a)-2 (as amended in 1960). Code § 61 provides a tax on "all income from whatever source derived," including gross income derived from business, gains de-

deductions and credits allowed to individuals.[131] For instance, trustees and executors can deduct charitable contributions.[132] Estates and trusts can also deduct any amount of income required for distribution to beneficiaries as long as the amount is included in the gross income of the estate or trust.[133] The beneficiary of the estate or trust is taxed for the amount required to be distributed.[134] The estate or trust, however, cannot take a deduction for more than its distributable net income.[135] Similarly, a beneficiary is not required to include the entire distribution in his gross income if the amount to be distributed to all beneficiaries exceeds the estate or trust's distributable net income.[136] Regulation § 1.662(c)(4) provides a comprehensive example of how income and expenses are allocated to beneficiaries when the required distribution exceeds distributable net income.[137] The example illustrates that a trust subtracts allowable administrative expenses before determining distributable net income.[138] The beneficiary then calculates his or her gross income based on the trust's distributable net income.[139]

An estate or trust cannot deduct a specific sum of money or specific property which it properly pays or credits under the terms of the governing instrument.[140] A beneficiary also is not required to include this specific sum of money or specific property in his gross income.[141] An amount which can be paid or credited only from the income of an

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rived from dealings in property, interest, rents, royalties, dividends, income in respect of a decedent, and income from an estate or trust. I.R.C. § 61 (1988). For an estate or trust, gross income includes all items of income received during the year, such as: (a) income accumulated for unborn, unascertained persons, or persons with contingent interests; (b) income held for future distribution; (c) income to be distributed currently; (d) income received by estates of deceased persons during administration of the estate; and (e) income, which in the discretion of the administrator, should be accumulated. Treas. Reg. § 1.641(a)-2 (as amended in 1960). The estate fiduciary remains personally responsible for the payment of these taxes during his administration. Treas. Reg. § 1.641(b)-2 (as amended in 1961) (holding fiduciary liable after administration of estate has ended, if he knew of delinquent taxes or failed to pay taxes with due diligence).

131. Treas. Reg. § 1.641(b)-1 (as amended in 1960). Some of the deductions that the Code allows are ordinary and necessary business expenses (§ 162), interest (§ 163) and taxes (§ 164).

132. I.R.C. § 642(c) (1988 & Supp. 1993); *see infra* notes 163-68 and accompanying text.

133. I.R.C. § 661(a) (1988).

134. *Id.* § 662(a). Such amount is taxable to the beneficiary whether or not distributed. Treas. Reg. § 1.662(a)-2(a) (as amended in 1973).

135. I.R.C. § 661(a). "Distributable net income" refers to the taxable income of the estate. I.R.C. § 643(a) (1988 & Supp. 1993).

136. I.R.C. § 662(a)(1) (1988).

137. Treas. Reg. § 1.662(c)(4) (as amended in 1960).

138. *Id.* § 1.662(c)(4)-(c).

139. *Id.* § 1.662(c)(4)-(g), (h).

140. I.R.C. § 663(a)(1) (1988). The specific bequest or gift must be paid in less than three installments. *Id.*

141. *Id.* § 663(a)(1).

estate or trust is not considered as a specific bequest or gift.[142] Additionally, a trust or estate cannot consider the residual estate or the corpus of the trust as a specific bequest.[143]

Similar to individuals, estates and trusts can deduct "all the ordinary and necessary expenses paid or incurred . . . for the production or collection of income."[144] They can also deduct "all ordinary and necessary expenses paid or incurred . . . for the management, conservation, or maintenance of property held for the production of income."[145] The estate or trust must include the income used to pay these expenses in its gross income in order to merit an administrative expense deduction.[146]

1. Administrative Expenses

Congress provides estates and trusts with the option to deduct administrative expenses[147] on the estate tax return[148] or the income tax return,[149] but does not permit a double deduction.[150] In order for an estate to deduct its administration expenses on its income tax return, it must file a statement with its estate tax return waiving its right to take the deductions at any time on its estate tax return.[151] The estate, however, may file its statement "at any time before the statutory period applicable to the taxable year for which the deduction is sought."[152]

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142. Treas. Reg. § 1.663(a)-1(b)(2)(i) (as amended in 1960).

143. *Id.* § 1.663(a)-1(b)(2)(iii).

144. I.R.C. § 212(2) (1988).

145. *Id.*

146. Treas. Reg. § 1.212-1(a)(1) (as amended in 1975).

147. *See supra* text accompanying notes 80-92.

148. I.R.C. § 2053(a)(2) (1988).

149. *Id.* § 212.

150. I.R.C. § 642(g) (1988 & Supp. 1993). Section 2053 allows deductions for funeral expenses, administration expenses, claims against the estate, and unpaid mortgages on any indebtedness. I.R.C. § 2053(a) (1988). Section 2054 allows a deduction for losses incurred during the settlement of the estate. *Id.* § 2054; *see* Burrows Trust v. Commissioner, 39 T.C. 1080, 1090-91 (1963) (noting that § 642(g) conspicuously omits the word "trust").

151. I.R.C. § 642(g) (1988 & Supp. 1993). The 642(g) election allows an estate executor the opportunity to minimize the aggregate taxes paid by the estate. *In re* Estate of Bixby v. Latham, 245 P.2d 68, 74 (Cal. Ct. App. 1956). In *Bixby*, the executor elected to deduct administrative expenses from income, reporting income of $160,000 and paying income tax of $18,728. *Id.* Had the executor not taken the 642(g) election, the estate would have incurred $120,378 in income taxes. *Id.* The decision was unfortunate for the decedent's residuary beneficiaries who paid an additional $58,932 in estate tax. *Id.* at 75. The court held that the difference between the $101,650 ($120,378 - $18,728) saved in income taxes and the $58,932 of additional estate taxes should be reallocated. *Id.* The decedent's spouse received $76,000 in stock dividends which accounted for just less than one-half of the estate's gross income and one-half of the income tax savings. *Id.* at 76. The court, therefore, added $27,887 (approximately one-half of $58,932) to the decedent's corpus. *Id.*

152. Treas. Reg. § 1.642(g)-1 (as amended in 1960).

Once a statement is filed with respect to a particular item or portion thereof, the estate may not change its position.[153]

Federal legislation does not direct estates or trusts to pay administrative expenses from either principal or income. Some states have adopted the Revised Uniform Principal and Income Act,[154] which directs:

> (a) Unless the will otherwise provides and subject to subsection (b), all expenses incurred in connection with the settlement of a decedent's estate, including debts, funeral expenses, estate taxes, interest and penalties concerning taxes, family allowances, fees of attorneys and personal representatives, and court costs shall be charged against the principal of the estate.[155]

Subject to the testator's direction, subsection (b) requires the executor or trustee to apply trustee rules in determining income from assets

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153. *Id.* In *Estate of Darby v. Wiseman*, the executors elected to claim the administrative expenses on the income tax return and filed a waiver with the estate tax return. 323 F.2d 792, 793 (10th Cir. 1963). Later, the executors determined that the administrative expenses would result in no deduction on the income tax return and filed a statement with the Director of the Internal Revenue Service changing their election. *Id.* Although the Internal Revenue Service was reviewing both the estate tax return and the income tax return at the time of the new waiver filing, the Commissioner prohibited the executors from changing the election. *Id.* The executors appealed to the court, claiming they had made a mistake of fact and law. *Id.* at 794. The court noted that the regulations generously permit executors to defer an election until the end of the statutory period. *Id.* The court, however, determined that Congress did not intend for taxpayers to play a game of "last best guess" with the Commissioner in determining tax liability. *Id.* The court thus held that the mistake as to the tax consequences did not entitle the executors to make a second choice regarding their election. *Id.*

154. 7B U.L.A. 145 (1985). The National Conference of Commissioners on Uniform State Laws approved the original Uniform Principal and Income Act in 1931. UNIFORM PRINCIPAL & INCOME ACT, Historical Note, 7B U.L.A. 183, 183 (1985). The Act, however, did not deal with income earned during administration of a decedent's estate. *Id.* at Prefatory Note.

155. REVISED UNIFORM PRINCIPAL & INCOME ACT, 7B U.L.A. § 5(a), at 145, 160 (1985). States adopting similar language include: ARIZ. REV. STAT. ANN. § 14-7405(A) (Supp. 1993); ARK. CODE ANN. § 28-70-105(a) (Michie 1987); CONN. GEN. STAT. ANN. § 45a-218(a) (West 1993); FLA. STAT. ANN. ch. 738.05(1) (Harrison Supp. 1994); IDAHO CODE § 68-1005(a) (1989); KAN. STAT. ANN. § 58-904a(a) (1983); KY. REV. STAT. ANN. § 386.225(1) (Baldwin Supp. 1993); MICH. COMP. LAWS ANN. § 555.55(a) (West 1988); MISS. CODE ANN. § 91-17-11(1) (1994); MONT. CODE ANN. § 72-34-406(1) (1993); NEB. REV. STAT. § 30-3106(1) (1989); NEV. REV. STAT. ANN. § 164.250(1) (Michie 1993); N.M. STAT. ANN. § 46-3-5(A) (Michie 1989); N.Y. EST., POWERS & TRUSTS LAW § 11-2.1(d)(1) (McKinney 1967); OHIO REV. CODE ANN. § 2109.67(A) (Anderson 1994); UTAH CODE ANN. § 22-3-6(1) (1991); WIS. STAT. ANN. § 701.20(5)(a) (West Supp. 1993). Washington qualifies § 5(a) of the Revised Principal and Income Act by requiring the trustee/executor to reimburse the principal from income "for any increase in estate taxes due to the use of administration expenses that were paid from principal as deductions for income tax purposes." WASH. REV. CODE ANN. § 11.104.050(1) (West Supp. 1994). Delaware follows § 5(a) of the Revised Principal and Income Act except that "expenses shall be charged against income to the extent necessary to prevent the abatement of any nonresiduary devise or bequest." DEL. CODE ANN. tit. 12, § 6105(a) (1987).

earned after the decedent's death but not yet distributed.[156] Subsection (c) requires the trustee to treat income received under subsection (b) as income of the trust.[157] Section 4(a) states that an asset of a testamentary trust becomes subject to that trust as of the date of the decedent's death, regardless of the intervening period of administration.[158]

Under the Uniform Principal and Income Act (UPIA), accounting for income during the settlement of a decedent's estate differs from accounting for income during the operation of a trust. During the settlement of an estate, UPIA directs the executor to charge all expenses against the estate's principal.[159] UPIA directs a trustee to charge ordinary expenses incurred in connection with the administration, management, or preservation of trust property against the income of the trust.[160] Further, it directs the trustee to charge one-half of court costs, attorney's fees, and trustee's compensation against the income of the trust.[161] The other one-half of the administrative expenses and extraordinary expenses are to be charged against principal.[162]

2. Charitable Deductions

The Code allows the estate and trust income tax return[163] and the estate tax return[164] to take charitable deductions. Code § 642(c)(1) allows a deduction for any amount of the gross income that is paid under the governing instrument to a qualified charity.[165] Estates utilize the relationship between the estate tax return and the estate income tax return in an attempt to increase the charitable deduction on the estate tax return.

For instance, some estates claim that income earned during the administration of the estate and passed to a charity, not deducted on the estate income tax return, should increase the value of the charitable deduction on the estate tax return.[166] The courts, however, have prohib-

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156. REVISED UNIFORM PRINCIPAL & INCOME ACT § 5(b), 7B U.L.A. 145, 160 (1985).
157. *Id.* § 5(c).
158. *Id.* § 4(a).
159. *Id.* § 5(a) (1962).
160. *Id.* § 13(a)(1).
161. *Id.* §§ 13(a)(3)-(5).
162. *Id.* § 13(c)(1).
163. I.R.C. § 642(c) (1988); *see also id.* § 170(a).
164. *See supra* notes 116-20 and accompanying text.
165. I.R.C. § 642(c)(1). Only certain trusts, such as pooled income trusts, qualify for the charitable deduction on the estate income tax return. *Id.* § 642(c)(3). The various types of charitable trusts, however, are beyond the scope of this Note.
166. Bowes v. United States, 593 F.2d 272, 275 (7th Cir. 1979). In *Bowes*, Lyle Spencer died testate bequeathing over $70 million to the Spencer Foundation. *Id.* at 274. The estate argued that the income earned during administration, over and above the necessary amount to pay administration expenses and taxes, should be added to the charitable deduction. *Id.* at 275. The

ited a charitable deduction on the estate tax return when the estate has distributed estate income to a charity.[167] These courts recognize that Congress has allowed estates a charitable deduction on the estate's income tax return for charitable contributions paid from income. Thus, these courts reason that the estate was not unfairly treated when not permitted to increase the charitable deduction on the estate tax return.[168]

The following discussions of *Estate of Street v. Commissioner*[169] and *Hubert v. Commissioner*[170] provide a useful analysis of these concepts.

III. ESTATE OF STREET V. COMMISSIONER

In 1982, Gordon P. Street died testate.[171] In his will, Mr. Street directed his executors to pay all "just debts, funeral expenses, and the cost of the administration of [his] estate as soon after [his] death as practicable."[172] The will further provided that "[a]ll estate and inheritance or death taxes on [his] estate or occasioned by [his] death [should] be paid from [the] residuary estate and not charged to any specific legatee or devisee."[173] Mr. Street then left the remainder of his estate in trust for the benefit of his wife during her lifetime.[174]

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court noted that the estate advanced its argument in terms of "present value of the right to [receive] the income" rather than as additional post-mortem income added to the residuary bequest. *Id.* The court suggested that whether it is called the "right to receive income" or income received by the estate, the estate was discussing the same sum of money. *Id.* at 276. The court noted that, although the estate could not deduct the amount of income passing to charity on the estate tax return, the estate actually received a windfall from the income. *Id.* The court reasoned that the income tax regulations already afforded the estate a charitable deduction on the income tax return for the amount of income distributed to charity. *Id.* Thus, denying a corresponding estate tax deduction was not unjust. *Id.*; *see also* Waldrop v. United States, 137 F. Supp. 753, 756 (Ct. Cl. 1956) (holding that charity allowed unlimited deduction from post-mortem income, not on estate tax return, even though money went to same party); Buchanan v. United States, 377 F. Supp. 1011, 1014 (W.D. Pa. 1974) (holding that estate was prohibited from adding interest earned during administration and paid to charity when calculating charitable deduction), *aff'd*, 511 F.2d 1392 (3d Cir. 1975).

167. See cases cited *supra* note 166.

168. *See supra* note 166.

169. 56 T.C.M. (CCH) 774 (1988), *aff'd in part and rev'd in part*, 974 F.2d 723 (6th Cir. 1992); *see infra* text accompanying notes 171-217.

170. No. 22333-90, 1993 T.C. LEXIS 63 (Oct. 19, 1993).

171. *Estate of Street*, 56 T.C.M. (CCH) at 774.

172. *Id.* at 775.

173. *Id.* He bequeathed to his daughter and son equal shares in his estate, but no amounts that would be subject to federal estate taxes. *Id.*

174. *Id.* Mr. Street's will also provided that all the net income produced by the trust be paid to his wife during her lifetime. *Id.* The will further mentioned his desire to take full advantage of the Economic Recovery Tax Act of 1981 which provided an unlimited marital deduction. *Id.*

Pursuant to Code § 642(g),[175] Mr. Street's executors elected to claim estate administrative expenses as deductions on the income tax return.[176] From 1982 through 1984, the executors reported income received by the trust and deducted administrative fees and expenses on the income tax return.[177] In *Street I*, the Tax Court addressed whether administrative expenses and interest payable on estate and inheritance taxes reduce the net value of the property interest passing to the surviving spouse.[178] To decide this issue, the court first had to determine whether the estate should charge the expenses to principal or income.[179] The Tax Court acknowledged that if such expenses were paid from estate income, the expenses would not reduce the amount of principal passing to the surviving spouse.[180] The court held that state law controlled this issue.[181] The Tennessee statute provided that "ordinary expenses incurred in connection with the trust estate or with its administration and management shall be paid out of income."[182] Although it was unclear whether this statute applied to probate estates, the court noted that the creator of the principal could alter the statutory arrangement for allocating items between principal and income.[183] Thus, the court examined the intent of the testator.[184] The Tax Court held that Mr. Street intended for his executors to pay interest expenses on estate taxes from income.[185]

Regarding administrative expenses, the Commissioner argued that Mr. Street intended to have the expenses paid from principal because Mr. Street's testamentary language required his estate to pay administration expenses as soon as possible after his death.[186] The court, by contrast, found compelling evidence that Mr. Street wanted to maximize Mrs. Street's marital deduction. The court cited a Tennessee statute that requires an allocation to income if it will protect the marital

175. *See supra* notes 147-53 and accompanying text.

176. *Estate of Street*, 56 T.C.M. (CCH) at 775.

177. *Id.* In 1982, the income tax return showed income of $325,223 and administration deductions of $11,509; in 1983, the return showed income of $763,416 and administration deductions of $217,483; in 1984, it showed income of $1,885,518 and administration deductions of $234,000. *Id.*

178. *Id.* at 776.

179. *Id.*

180. *Id.* See *supra* text accompanying notes 93-115 for a discussion of the marital deduction. See *supra* text accompanying notes 80-92 for a discussion of administrative expenses.

181. *Estate of Street*, 56 T.C.M. (CCH) at 776.

182. *Id.* (quoting TENN. CODE ANN. § 35-6-113(a) (1984)).

183. *Id.* (citing TENN. CODE ANN. § 35-6-103 (1984)).

184. *Id.*

185. *Id.*

186. *Id.*

deduction.[187] Thus, the court found no justification to charge administration expenses against principal.[188] The court noted that in *Estate of Richardson v. Commissioner*,[189] it allowed the estate to deduct interest on delinquent taxes from estate income as an administrative expense.[190] The *Street I* court found it logical to extend the treatment to other types of administrative expenses.[191] As a result, the court determined that both interest and administrative expenses were chargeable to income and did not reduce the amount passing to the surviving spouse.[192] Therefore, the court did not require a corresponding reduction in the marital deduction.[193] The Commissioner appealed the decision.[194]

On appeal, the United States Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision for interest on taxes, but it reversed the Tax Court's decision on administrative expenses.[195] The *Street II* court pointed out that this case involved two types of expenses: administrative expenses and interest on taxes which accrue af-

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187. *Id.*

188. *Id.*

189. 89 T.C. 1193 (1987). In *Estate of Richardson*, Mr. Richardson bequeathed to his wife the fractional share of his estate required to obtain the maximum marital deduction. *Id.* at 1194. He further provided that his executors had the authority to apply the deduction allowable by the Code to minimize the total state and federal income taxes payable by his estate. *Id.* at 1195. He directed his executors to arrive at the lowest tax payable by allocating the charges against any beneficiary, regardless of whether it would favor other beneficiaries. *Id.* The Tax Court faced the principal issue of whether interest payable on federal estate taxes, state inheritance taxes, and deficiencies is chargeable against principal or income. *Id.* at 1200. The Tax Court, therefore, reviewed the Tennessee Principal and Income Act to determine if Tennessee required the estate to charge interest on taxes to principal or income. *Id.* at 1201. The Act provided that "[a]ll other expenses . . . and other costs incurred in maintaining or defending any action to protect the trust or property . . . shall be paid out of principal." *Id.* (quoting TENN. CODE ANN. § 35-6-113(b) (1993)). The Tax Court held that interest on delinquent federal estate or state inheritance taxes does not pertain to protecting the trust or property. *Id.* at 1202. Because the court held that Tennessee did not direct the estate to charge expenses to principal or income, the court looked to Mr. Richardson's intent. *Id.* Mr. Richardson directed his executors to "pay out of my residuary estate . . . all fees and expenses incident to the administration of my estate." *Id.* The court noted it would be more equitable to charge the interest on deferred estate and inheritance taxes to income from the assets not used immediately to pay taxes. *Id.* The court noted that the Commissioner was attempting to reduce the principal of the estate, the marital deduction, by interest accruing after the decedent's death. *Id.* at 1205. The court recognized that paying interest on deferred taxes out of income of the estate would neither increase nor decrease the gross estate. *Id.* Further, Kentucky law did not impose the burden on the spouse's share. *Id.* The court held that Mr. Richardson primarily intended to obtain the maximum marital deduction for the benefit of the estate. *Id.* at 1203. The court, therefore, held that the marital deduction did not need to be reduced for interest on estate taxes paid from income of the estate. *Id.*

190. *Estate of Street*, 56 T.C.M. (CCH) at 776.

191. *Id.*

192. *Id.*

193. *Id.*

194. Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992).

195. *Id.* at 729.

ter the decedent's death.[196] The Sixth Circuit began its analysis by reviewing Code § 2056(a), which provides a marital deduction for "an amount equal to the value of any interest in property which passes . . . from the decedent to his surviving spouse."[197] The court noted that the language in Code § 2056(b)(4)(B) requires that any encumbrance or obligation of the decedent be considered in determining the value of property passing to the surviving spouse.[198] The *Street II* court thus determined that the estate should value the marital deduction by the property that the surviving spouse actually received.[199] Based on Regulation § 20.2056(b)-4(a), the court concluded that, in valuing the marital deduction, the estate would have to consider "any material limitations upon . . . [the] right to [receive] income from the property."[200] The court focused on the example provided in the Regulation:

> 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.[201]

The court determined that this Regulation directed the estate to decrease the marital deduction when it uses estate income to pay various administrative expenses.[202] The *Street II* court thus held that income from property earned by the estate from the time of the decedent's death until distribution, and which is used to pay administrative expenses, must be set off to reduce the marital deduction.[203]

The *Street II* court noted that income earned during estate administration enhances the value of the marital share.[204] The court also indi-

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196. *Id.* The Sixth Circuit agreed that interest on taxes is an obligation accruing sometime after death. *Id.* Because the marital deduction is to be determined as of the date of death, the court held that income used to pay expenses arising after death will not affect the value of the estate because that value is fixed. *Id.*

197. *Id.* at 726 (quoting I.R.C. § 2056(a) (1988)).

198. *Id.* Code § 2056(b)(4)(B) states:

> 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 - (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.

I.R.C § 2056(b)(4)(B) (1988).

199. *Estate of Street*, 974 F.2d at 726.

200. *Id.*

201. *Id.* at 727 (citing Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958)).

202. *Id.*

203. *Id.*

204. *Id.*

cated that expenses paid from income during this period decreases the amount of estate property bequeathed to the surviving spouse.[205] The court, therefore, determined that "the payment of administrative expenses from income must operate to reduce the size of the marital deduction, otherwise the spouse would receive a deduction which exceeded the amount actually in the estate, and available for distribution."[206] Thus, the *Street II* court rejected the *Street I* court's reliance on *Estate of Richardson*.[207]

The *Street II* court distinguished *Estate of Richardson* because it dealt only with interest on taxes that accrue after the date of death, while *Street* dealt with administrative expenses that accrue at death.[208] Because interest on taxes accrues after the decedent's death, the *Street II* court reasoned that these expenses and their payment from income had no effect on the gross estate.[209] The *Street II* court stated that *Estate of Richardson* stood only for the proposition that the payment of interest on estate and inheritance taxes from income did not reduce the marital deduction.[210] Instead, the court agreed with the holding in *Estate of Roney v. Commissioner*.[211] The *Street I* court reasoned that since Tennessee law did not direct the source of payment of estate expenses, the estate should follow the decedent's expressed intent.[212] The *Street II* court, by contrast, held that Treasury Regulations control the tax treatment of administrative expenses regardless of state law or tes-

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205. *Id.* at 728.
206. *Id.* at 727.
207. *Id.* at 728.
208. *Id.* at 727.
209. *Id.* at 729.
210. *Id.*
211. 33 T.C. 801 (1960). In *Estate of Roney*, Newton Roney left no directions as to the source of payment of administrative expenses. *Id.* at 801. The executrix issued a 642(g) waiver and elected to deduct $37,251 of administrative expenses on the estate income tax return. *Id.* at 802. Mr. Roney left two specific bequests, set up a trust containing a hotel, and directed his trustees to pay all federal and estate taxes from the trust. *Id.* The Tax Court noted that Mrs. Roney received the residuary estate into which all assets fell after payment of all other legacies, debts, and costs of administration. *Id.* at 804. Further, a Florida statute provided that charges against the estate would be paid from "(1) property not disposed of by the will [or] (2) property devised or bequeathed to the residuary legatee." *Id.* (citing FLA. STAT. ANN. § 734.05 (West 1991)). Thus, Mrs. Roney's estate was chargeable with all expenses, except for estate taxes. *Id.* The court held that Mrs. Roney's marital deduction should be reduced because the value of the residue passing to her decreased. *Id.* The court further stated that the marital deduction should be reduced regardless of whether the estate paid administrative expenses from estate principal or income. *Id.* Noting that the estate's ability to pay administrative expenses from income was fortuitous, the court did not relieve the residuum. *Id.* at 804. The court relied on the legislative history of the marital deduction in arriving at its conclusion. *Id.* at 105. See *supra* notes 93-104 and accompanying text for a discussion of legislative history.
212. Estate of Street v. Commissioner, 56 T.C.M. (CCH) 774 (1988), *aff'd in part and rev'd in part*, 974 F.2d 723 (6th Cir. 1992); *see supra* notes 170-89 and accompanying text.

tator intent.[213] The *Street II* court reasoned that federal law, not the whim of the state legislature or state court, should decide whether the marital deduction should be reduced to reflect administrative expenses.[214]

The court found the legislative history dispositive on this point:

> 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.[215]

The *Street II* court determined that income earned on the residue of the estate prior to distribution increased the residue, while expenses paid during this period decreased the residue.[216] The court, therefore, held that the estate must decrease the amount of the marital deduction to reflect the reduced value of assets available at the decedent's death.[217]

Because the *Street II* court believed that the Tax Court in *Street I* overlooked applicable Regulations, *Estate of Hubert v. Commissioner*[218] took on special significance. In *Hubert*, the Tax Court expressly considered the Regulations but still declined to follow the Sixth Circuit's holding in *Street II*.

IV. ESTATE OF HUBERT V. COMMISSIONER

A. Statement of Facts

Otis C. Hubert died on June 2, 1986, leaving behind a wife and four children.[219] In 1977, Mr. Hubert published a will bequeathing his residence and personal effects to his wife, Ruth Swann Hubert.[220] Hubert further bequeathed, in trust, the amount of assets equal to the maximum marital deduction, while taking full advantage of any cred-

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213. *Estate of Street*, 974 F.2d at 728.
214. *Id.*
215. *Id.* (citing REVENUE ACT OF 1948, S. REP. NO. 1013, 80th Cong., 2d Sess. II-6 (1948)).
216. *Id.*
217. *Id.* at 728-29.
218. No. 22333-90, 1993 T.C. LEXIS 63 (Oct. 19, 1993).
219. *Id.* at *4.
220. Last Will & Testament of Otis C. Hubert, Item II & III (Nov. 7, 1977) (on file with the *University of Dayton Law Review*).

its.[221] He gave Mrs. Hubert the power to appoint all or a portion of the marital trust to any of her lineal descendants or their spouses or to any other trusts or subtrusts Mr. Hubert created.[222] In the event Mrs. Hubert did not appoint the marital trust by inter-vivos transfer or by will, the marital trust would be distributed to the charitable remaindermen.[223] Mr. Hubert also left approximately $1 million in trust for income or principal distribution to his wife or children at his trustee's discretion.[224] Upon the death of Mrs. Hubert, the trustees were to divide the trust into four shares.[225] Mr. Hubert left all other property not otherwise bequeathed or needed for estate expenses to a charitable remainder unitrust.[226] Mr. Hubert gave his executors and trustees the authority to apportion any income from his estate or trusts between income and principle.[227] He also gave his executors and trustees the authority to charge any expenses against principal or income or to apportion the same.[228]

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221. *Id.* at Item VII. In maximizing the marital deduction, Mr. Hubert made it clear that he did not wish to reduce the estate tax by an amount that would waste his available credits. *Id.* In maximizing this amount, Mr. Hubert placed in trust for Mrs. Hubert an amount of assets equal to the aggregate value of all interests in property less the items passing under other items of the will. *Id.* From this trust, Mr. Hubert directed his trustees to pay Mrs. Hubert income sufficient for her maintenance and support. *Id.* at Item VII, pt. A.

222. *Id.* at Item VII, pt. C. Mr. Hubert set up two separate subtrusts of $75,000 for the benefit of Redford C. Trammell and Roland Cornelius, Jr. *Id.* at Item VIII. Upon the death of each of these men, any accumulated income and the remaining corpus would be delivered to Shorter College for the Ruth Swann Hubert Educational Foundation. *Id.* at pt. (2).

223. *Id.* at Item VII, pt. D.

224. *Id.* at Item IX, pt. A. This figure was raised to $2 million in Mr. Hubert's first codicil. First Codicil to Last Will & Testament of Otis C. Hubert, Dec. 29, 1977 (on file with the *University of Dayton Law Review*).

225. Last Will & Testament of Otis C. Hubert Item X, pt. C. (Nov. 7, 1977) (on file with the *University of Dayton Law Review*).

226. *Id.* at Item X. Mr. Hubert directed his trustees to pay on an annual basis the entire unitrust amount from income or principal to his family. *Id.* at Item X, pt. (a). Upon Mrs. Hubert's death, the trust would terminate. *Id.* at Item X, pt. (c). At that point, Shorter College and the Foreign Mission Board of the Southern Baptist Convention would both receive one-half of the trust. *Id.* at Item X, pt. (c)(1). A charitable remainder trust is defined in part as a trust:

> (A) from which a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons . . . (B) from which no amount other than payments described in subparagraph (A) may be paid to or for the use of any person other than an organization
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> . . . .

I.R.C. § 664(d)(1) (1988). A charitable remainder unitrust fixes the percentage distribution of the net fair market value of trust assets, annually assessed, while a charitable remainder annuity trust fixes the sum of the annual distribution of all the assets valued when placed in trust. Treas. Reg. § 1.664-1(a)(1)(i) (as amended in 1984); *see also* Item X of the Last Will & Testament of Otis C. Hubert (Nov. 7, 1977) (on file with the *University of Dayton Law Review*).

227. *Id.* at Item XIX, pt. 13.

228. *Id.*

On July 7, 1982, Mr. Hubert republished his will.[229] This will differed from his prior will in that it increased the amount in the subtrusts, bequeathed specific real property to his children if his wife predeceased him, and named Robert Hubert Owen as a co-executor/co-trustee.[230] In his second codicil[231] to this will, Mr. Hubert deleted the provisions in his will that left Mrs. Hubert the power to appoint all or a portion of her trust.[232]

Shortly after Mr. Hubert's death, a dispute arose.[233] Mr. Hubert's nephew, Robert Hubert Owen, contended that Mr. Hubert's 1982 will and three codicils represented his true intentions.[234] Mr. Hubert's wife and children contended that Mr. Owen exercised undue influence over Mr. Hubert to the benefit of Mr. Owen and the charities.[235]

On June 24, 1987, the parties entered into a settlement agreement.[236] The temporary administrator filed an action for declaratory judgment addressing the import of the settlement agreement.[237] The State Revenue Commissioner filed an answer that included statements that the agreement did not allow Mr. Hubert the right to dispose of his property by will and that the Commissioner, as a representative of the

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229. Last Will & Testament of Otis C. Hubert (Jan. 7, 1982) (on file with the *University of Dayton Law Review*).

230. *Id.* at Item VII, Item VIII, pt. E, Item XVIII.

231. "Codicil" is defined as "[a] supplement or an addition to a will; it may explain, modify, add to, subtract from, qualify, alter, restrain or revoke provisions in an existing will." BLACK'S LAW DICTIONARY 258 (6th ed. 1990).

232. Second Codicil to Last Will & Testament of Otis C. Hubert (Feb. 19, 1982) (on file with the *University of Dayton Law Review*). In all three of Mr. Hubert's codicils to his final will and testament, Mr. Hubert's nephew, Robert Owen and Mr. Owen's wife Mary signed as witnesses. First Codicil to Last Will & Testament of Otis C. Hubert (Feb. 4, 1982) (on file with the *University of Dayton Law Review*); Second Codicil to Last Will & Testament of Otis C. Hubert (Feb. 19, 1982) (on file with the *University of Dayton Law Review*); Third Codicil to Last Will & Testament of Otis C. Hubert (June 8, 1983) (on file with the *University of Dayton Law Review*).

233. Second and Final Settlement Agreement of Interested Persons Regarding the Estate of O.C. Hubert 2 (Oct. 10, 1990) (on file with the *University of Dayton Law Review*).

234. *Id.*

235. *Id.* On August 5, 1982, Mr. Owen filed a petition to probate in solemn form the 1982 will and its three codicils. *Id.* at 3. Mrs. Hubert challenged Mr. Owen's fitness to serve as co-executor or trustee. *Id.* On August 14, 1986, the Cobb County Probate Court appointed the Citizens and Southern Trust Company, N.A., as temporary administrator. *Id.* On August 22, 1986, Mrs. Deborah Hubert Jones, Mr. Hubert's daughter, filed a caveat charging that Mr. Owen and his wife were not competent witnesses to the will, as well as stating Mr. Hubert lacked testamentary capacity when making his 1982 will and three codicils. *Id.* at 3-4. On August 29, 1986, Ms. Marilyn Hubert Kemper and Ms. Judith Hubert Manning, Mr. Hubert's daughters, filed similar caveats attacking Mr. Hubert's testamentary capacity and Mr. Owen's influence. *Id.* at 4-5. On September 5, 1986, Mr. Owen filed a complaint under the Wage and Hour Law against the estate, its heirs at law, and counsel for compensation. *Id.* at 5. On December 8, 1986, Mr. Owen also filed an action seeking damages for harm to his reputation, damages for slander, and exemplary damages. *Id.* at 5-6.

236. *Id.* at 6.

237. *Id.*

charities, was a necessary party.[238] Thus, the parties, including the Georgia Revenue Commissioner, entered into another agreement on October 10, 1990.[239] The Cobb County Probate Court accepted the agreement as binding on all the interested parties on November 28, 1990.[240]

The final 1990 settlement agreement altered the disposition provided for in the 1982 will and its codicils.[241] Mr. Owen relinquished and revoked his right to be co-executor/co-trustee or legal counsel for the executors or trustees.[242] The parties agreed not to challenge the wills or codicils if the court approved the agreement.[243] The agreement named as trustees Citizens and Southern Trust Company, Richard Hubert, and a third party to be selected by the joint agreement of the State Revenue Commissioner and Mrs. Hubert.[244] Also provided in the agreement was a distribution for residual assets into a marital and charitable trust.[245] The agreement directed the trustee to set up a GPA Marital trust[246] and a QTIP trust[247] for Mrs. Hubert.[248] The agreement initially funded the marital trusts at $14,390,000.[249] According to the agreement, the trustees were obliged to subtract from this amount predistribution/segregation expenses and predistribution/segregation advancements.[250] The agreement also directed the trustees to add the income earned from this property between April 1, 1990 and October

238. *Id.* at 7. The Commissioner also stated that the interested parties defeated and terminated the purpose of the charitable trust; that their agreement violated the spendthrift clause of the will; that their agreement placed the trustee of the charitable trust in a position of conflict; and that their agreement did not represent a consent by all interested parties, specifically the charitable beneficiaries. *Id.*

239. *Id.* at 10-30.

240. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63, at *7 (Oct. 19, 1993).

241. *See generally* Second and Final Settlement Agreement of Interested Persons Regarding the Estate of Otis C. Hubert (Oct. 10, 1990) (on file with the *University of Dayton Law Review*).

242. *Id.* at 10.

243. *Id.* at 11.

244. *Id.*

245. *Id.* at 15.

246. *Id.* The General Power of Appointment Trust (GPA) conferred upon Mrs. Hubert a general power to turn over any part of the property in the trust to herself, her creditors, her estate, or the creditors of her estate. GPA Marital Trust, Exhibit M (on file with the *University of Dayton Law Review*).

247. A Qualified Terminable Interest Property Trust (QTIP) is a trust which passes property from the decedent to his surviving spouse, pays all the income from the property to her for her life, and no person has the power to appoint the property to anyone other than the surviving spouse. I.R.C. § 2056(b)(7) (1988).

248. Second and Final Settlement Agreement of Interested Persons Regarding the Estate of Otis C. Hubert 15 (Oct. 10, 1990) (on file with the *University of Dayton Law Review*).

249. *Id.*

250. *Id.* at 15-16.

10, 1990 to the two trusts.[251] Additionally, the agreement provided for Mrs. Hubert to select estate property to fund the QTIP and GPA trust, and for the Commissioner to select items for the charitable trust.[252] Moreover, the agreement directed the estate to fund the trusts as soon as possible after the settlement of all claims, controversies, and disputes regarding the decedent's estate.[253]

Following the distribution of the marital trusts, the residue of the estate passed to the Charitable trust.[254] The agreement also stated:

> From the date of the execution of this Agreement, the income and expenses separately identifiable as being allocable to specific properties shall be separately accounted for, and separately credited and charged to the respective segregated shares holding such properties. All general expenses of the Estate, including Executors' fees and commissions and attorney's fees . . . shall be allocated to the respective shares on the basis of forty-eight percent to the Marital Share and fifty-two percent to the Charitable Share.[255]

In 1987, the executors filed the estate tax return.[256] The return valued the gross estate at $30,254,219 and took a marital deduction of $13,353,572 and a charitable deduction of $12,870,864.[257] The estate thus valued the residuary estate at $26,224,436.[258] The Commissioner filed a notice of deficiency.[259] Mr. Hubert's estate petitioned the Tax Court for a determination of the deficiency.[260] Following concessions by the parties, the court considered three issues: (1) whether the settlement agreements or the 1982 will with three codicils controlled the amount claimed as the marital and charitable deductions;[261] (2)

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251. *Id.* at 16.
252. *Id.* at 18.
253. *Id.* at 19.
254. *Id.* at 20.
255. *Id.* at 21-22.
256. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63 (Oct. 19, 1993).
257. *Id.* at *69.
258. *Id.*
259. *Id.* at *7.
260. *Id.*
261. *Id.* at *2. The Commissioner argued that the estate's marital deduction was the lesser of the amount distributed to Ms. Hubert under the settlement agreement or the amount that the estate would have distributed under the 1982 will and codicils. *Id.* at *9-10. The Hubert estate argued that the settlement agreement was a good faith compromise of a bona fide dispute concerning uncontested provisions of state law, and, therefore, the settlement agreement should control. *Id.* at *10. The Tax Court reviewed Code § 2056(a), which directs the executor to deduct from the value of the gross estate any property which passes or has passed to the decedent's surviving spouse, if the estate included the value of that property when valuing the gross estate. *Id.* at *8 (citing I.R.C. § 2056(a) (1988)). The court also reviewed a Regulation that directed a surrender or assignment of rights in a will to a spouse to be considered as having passed to the

whether the amounts of the marital and charitable deductions must be reduced for administration expenses paid out of income;[262] and (3) whether the estate had to discount the marital and charitable portions by seven percent to reflect income earned by the residue.[263]

B. The Opinion of the Tax Court

The Tax Court had to decide whether administrative expenses should reduce the marital and charitable deductions.[264] The court allowed a full marital and charitable deduction on the estate tax return and allowed a full administrative expense deduction on the income tax return.[265] The Tax Court took this position despite the Sixth Circuit Court's decision in *Estate of Street v. Commissioner*,[266] which overruled the Tax Court on the same issue in 1989.[267]

1. The Majority Opinion

Mr. Hubert's 1982 will gave the executors of his estate the authority "to charge any expenses against income or principal or apportion the same."[268] The Commissioner asserted that the amount claimed as administrative expenses must reduce the amount of the marital and charitable deductions, regardless of whether the executor charged the expenses against principal or income.[269] The Commissioner referred the court to Regulation § 20.2056(b)-4(a)[270] and the legislative history of

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spouse if the "assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate." *Id.* (citing Treas. Reg. § 20.2056(e)-(2)(d)(2) (as amended in 1958)). The Regulation further stipulates that, in order to meet this requirement, the agreement must have been the result of an active contest, before a local court, in an adversarial proceeding. *Id.* The Regulation also directs that if the agreement was one of consent, or one not to contest or probate the will, the resulting agreement may not be upheld as a bona fide evaluation of the right of the spouse. *Id.* at *9. The court concluded that the settlement agreement was a bona fide adversarial proceeding which had harmed Mrs. Hubert's estate interest. *Id.* at *14. Since a full marital deduction would have been allowed under the 1982 will and its codicils, the parties could not have acted in a manner contrary to the Commissioner's interest. *Id.* Further, Mrs. Hubert received property under the settlement agreement in satisfaction of an enforceable right. *Id.* at *16. The court, therefore, held that the Hubert estate could take a marital deduction for the amount passing to Mrs. Hubert under the settlement agreement as if it passed directly from Mr. Hubert. *Id.* The Tax Court used similar reasoning in deciding that the settlement agreement was enforceable with respect to the charities. *Id.* at *16-17.

262. *Id.* at *2.

263. *See infra* note 336.

264. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *16-17.

265. *Id.* at *16.

266. 974 F.2d 723 (6th Cir. 1992); *see supra* text accompanying notes 169-218.

267. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *30-31.

268. *Id.* at *18. The executors allocated $506,809 funeral and administration expenses to the principal of the estate and the rest to estate income. *Id.*

269. *Id.*

270. Treas. Reg. § 2056(b)-4(a) (as amended in 1958).

Code § 2056.[271] The Commissioner argued that courts "uniformly recognize" that administration expenses, whether from income or principal, decrease the amount of the marital and the charitable deduction.[272] Further, the Commissioner contended that Georgia law and the settlement agreement supported the same result.[273]

The Tax Court began its analysis by stating that the starting point for determining federal estate taxes is the date-of-death valuation or the alternate date valuation of estate property.[274] The Tax Court noted that the Code allows deductions from the gross estate for various expenses, claims against the estate, bequests to decedent's spouse, and bequests to charities.[275] The court also recognized that income earned by the estate has no effect on the gross estate for federal estate tax purposes.[276] Instead, income earned by the estate is reported separately on the estate's income tax return.[277]

The Tax Court acknowledged that Congress gave estate executors discretion to deduct administrative expenses on the estate tax return or the estate income tax return.[278] Further, many states do not statutorily direct the executor to allocate such expenses between estate income or principal, leaving the allocation to the discretion of the executor.[279] The court noted that if administrative expenses are charged against principal, the beneficiaries receive less property from the estate.[280] When charitable beneficiaries and the surviving spouse receive less principal, the estate must reduce the amount claimed as the marital and charitable deduction.[281] The court, however, wanted to avoid confusion between administrative expenses incurred and accruing during the administration of the estate and claims against the estate that existed at the date of death.[282]

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271. I.R.C. § 2056 (1988); *Estate of Hubert*, 1993 T.C. LEXIS 63 at *18. See *supra* text accompanying notes 93-104 for a discussion of the legislative history.

272. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *18.

273. *Id.*

274. *Id.* at *19. See *supra* text accompanying notes 33-79 for a discussion of gross estate valuation.

275. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *19. See *supra* text and accompanying notes 80-128 for a discussion of the applicable deductions from the gross estate.

276. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *19.

277. *Id.* See *supra* notes 129-68 and accompanying text for a discussion of the estate's income tax return.

278. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *19.

279. *Id.* See *supra* note 155 for the states that require the executor to charge administrative expenses to the principal, unless the decedent specified otherwise.

280. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *19.

281. *Id.* at *19-20.

282. *Id.* at *20.

The court concluded that estates do not realize a double deduction if the estates pay administrative expenses from income and take full marital and charitable deductions on their estate tax return.[283] Code § 642(g) prohibits a deduction on the estate tax return for any expense deducted on the estate's income tax return but does not prohibit or reduce the marital or charitable deduction.[284] The court noted that this section applies to Code §§ 2053[285] and 2054,[286] not to the marital deduction under Code § 2055 or the charitable deduction under Code § 2056.[287] Thus, the court concluded that section 642(g) does not impair the executor's ability to preserve the value of the marital and charitable bequests when allocating administrative expenses to income.[288]

The court acknowledged that Georgia law controls the allocation of administrative expenses between principal and income.[289] Mr. Hubert's 1982 will authorized the use of estate income to pay administrative expenses.[290] Since the estate used income to pay administrative expenses, the court held that the Hubert estate did not need to reduce the marital and charitable deductions.[291]

The Commissioner argued that Regulation § 20.2056(b)-4(a),[292] not state law, controlled the issue.[293] The Tax Court disagreed, viewing the regulation as a valuation provision.[294] The court determined that the regulation was a valuation provision because it considers material limitations when valuing the property interest passing to the surviving spouse.[295] Since using income to pay administrative expenses may not

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283. *Id.*

284. *Id.* See *supra* text accompanying notes 147-53 for a discussion of the 642(g) election.

285. Code § 2053 authorizes deductions from the gross estate for various expenses, such as funeral and administrative. I.R.C. § 2053 (1988).

286. Code § 2054 discusses deductions for losses incurred by the estate during settlement, such as fires and storms. *Id.* § 2054.

287. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *20-21.

288. *Id.*

289. *Id.* at *21; *see also* GA. CODE ANN. §§ 53-2-101, 53-15-3 (1982).

290. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *21.

291. *Id.*

292. Regulation § 20.2056(b)-4(a) provides:

> 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. 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) (as amended in 1958).

293. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *21.

294. *Id.* at *22.

295. *Id.*

be a material limitation on the date-of-death value of estate property, the court did not interpret the regulation as mandating a set off of administrative expenses against the marital deduction.[296]

To further support its conclusion that Regulation § 20.2056(b)-4(a)[297] was a valuation provision, the court reasoned that the Regulation requires that the value of the interest passing to the surviving spouse be ascertained "as if the amount of a gift to the spouse were being determined."[298] Therefore, the court turned its attention to gift taxes and the marital deduction for gifts to spouses under Code § 2523.[299] The court noted that under Code § 2523(e), if the spouse has a general power of appointment and is entitled to all the income from the trust, then the donor may deduct the value of the trust property given to his spouse.[300] The court reviewed Regulation § 25.2523(e)-1(f)[301] to establish that a spouse is considered to have received all the income from the trust, even if administrative expenses are paid from that income, so long as the spouse is not deprived of "substantial beneficial enjoyment."[302]

Although not binding precedent, the Tax Court also noted that Revenue Ruling 69-56[303] stated that the power to charge the executor's

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296. *Id.*

297. *See supra* note 292.

298. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *23 (citing Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958)).

299. *Id.*

300. *Id.* (citing I.R.C. § 2523(e) (1988)).

301. Regulation § 25.2523(e)-1(f)(1) provides:

> If an interest is transferred in trust, the donee spouse is "entitled for life to all of the income from the entire interest or a specific portion of the entire interest," for the purpose of the condition set forth in paragraph (a)(1) of this section, if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of trust law accord to a person who is unqualifiedly designated as the life beneficiary of a trust.

Treas. Reg. § 25.2523(e)-1(f)(1) (as amended in 1961).

302. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *23 (citing Treas. Reg. § 25.2523(e)-1(f) (as amended in 1961)).

303. Rev. Rul. 69-56, 1969-1 C.B. 224. The ruling gave examples to illustrate that administrative powers or directions conferred on fiduciaries under wills, inter-vivos trusts, or by applicable local law did not result in the disallowance or diminution of the marital deduction under section 2056 and 2523 of the Code. *Id.* Transferors sought advice for transfers of property in testamentary or inter vivos trusts. *Id.* In each case, the trust instrument directed the fiduciary to pay at least annually, all of the net income from the trust to the transferor's wife for life. *Id.* The transferor also gave the surviving spouse testamentary power, exercisable by her alone, to appoint the entire trust principal to her estate. *Id.* The ruling gave many examples of potential situations, including, "[t]o charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses." *Id.* The ruling noted that Treasury Regulation § 20.2056(b)-5(f)(2) to -5(f)(4) specifically referred to fiduciary powers to apportion receipts and expenditures between income and principal. *Id.* Such fiduciary powers or directions did not evidence an intention to deprive the surviving spouse of the beneficial enjoyment

or trustee's commissions to income or principal "does not result in the disallowance or diminution of the marital deduction."[304] The *Hubert* court determined that the power addressed in the Revenue Ruling was substantially the same as the power granted in Mrs. Hubert's case.[305] Furthermore, the amount of income used to pay administrative expenses was insignificant compared to the value of trust income Mrs. Hubert would receive during her lifetime.[306] The court thus concluded that the payment of administrative expenses from the income did not deprive Mrs. Hubert of substantial beneficial enjoyment of her property. Under Regulation § 25.2523(e)-1(f), Mrs. Hubert would be treated as having received all of the income of the trust.[307] For this reason, the court determined that Mrs. Hubert suffered no material limitation on her right to receive income.[308]

The court also declined to interpret the legislative history as mandating a decrease in the marital deduction.[309] The court noted that the legislative history stated that claims against the estate paid out of income increase the residue by purchase, not by bequest.[310] Therefore, "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."[311] The court noted, however, that the Senate Report never mentioned administration expenses. The Senate Report only mentioned income used to pay claims against the estate.[312] Further, in accordance with Mr. Hubert's wishes and Georgia law, the executor charged administration expenses against income.[313] Thus, the court concluded that the legislative history cited by the respondent did not determine the amount of the marital deduction in the Hubert estate.[314]

In arriving at this conclusion, the *Hubert* court addressed the holdings in *Estate of Street v. Commissioner*[315] and *Estate of Richard-*

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of the property. *Id.* Thus, it was unimportant whether state law or the governing instrument conferred the power on the fiduciary. *Id.* The revenue ruling finally held that the inclusion of such powers or directions in the governing instrument "does not result in the disallowance or diminution of the marital deduction." *Id.*

304. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *24 (citing Rev. Rul. 69-56, 1969-1 C.B. 224). The Tax Court also noted that a revenue ruling represents the view of the Commissioner. *Id.* (citing Crow v. Commissioner, 85 T.C. 376 (1985)).

305. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *24.

306. *Id.*

307. *Id.*

308. *Id.*

309. *Id.* at *25.

310. *Id.*

311. *Id.* at *25; *see supra* notes 93-104 and accompanying text.

312. *Estate of Hubert*, 1993 T.C. LEXIS 63 at *25.

313. *Id.* at *25-26.

314. *Id.* at *26.

315. 974 F.2d 723 (6th Cir. 1992); *see supra* text accompanying notes 171-217.

son v. Commissioner.[316] The *Estate of Richardson* court determined that "whether an expenditure on behalf of an estate is chargeable to principal, or the income produced thereby, depends on the law of the State wherein decedent was a resident at the time of his death, or upon the terms of the decedent's will."[317] The court found that the executors had the authority to charge administrative expenses against income because of the *Hubert* facts, the lack of state law in the area, and the testator's intent to minimize taxes.[318] The Tax Court previously held in *Street I* that the amount claimed as a marital deduction need not be reduced as a result of administrative expenses paid out of trust income.[319] The *Hubert* court accepted the Commissioner's argument that Mrs. Hubert would receive less property because part of the income to which she was entitled was used to pay administration expenses.[320] The court noted, however, that it considered Mrs. Hubert to have received the full value of the trust because of her general power of appointment.[321]

The Tax Court also distinguished *Hubert* from *Estate of Roney v. Commissioner*.[322] In *Roney*, Florida law required that the executor pay administrative expenses out of the residuary of the estate.[323] The Tax Court in *Roney*, therefore, held that the estate must reduce the residuary paid to the spouse for the payment of administrative expenses and take a corresponding decrease in its marital deduction.[324]

Although neither the Commissioner nor Mr. Hubert's estate relied upon *Estate of Wycoff v. Commissioner*,[325] the *Hubert* court felt compelled to distinguish it.[326] In *Wycoff*, the executor had the option of

316. 89 T.C. 1193 (1987); *see supra* note 189.

317. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *26-27 (citing Estate of Richardson v. Commissioner, 89 T.C. 1193, 1201 (1987)).

318. *Id.* at *27.

319. *Id.*

320. *Id.*

321. *Id.* at *28.

322. 33 T.C. 801 (1960); *see also supra* note 211.

323. *See supra* note 211.

324. *See supra* note 211.

325. 59 T.C. 617 (1973). In *Estate of Wycoff*, the estate executors had the authority to use any asset in the estate to pay inheritance, estate, and transfer taxes without respect to whether the assets were included in the marital trust. *Id.* at 620. Mr. Wycoff left $309,623 in the marital trust, comprised almost entirely of stock. *Id.* The Tax Court charged the marital trust property with the potential inheritance, estate, and transfer taxes. *Id.* at 622. The Tax Court reasoned that if the marital deduction was not reduced for these expenses, the estate would receive a marital deduction for amounts which could be used for the payment of taxes. *Id.* The court noted that the will very clearly evidenced an intention contrary to a maximum marital deduction, because the executor could elect to use marital property to pay administration expenses. *Id.* at 622.

326. *Estate of Hubert v. Commissioner*, No. 22333-90, 1993 T.C. LEXIS 63, at *34 (Oct. 19, 1993).

paying inheritance taxes out of either the marital or nonmarital trust, but not out of income.[327] Because the estate could have reduced the marital property to pay administrative expenses, the *Wycoff* court held that the potential of reduction was sufficient to require an actual decrease in the marital deduction.[328] In *Hubert*, however, the executor's choice was between paying administration expenses out of principal or income.[329]

The Commissioner also argued that Georgia law required that expenses be allocated to principal rather than to income.[330] The court disagreed, noting that Georgia law required this allocation only if the will did not specify otherwise.[331] The court then recognized that Mr. Hubert had given his executors the discretion to allocate expenses to income.[332]

Finally, the court held that the settlement agreement did not alter the executor's discretion to allocate expenses to income.[333] The settlement agreement merely set forth a formula for determining the allocation of income and principal between Mrs. Hubert and the charities.[334] The court found that the settlement agreement did not alter the will's grant of discretion to the executors to allocate expenses to income.[335] Thus, the Tax Court held that the estate need not reduce either the marital or charitable deduction after the executors allocated the expenses to trust income.[336]

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327. *Id.* at *35.

328. *Estate of Wycoff*, 59 T.C. at 622. The Tax Court later noted that it would apply the holding in *Estate of Wycoff* narrowly. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *38.

329. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *38.

330. *Id.* at *35.

331. *Id.* (citing GA. CODE ANN. § 53-15-3 (1982)).

332. *Id.* at *36.

333. *Id.*

334. *Id.*

335. *Id.*

336. *Id.* at *37. The Tax Court also had to decide whether it should reduce the marital and charitable deduction by 7% to take into account income earned by the trust. *Id.* The estate executors urged the court to use the actual income figures, while the Commissioner urged the use of an imputed figure of 7% per annum. *Id.* The Tax Court looked to the value of the residue at the date of death to determine what amount of the residue went to deductible administrative expenses and what amount went to the marital and charitable bequests. *Id.* at *39. The Tax Court noted that it could determine the amount of the residue and divide this value three ways, between the marital deduction, charitable deduction, and administration expenses. *Id.* The court then held that the entire residue was deductible at its date of death valuation without regard to how much income it later earned. *Id.* at *39.

2. The Dissenting Opinion

Judge Beghe dissented from the majority holding in *Estate of Hubert* for a number of reasons.[337] Judge Beghe agreed with the *Street II* court's analysis that paying administrative expenses from marital and charitable property necessarily reduced the interest actually passing to these beneficiaries.[338] He expressed concern that the *Hubert* majority's position would be misinterpreted as holding that charging administrative expenses to income would never affect the marital and charitable deduction.[339] Furthermore, Judge Beghe disagreed with the majority's contention that paying the estate's administrative expenses from income did not create a material limitation on Mrs. Hubert's interest.[340]

After five years of administration, Mr. Hubert's estate had incurred $2 million in administrative expenses and charged these expenses to income.[341] His estate also generated gross income of $4.5 million during this period.[342] Judge Beghe noted that these expenses were the equivalent of a five-year annuity of approximately $400,000 charged against the income interests of the surviving spouse and the charities.[343] Based on the ordinary meaning of "trustee's commissions, and other charges" in Regulation § 25.2523(e)-1(f)(3), Judge Beghe suggested that the amount charged in Mr. Hubert's estate greatly exceeded the Regulation drafters intentions.[344] Rather than reducing the marital and charitable shares dollar for dollar as the Commissioner argued, Judge Beghe suggested that the estate should reduce the marital and charitable shares by the date-of-death present value of the annuity proportionally to the total estate.[345] Judge Beghe concluded that the Tax Court stands alone on this issue and practitioners would be wise not to rely on the court's position.[346]

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337. *Id.* at *64 (Beghe, J., concurring in part and dissenting in part). Judge Beghe was concerned that: (1) the majority's opinion creates the impression that the payment of administrative expenses from estate income never affects the income passing to the estate beneficiaries; (2) the majority omitted the actual amount of administrative expenses charged against Mr. Hubert's beneficiaries, supporting their position; and (3) the majority did not address the affect on the estate tax charitable deduction of charging administrative expenses to income. *Id.* at *66.

338. *Id.* at *67 n.1.

339. *Id.*

340. *Id.* at *68.

341. *Id.* at *70.

342. *Id.*

343. *Id.* at *71.

344. *Id.* at *70.

345. *Id.* at *71.

346. *Id.* at *74.

V. ANALYSIS

This section analyzes the issues raised and addressed in *Estate of Hubert*[347] and *Estate of Street*.[348] First, this section considers whether income earned during the administration of the estate is included in valuing the gross estate. The section concludes that the net present value of future rights to income may be considered in the gross estate valuation process, but actual income is not added to the gross estate.[349] Next, this section considers what effect deductions taken for administration expenses on the income tax return have on the marital deduction. The section concludes that Congressional history requires a corresponding reduction in the marital deduction for administration expenses paid from estate income under certain conditions, but that the Code and Regulations are much less clear.[350] Finally, this section considers whether the charitable deduction should be reduced for the payment of administration expenses deducted on the income tax return. The section concludes that courts should apply the same principles to the charitable deduction as courts apply to the marital deduction.[351]

A. Income Earned During the Administration of the Estate

Both the *Street II* court and the *Hubert* court mentioned the relationship between the gross estate and estate income. In doing so, the courts made conflicting, sometimes erroneous statements, and thus confused the primary issues. Whether income is part of the gross estate appears, at first, to be important. In order for estate property to qualify for the marital deduction, its value must be included in the gross estate and the property must pass from the decedent to his surviving spouse.[352] If the estate distributes property to the decedent's surviving spouse which it did not include in its valuation, the estate cannot deduct the value of the property. Similarly, if the gross estate includes property in its valuation, then distributes the property to someone other than the surviving spouse or a qualified charity, the estate cannot deduct the value of the property from the gross estate. Therefore, it would seem important to compare the value of the surviving spouse's property included in the gross estate with the value of the property the spouse actually received to verify that the estate has successfully met both requirements for the marital deduction.

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347. *See supra* notes 219-346 and accompanying text.
348. *See supra* notes 171-217 and accompanying text.
349. *See infra* notes 352-74 and accompanying text.
350. *See infra* notes 375-447 and accompanying text.
351. *See infra* notes 448-56 and accompanying text.
352. I.R.C. § 2056(a) (1988).

If the estate executor elects to use estate income to pay administrative expenses and the income is not included in the gross estate, then the amount of property passing to the surviving spouse from the gross estate and the corresponding marital deduction appear to be unaffected. Conversely, if all of the decedent's estate is contained in the gross estate,[353] then the income must arguably also be included in the gross estate, as part of the one hundred percent of the decedent's estate left to his spouse. Therefore, when the estate uses income to pay estate expenses, the gross estate property available for distribution must be affected in some manner. Based on the complexity of the valuation process, neither concept is correct.[354] But as discussed in the following subsection, the issue is not relevant.[355]

The *Street II* court stated that the "[i]ncome earned by the estate during [settlement] builds up the marital share."[356] The *Street II* court reasoned that since this income enhanced the marital property, the marital share must be reduced or the spouse would receive more property, and a larger marital deduction, than the amount included in the gross estate.[357] The *Hubert* court majority stated that "[i]ncome earned by the estate has no effect on the estate for Federal estate tax purposes."[358] The dissent in *Hubert* stated that "[o]nly by considering principal and income as a unit, and discounting them together to their present value . . . can the gross estate property be valued."[359] Generally, an executor values the gross estate on the day the decedent died.[360] Alternately, an executor can value the gross estate six months after the decedent's death.[361] The executor can only select the alternate

353. "The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give." REVENUE ACT OF 1948, S. Supp. Rep. No. 1013, 80th Cong., 2d Sess. 7 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1222, 1228; *see also* Burke v. United States, 994 F.2d 1576, 1581 (Fed. Cir.) ("In sum, when a decedent dies, a finite amount known as the gross estate is legally created. Any deductions for expenses incurred in administering the estate are theoretically derived from this amount . . . and accounted for within the gross estate"), *cert. denied*, 114 S. Ct. 546 (1993).

354. *See infra* notes 356-74 and accompanying text.

355. *See infra* notes 375-447 and accompanying text.

356. Estate of Street v. Commissioner, 974 F.2d 723, 727 (6th Cir. 1992); *see also supra* notes 171-217 and accompanying text.

357. *Estate of Street*, 974 F.2d at 727.

358. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63, at *19 (Oct. 19, 1993); *see also* Waldrop v. United States, 137 F. Supp. 753, 756 (Ct. Cl. 1956) (holding "[i]ncome earned during administration is not a part of the gross estate for estate tax purposes, and is not taxable as such"). *But see Estate of Hubert*, 1993 T.C. LEXIS 63, at *58 (Halpern, J., concurring in part and dissenting in part) (noting that majority "is undone by its view that income earned on estate property is not included in the gross estate").

359. *Id.* at *57 (Halpern, J., concurring in part and dissenting in part).

360. I.R.C. § 2031(a) (1988).

361. *Id.* § 2032(a).

valuation date if the estate value and the corresponding estate tax decrease during this period.[362] Thus, an estate cannot reflect an increase in value after the decedent's death, and income earned by an estate after the decedent's death is not added to the value of the gross estate.[363] For post-death income to affect gross estate computations, the income must be reflected in the fair market value of the asset on the decedent's death.

Valuation requires looking into the future,[364] and net present value computations are one method by which an appraiser might arrive at the fair market value of property.[365] Unfortunately, estate asset valuation does not lend itself to simple net present value computations.[366] For example, Mr. Hubert's estate contained three parcels of income-producing real estate.[367] In calculating each parcel's fair market value on the date of death, the appraisers properly considered their ability to generate income. The appraisers, however, did not simply calculate the net present value and add it to the principal. Instead, the appraisers considered whether the leases still reflected fair market value, as well as many other factors.[368] Although both the direct and yield capitalization approaches calculate the net present value of future rights to income, appraisers consider many other variables.[369] Therefore, a real estate appraisal only contains a net present value calculation if it helps reflect the asset's fair market value.

Similarly, appraisers do not utilize simple net present value numbers when calculating the value of closely held stock. A stream of dividend income may be a poor indicator of the closely held stock's

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362. *Id.* § 2032(c).

363. Maass v. Higgins, 312 U.S. 443, 447 (1941); *see also supra* notes 70-79 and accompanying text.

364. *See supra* text accompanying notes 37-39.

365. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *56-57 (Beghe, J., dissenting) (giving example of net present value calculation for bond).

366. As the Supreme Court stated:

> And the promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments, the past and prospective regularity of the payments, and other elements bearing upon the expectation of the receipt of income affect the value of any income producing property. But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all the elements that go to give it value in the market.

Maass, 312 U.S. at 448.

367. Fourth Codicil to Last Will & Testament of Otis C. Hubert (May 15, 1981) (on file with the *Universoty of Dayton Law Review*). This real estate included a shopping mall and a tract under lease to a major corporation. *Id.* The land was placed in trust for Mrs. Hubert until her death, when it would be distributed. *Id.*

368. See *supra* notes 55-64 and accompanying text for a discussion of real estate appraisal.

369. *See supra* notes 55-64 and accompanying text.

value.[370] This is especially true if a controlling shareholder or partner dies. As with real estate, many factors are considered, including the economic market and economic outlook.[371] Therefore, it is overly simplistic to arrive at this value through a net present value computation.

Both the Sixth and the Fifth Circuit Courts of Appeals stated that income earned during the administration of an estate increases the size of the residue.[372] An estate, however, cannot add estate income earned after the decedent's death to its gross value.[373] Instead, the courts should have stated carefully that the residue increase results from choosing not to reduce the gross estate's existing value by the payment of expenses and not from the infusion of income. The *Hubert* court criticized the *Street II* court for the impropriety of its statement.[374]

The next subsection indicates why the *Street II* court is ultimately correct, despite the court's disingenuous wording. The following subsection also explains why Congress is not concerned about who pays administrative expenses.

B. The Marital Deduction Valuation and Estate Expenses

In determining whether the payment of administration expenses from estate income affects the marital deduction, both the *Hubert* court and the *Street II* court analyzed the same sections of the Code, Regulations, and Congressional history.[375] The *Hubert* court held that the payment of administrative expenses from estate income did not affect the Hubert estate's marital deduction.[376] The *Street II* court held that the payment of administrative expenses from estate income reduced the Street estate's marital deduction.[377] The courts disagreed, initially, on the timing of administrative expenses.[378] They further disagreed on the interpretation of the Regulations[379] and the applicability of Congressional history.[380]

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370. *See supra* notes 46-47 and accompanying text.

371. *See supra* text accompanying note 47.

372. Estate of Street v. Commissioner, 974 F.2d 723, 728 (6th Cir. 1992); Estate of Alston v. United States, 349 F.2d 87, 88 (5th Cir. 1965).

373. Maass v. Higgins, 312 U.S. 443, 446 (1941); *see also supra* notes 70-79 and accompanying text.

374. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63, at *30-31 (Oct. 10, 1993).

375. *See infra* notes 398-446 and accompanying text.

376. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *32; *see also supra* notes 219-346 and accompanying text.

377. Estate of Street v. Commissioner, 974 F.2d 723, 728 (6th Cir. 1992); *see also supra* notes 219-346 and accompanying text.

378. *See infra* notes 398-412 and accompanying text.

379. *See infra* notes 404-13 and accompanying text.

380. *See infra* notes 414-28 and accompanying text.

The Code allows a marital deduction for the value of property included in the gross estate and passed by the decedent to his surviving spouse.[381] When valuing the marital deduction, the Code requires the estate to take into account any encumbrance or obligation the decedent imposes against the property.[382] The Code and Regulations instruct the estate to consider these encumbrances or obligations against the property "in the same manner as if the amount of a gift to the spouse of such interest were being determined."[383] In valuing the property interest passing to the surviving spouse, the Regulations require the estate to consider any "material limitations upon [the surviving spouse's] right to income from the property."[384] Regulation § 25.2523(e)-1(f) values the marital deduction for spousal gifts by the recipient's "degree of beneficial enjoyment" of the trust property.[385] This Regulation defines "degree of beneficial enjoyment" as the unqualified designation of the spouse as the life income beneficiary of the trust or as giving the survivor such use of trust property as is consistent with the value of the trust corpus and its preservation.[386]

To aide the analysis, it will be helpful to consider the simple, hypothetical estate of Mr. Brown. Mr. Brown died testate with $100 in his gross estate. Following the payment of expenses, he left everything to his wife. His estate incurred $5 in administrative expenses for legal and accounting fees. Mr. Brown died in a perfect world in which his estate was closed on the day he died. His estate earned no income because settlement occurred on the date of his death. Mr. Brown's estate tax return would reflect the following:

ESTATE TAX RETURN

Total Gross Estate:	$100
Total Allowable Deductions:	$100
Taxable Estate:	$ 0

Schedule M; Property Passing to Surviving Spouse:	$ 95
Schedule K; Decedent Debts:	$ 5
Total Deductions:	$100

381. I.R.C. § 2056(a) (1988); *see also supra* notes 93-115 and acompanying text.
382. I.R.C. § 2056(b)(4)(B).
383. *Id.*; *see also* Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958).
384. Treas. Reg. § 20.2056(b)-4(a).
385. Treas. Reg. § 25.2523(e)-1(f)(1) (as amended in 1961).
386. *Id.*

Clearly, Mrs. Brown cannot receive more than the $95 remaining after Mr. Brown's estate pays the $5 in administrative expenses. Further, the estate paid the entire amount from the principal of the estate because the estate earned no income. Therefore, the Brown estate received a marital deduction of $95. Both the *Hubert* court and the *Street II* court agree with this result.[387]

The divergence in opinion between the *Hubert* court and the *Street II* court can be seen more clearly with the following, more realistic hypothetical. The fictitious Mr. Brown died testate with a $100 gross estate. He left his entire estate after the payment of expenses to his wife. His estate remained open for nine months and earned $10 in income. Mr. Brown's executors and attorneys charged the estate with $5 in administrative expenses. His executors elected to pay the $5 out of the $10 in income. The estate deducted the $5 on its income tax return and filed a waiver with its estate tax return, as required under Code § 642(g).[388]

ESTATE TAX RETURN		INCOME TAX RETURN	
Total Gross Estate:	$100	Gross Income:	$ 10
Schedule M; Property Passing to Surviving Spouse:	$100		$ 0
Schedule K; Administrative Expenses:	$ 0		$ 5
Taxable Estate:	$ 0	Taxable Income:	$ 5

The *Street II* court would require the estate to show a marital deduction of $95 even though Mrs. Brown received $100 of the gross estate.[389] In resolving this issue, the *Street II* court would not find it necessary to review state law or testator intent.[390] The *Hubert* court would allow Mr. Brown's estate to take a $100 marital deduction but

387. Estate of Hubert v. Commissioner, 1993 T.C. LEXIS 63, at *19-20 (Oct. 19, 1993) ("If the administration expenses were paid out of the principal, they would reduce the amount of such principal received by the beneficiaries and would reduce the marital and charitable deductions."); Estate of Street v. Commissioner, 974 F.2d 723, 727 (6th Cir. 1992).

388. *See supra* notes 147-52 and accompanying text.

389. *Estate of Street*, 974 F.2d at 729 ("To the extent that income was used to pay administrative expenses, the marital deduction must be reduced accordingly."); *see also* Estate of Fisher v. United States, 28 Fed. Cl. Ct. 88, 94 (1993) ("Therefore whether administration expenses are paid from estate income or estate principal is immaterial. Such amounts must be reflected in the gross estate at the date of death . . . .").

390. *Estate of Street*, 974 F.2d at 728 ("Instead, Treasury Regulation § 20.2056(b)-4(a) controls the tax treatment of administrative expenses paid from income regardless of state law or the dictates of a decedent's will."). See *infra* text accompanying note 404 for Treasury Regulation § 20.2056(b)-4(a).

would review state law and testator's intent.[391] The courts' conflicting opinions lie in the perceived timing of administrative expenses,[392] the applicability of Congressional history,[393] and the interpretation of the Regulations.[394]

One area upon which the two courts agree concerns the payment of estate tax deficiencies from estate income. Both courts agree that the payment of interest on estate taxes from estate income does not merit a reduction in the marital deduction.[395] The courts conclude that, on the date of the decedent's death, any interest on tax deficiencies is unknown and uncertain.[396] The courts thus determine that this amount accrues sometime after the date of death and should not be used to adjust the gross estate upon which the marital deduction is based.[397]

The Tax Court in *Estate of Hubert* extended the same reasoning to administrative expenses.[398] The *Hubert* court determined that administrative expenses accrue after death and are as uncertain as interest on estate taxes.[399] The *Street II* court disagreed, holding that administrative expenses accrue at death.[400] The *Street II* court, however, never explained why expenses incurred after the decedent's death accrue on the date of death. Regarding that issue, the Fifth Circuit Court of Appeals determined "[a]t the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration."[401]

The Fifth Circuit's language indicates that administrative expenses are similar to estate taxes and decedent debts. On the date of death, while the actual figures may not be known with certainty, the existence of administrative expenses is fairly certain. As seen with Mr. Brown's estate, even if executors could close the estate on the same day he died, the estate would incur expenses for the "collection of assets, payment of debts, and distribution of property to persons entitled to

391. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *20 ("the administration expenses that are allocable to income in this case do not change the amount of the estate principal received by the spouse or the charity and do not reduce the marital and charitable deductions.").

392. *See infra* notes 398-412 and accompanying text.

393. *See infra* notes 414-28 and accompanying text.

394. *See infra* notes 404-14 and accompanying text.

395. Estate of Street v. Commissioner, 974 F.2d 723, 729 (6th Cir. 1992); Estate of Richardson v. Commissioner, 89 T.C. 1193, 1205-06 (1987).

396. *Estate of Richardson*, 89 T.C. at 1206.

397. *Estate of Street*, 974 F.2d at 729; *Estate of Richardson*, 89 T.C. at 1205-06.

398. *See supra* notes 219-346 and accompanying text.

399. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. 63, at *32 (1993).

400. *Estate of Street*, 974 F.2d at 727.

401. Estate of Ballantine v. Tomlinson, 293 F.2d 311, 312 (5th Cir. 1961); *see also* Ithaca Trust Co. v. United States, 279 U.S. 151 (1929).

it."[402] Although Congress allows estates nine months after the decedent's death to file the estate tax return and time to complete the estate's administration, this time is not to be used as a vehicle to accumulate income to pay estate expenses.[403] Interest on estate tax deficiencies, by contrast, can be distinguished from estate taxes and administrative expenses because the executors can choose not to incur deficiencies by paying assessed taxes.

The *Street II* court did not find it necessary to discuss this issue, since it found the following Treasury Regulation as conclusive:

> 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.[404]

The *Hubert* court questioned the *Street II* court's application of this example to administrative expenses alone and not to estate tax deficiencies.[405] Further, the *Hubert* court did not find the example persuasive.[406] The *Street II* court is correct that the example is important, but a literal reading of this example is not conclusive. The Regulation gives an example for the application of a rule. Logically, the rule precedes the example. The sentence prefacing the illustration states that "[i]n 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."[407] The instruction to take into account any "material limitations" is not a mandate for a set-off.[408] Instead, it suggests a subjective analysis of the relationship between estate income and estate expenses. The *Hubert* court, finding the example a valuation provision, reviewed the relationship between the lifetime income of Mrs. Hubert and the administrative expenses incurred by the estate.[409] Utilizing the "substantial beneficial enjoyment" requirement in the Gift Tax Regulations, the court set boundaries for the "material limitations" threshold in the Estate Tax Regulations.[410] The court then

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402. Treas. Reg. § 20.2053-3(a) (as amended in 1979).

403. Buchanan v. United States, 377 F. Supp. 1011, 1014 (W.D. Pa 1974), *aff'd*, 511 F.2d 1392 (3d Cir. 1975).

404. Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958); *Estate of Street*, 974 F.2d at 728 ("The example set forth in the regulation states that income used to pay expenses of administration must reduce the size of the marital deduction.").

405. Estate of Hubert v. Commissioner, 1993 T.C. LEXIS 63, at *30-31 (Oct. 19, 1993).

406. *Id.*

407. Treas. Reg. § 20.2056(b)-4(a) (as amended in 1958).

408. *Estate of Street*, 974 F.2d at 728.

409. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *24.

410. *Id.* at *23 (citing Treas. Reg. § 25.2523(e)-1(f)(1) (as amended in 1961)).

determined that the payment of administrative expenses from income did not deprive Mrs. Hubert of substantial beneficial enjoyment of her property.[411] That analysis appears reasonable in light of the language of the Code and Regulations.

The *Street II* court, however, never entertained a similar analysis. Instead, it relied on the following passage in Congressional history:

> 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 increased 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.[412]

Finding this passage in Congressional history inapplicable, the *Hubert* court distinguished claims against the estate from administration expenses by stating that "[c]laims against the estate are, by definition, in existence at the date of death; therefore, by their very nature, claims against the estate relate to corpus . . . administration expenses come into existence only after the death of the decedent and may relate to both income and corpus."[413] While the *Hubert* court distinguished Congressional history and the *Street II* court applied it, neither court discussed the authoritative weight of the Congressional history in deciding the cases.

The starting point for the interpretation of any statute is the language itself.[414] The parties should regard the language as conclusive unless Congress expresses a contrary legislative intent.[415] "Committee reports and explanatory statements of members in charge made in presenting a bill for passage have been held to be legitimate aid to the interpretation of a statute where its language is doubtful or obscure."[416] The Code sections that apply to the marital deduction when calulating the estate and gift tax are both equally ambiguous, and an examination of legislative history is necessary.

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411. *Id.* at *24.

412. *Estate of Street*, 974 F.2d at 728 (citing REVENUE ACT OF 1948, S. Supp. Rep. No. 1013, 80th Cong., 2d Sess. II-6 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1222, 1228).

413. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *25.

414. Consumer Prods. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980) (finding § 6(b)(1) of Consumer Product Safety Act stating "any public disclosure" not limited to disclosures initiated by commission or only affirmative disclosures).

415. *Id.*

416. Rail Road Comm'n v. Chicago, Burlington & Quincy R.R., 257 U.S. 563, 589 (1922) (citing Duplex Printing Press Co. v. Deering, 254 U.S. 443, 475 (1921)).

Code § 2056(b)(4)(B), which directs the estate to value the marital deduction by taking into account any encumbrance or obligation imposed by the decedent in the same manner as if the estate were valuing a spousal gift, is vague.[417] Code § 2523 is similarly vague, directing the donor to take a deduction for a spousal gift that is equal to the value of property given to the spouse.[418] The ambiguity in these statutes supports a review of legislative history in order to determine Congressional intent.[419] One intent of the Revenue Act of 1948 was to correct existing inequalities between the estate tax and the gift tax.[420] The Senate Finance Committee, when discussing the interest passing to the surviving spouse and in the paragraph prior to the crucial sentences on this issue, stated "[t]his is a clarification which was not expressed by the bill as passed by the House."[421] Because the drafters of the Code used ambiguous language, a report by the Senate Finance Committee clarifying the proposed House bill is a persuasive extrinsic aide in the present case. For that reason, Congressional history was properly used by the *Street II* court.

In our previous example, Mr. Brown died with a gross estate of $100. He left everything to Mrs. Brown following the payment of $5 in administrative expenses. The estate chose to pay the $5 from estate income. Mrs. Brown, therefore, received $100 of the gross estate. According to Congressional history, however, Mr. Brown did not bequeath the additional $5 to her. Instead, the executor "purchased" $5 more of the gross estate for Mrs. Brown. Therefore, the *Street II* court correctly noted that the marital property passing by bequest from the decedent was only $95 and the estate should only be allowed a $95 deduction. The Tax Court reached this result under a similar set of facts by noting:

> That the estate had income over the administration years which would have enabled the payment of expenses from income and thus relieve the wife's residuum from the burden was a fortuitous one, . . . and should not relieve the residuary legacy, for valuation purposes, of that burden or encumbrance for such expenses which existed at the time of death.[422]

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417. I.R.C. § 2056(b)(4)(B) (1988).

418. I.R.C. § 2523(a) (1988 & Supp. 1993).

419. United States v. Donruss Co., 393 U.S. 297, 302 (1969) (finding "availed for the purpose of" inherently vague); *see also* Ferro-Co Corp. v. War Contracts Price Adjustment Bd., 248 F.2d 77, 78 (D.C. Cir. 1957) (holding that "any court" included Tax Court).

420. REVENUE ACT OF 1948, S. Rep. No. 1013, 80th Cong., 2d Sess. 1 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1163.

421. REVENUE ACT OF 1948, S. Supp. Rep. No. 1013, 80th Cong., 2d Sess. (1948), *reprinted in* 1948 U.S.C.C.A.N. 1222.

422. Estate of Roney v. Commissioner, 33 T.C. 801, 804 (1960); *see also supra* note 211.

The Tax Court in *Hubert* clearly reversed its position on this issue.[423] Attempting to distinguish *Hubert* from similar cases, the Tax Court emphasized state law and testator intent.[424]

To clarify the Tax Court's position, it will be necessary to complicate the illustration of Mr. Brown's estate. Mr. Brown died testate with a $100 gross estate. He left the residue of his estate to Mrs. Brown. His estate stayed open for nine months earning $10 in income and incurring $5 in administrative expenses. His executors elected to pay $5 in administrative expenses from estate income and deducted it on the estate income tax return. In his will, Mr. Brown authorized his executors to use estate income to pay estate expenses. State law also enabled the executor to apportion expenses of the estate between income and principal.

The *Hubert* court would hold that Brown's estate would not need to reduce the marital deduction because state law, as well as the testator's intent, permitted the allocation of expenses to income.[425] Thus, the court would hold that "[t]o the extent the executor exercised its discretion and allocated administration expenses to income, the marital and charitable deductions are not reduced by payment of those expenses."[426] Again, the *Street II* court resolved the issue correctly.

Mr. Brown, in spite of providing his executors with discretion to charge expenses to income, still bequeathed the residue of his estate to Mrs. Brown. According to the legislative history:

> 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 increased by purchase and not by bequest.[427]

Mr. Brown's executors still "purchased" $5 more of the gross estate for Mrs. Brown by paying administrative expenses from income. This analysis obviously applies when the surviving spouse receives the residue of

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423. Estate of Hubert v. Commissioner, No. 22333-90, 1993 T.C. LEXIS 63, at *32 (Oct. 19, 1993).

424. *Id.*; *see also supra* text accompanying notes 219-348.

425. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *21 (noting that Georgia law and Mr. Hubert authorized allocation of expenses to income). By comparison, the *Street II* court considers the Treasury Regulation conclusive and the issue completely resolved by federal law. Estate of Street v. Commissioner, 974 F.2d 723, 728 (6th Cir. 1992). "[T]he payment of administrative expenses from income must operate to reduce the size of the marital deduction, otherwise the spouse would receive a deduction which exceeded the amount which was actually in the estate, and available for distribution." *Id.* at 727. Thus, the *Street II* court would reduce the Brown estate's marital deduction by $5.

426. *Estate of Hubert*, 1993 T.C. LEXIS 63, at *21.

427. REVENUE ACT OF 1948, S. Supp. Rep. No. 1013, 80th Cong., 2d Sess. (1948), *reprinted in* 1948 U.S.C.C.A.N. 1222, 1228.

the estate or "that portion of the estate that is left after all debts and legal charges have been paid and other testamentary gifts have been satisfied."[428]

In some instances, however, the testator leaves his spouse the minimal amount that will reduce his estate taxes to zero. In the example, Mr. Brown left a gross estate of $100. He wished to leave Mrs. Brown just enough to reduce his estate taxes to zero, leaving the remainder to his son. He authorized his executors to apportion expenses between principal and income. State law also licensed the executors to apportion expenses between principal and income. Mrs. Brown received $60 of the estate and Mr. Brown's son received the rest of the taxable estate. The estate incurred $5 in administrative expenses that it deducted on the estate income tax return. Of the $10 in estate income, $5 is attributed to the assets for Mrs. Brown and $5 is attributed to the assets for Mr. Brown's son. The estate executors chose to charge none of the $5 that Mrs. Brown's assets earned with administrative expenses. The returns appeared as follows:

ESTATE TAX RETURN		INCOME TAX RETURN	
Total Gross Estate:	$100	Gross Income:	$ 10
Schedule M; Property Passing to Surviving Spouse:	$ 60		$ 0
Schedule K; Administrative Expenses:	$ 0		$ 5
Taxable Estate:	$ 0	Taxable Income:	$ 5

The Tax Court, in circumstances similar to Mr. Brown's estate, noted that the income attributable to the nonmarital share was large enough to pay administrative expenses.[429] The court thus noted that in that case, the executor need not burden the marital share at all.[430] The Tenth Circuit Court of Appeals held differently, stating that "it is immaterial that such expenses may actually be paid out of non-marital share funds, so long as there exists discretion or an obligation to charge the marital share."[431] Whether the executors use Mrs. Brown's own income or her son's income to relieve her share of the estate from expenses is immaterial. The same analysis applies and the marital share still must be reduced because the executors "purchased" a larger mari-

428. Republic Nat'l Bank v. Commissioner, 334 F.2d 348, 350 (5th Cir. 1964) (quoting Sinnott v. Gidney, 322 S.W.2d 507, 511 (Tex. 1959)).

429. Estate of Allen v. Commissioner, 101 T.C. 351, 358 (1993).

430. *Id.*

431. Jeschke v. United States, 814 F.2d 568, 576 (10th Cir. 1987).

tal share for Mrs. Brown. If however, Mr. Brown specifically charged his executors to not burden Mrs. Brown's share with administrative expenses, charging these expenses to income falls within the testamentary plan and is not a "purchase."[432]

A handful of state statutes mandate that the estate must pay settlement expenses from the principal of the estate.[433] These statutes, however, always give the testator the option of specifying other sources and beneficiaries to make the payment.[434] The remaining states allow the estate executor to choose the apportionment of expenses between principal and income.[435]

The administrative interpretation of the marital deduction valuation process has muddled the issue even further. The sentence prefacing the applicable example[436] in the Regulations states: "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."[437] The Regulations lack a clear statutory interpretation of applicable Congressional history on this point. As seen by the *Hubert* court's reasonable analysis of the readily accessible Regulations,[438] no marital deduction setoff is mandated for the payment of administrative expenses from estate income. The consequences to the unwary taxpayer, who does not have ready access to legislative history, can be severe.[439] A decrease in the marital deduction results in a larger taxable estate and a larger estate tax. This, in turn, results in a decrease in the marital deduction for its corresponding share of additional

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432. *See Jeschke*, 814 F.2d at 576 ("If, however, a testator specifically provides by will that administration and similar expenses *not* be paid out of the surviving spouse's share qualifying for the marital deduction, then the marital deduction is not reduced by its 'share' of the expenses.") (emphasis in original); *see also* REVENUE ACT OF 1948, S. Supp. Rep. No. 1013, 80th Cong., 2d Sess. (1948), *reprinted in* U.S.C.C.A.N. 1222, 1227-28 ("If the decedent by his will leaves to his surviving spouse real estate subject to a mortgage . . . [and] the decedent by his will directs the executor to pay off the mortgage, such payment constitutes an additional interest passing to the surviving spouse.").

433. *See supra* note 155 and accompanying text.

434. *See supra* note 155 and accompanying text.

435. *See supra* note 155 and accompanying text.

436. The Regulations provide an example:

> 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) (as amended in 1958).

437. *Id.*

438. *See supra* notes 292-302 and accompanying text.

439. *See* Schwegmann Bros. v. Calvert Distillers Corp., 341 U.S. 384, 396 (1951) (Jackson, J., concurring) (noting difficulty for lawyers to keep abreast of Congressional history).

estate tax and a larger taxable estate.[440] The executor again assesses the tax and reduces the marital deduction for a proportionate share, increasing the taxable estate and the estate tax.

Courts now agree that when an estate pays administration expenses from principal the gross estate is reduced.[441] Congress has directed a reduction in the marital deduction for administration expenses paid from estate income when the surviving spouse receives the residue.[442] The Code and Treasury Regulations, by contrast, suggest a subjective analysis be used to determine the material limitations upon the surviving spouse's right to income and incorporate a gift tax analogy.[443] The *Hubert* court reasonably followed the steps provided in the Code and Regulations but dealt ineffectively with Congressional history.[444] The *Street II* court applied Congressional history correctly in Gordon Street's estate, but overstated the applicability of Congressional history and the example in Regulation § 20.2056(b)-4(a).[445] Based on the *Street II* court's expansive reading of Congressional history and the Regulation,[446] an estate or testator cannot protect the marital deduction from a full reduction for administrative expenses.[447] A testator, however, should be able to draft protection for the marital deduction by placing the burden of expenses upon other beneficiaries, thus ensuring the full property value passes by bequest.

C. *The Charitable Deduction*

The Code permits an estate to deduct bequests to qualified charities to the extent that the transferred property is included in the gross estate.[448] The estate is entitled to deduct only that amount actually passing to the charitable beneficiary.[449] The Code also authorizes an

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440. "For example, assume that the only bequest to the surviving spouse is $100,000 and the spouse is required to pay a State inheritance tax in the amount of $1,500 . . . the value, for the purpose of the marital deduction, is $98,500." Treas. Reg. § 20.2056(b)-4(c)(2) (as amended in 1958).

441. *See supra* note 387 and accompanying text.

442. *See supra* text accompanying note 412.

443. *See supra* notes 390-95 and accompanying text.

444. *See supra* notes 418-28 and accompanying text.

445. *See supra* notes 429-37 and accompanying text.

446. *See supra* 195-217 and accompanying text.

447. Estate of Street v. Commissioner, 974 F.2d 723, 728 (6th Cir. 1992) ("Instead, for federal tax purposes, whether the marital deduction must be reduced to reflect a payment of expenses is a question of federal law, and cannot depend on the whim of state courts or legislatures.").

448. I.R.C. § 2055 (1988).

449. Harrison v. Northern Trust Co., 317 U.S. 476, 480 (1943).

estate to deduct charitable donations on the estate income tax return to the extent donated income is included in the estate's gross income.[450]

Identical to the marital deduction issue is the issue of whether the payment of administrative expenses from post-mortem income that is deducted on the estate income tax return affects the charitable deduction on the estate tax return.[451] The *Hubert* court held that the payment of administrative expenses from income did not affect the charitable deduction for the same reasons it did not affect the marital deduction.[452] Prior to *Hubert*, the Tax Court found the passage of Congressional history applicable to the charitable deduction as well as the marital deduction.[453] The court held that "the increase in the amount of the residue passing to the charity as a result of the use of post-mortem income to pay administration expenses cannot be included in the charitable deduction."[454] The Tax Court was correct when it found Congressional history equally applicable to the charitable deduction.[455]

In the example, Mr. Brown left a $100 gross estate. He bequeathed the entire estate, following the payment of expenses, to charity. His estate incurred $5 in administration expenses. His estate existed in a perfect world and closed on the date of his death. Clearly, the estate only passed $95 to the charity after it paid $5 of administration expenses. If the estate stayed open for nine months, earned $10 in income and paid $5 of income for administration expenses, then the charity received $100 of the gross estate. Applying the principles used when considering the marital deduction,[456] Brown's estate "purchased" $5 more of the gross estate for the charity than it would have received without the settlement period. Again, because the charity is to receive the residue after all payments of expenses, it seems reasonable to charge the residue for the payment of these expenses. A similar analysis can be applied whenever the estate executor elects to use estate income for administrative expenses, instead of burdening the charitable corpus. The testator, however, should be able to direct his executors to refrain from charging the charitable share with the administrative expenses without incurring a "forced" charitable reduction on the estate tax return.

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450. I.R.C. § 642(c) (1988).

451. Estate of Hubert v. Commissioner, 101 T.C. 314, 331 (1993).

452. *Id.* ("We hold that . . . the marital and charitable deductions are not reduced by expenses so allocated.").

453. Estate of Horne v. Commissioner, 91 T.C. 100, 109 (1988).

454. *Id.* at 110.

455. Burke v. United States, 994 F.2d 1576, 1582 (Fed. Cir. 1993) (noting that although Congressional history is framed in context of marital deduction, logic is no less applicable to charitable deduction).

456. *See supra* text accompanying notes 388-447.

VI. CONCLUSION

Net income may or may not be included in the valuation of the gross estate. Its inclusion or exclusion is not important in deciding whether to reduce the marital deduction for the payment of claims against the estate from estate income. Congressional history provides a clear directive to reduce the marital deduction for claims against the estate paid from estate income when the testator left the residue of his estate to his surviving spouse. It is easy to conduct a similar analysis whenever the surviving spouse's marital share was relieved of the burden of paying administration expenses from principal because of the availability of estate income. The analysis no longer holds when the testator directs his estate to refrain from charging his surviving spouse with claims against the estate. At that point, the relief of the surviving spouse's share of the expenses was a bequest from the decedent, not a "purchase" by the executor. The same analogy and reasoning applies to the charitable deduction with the same results.

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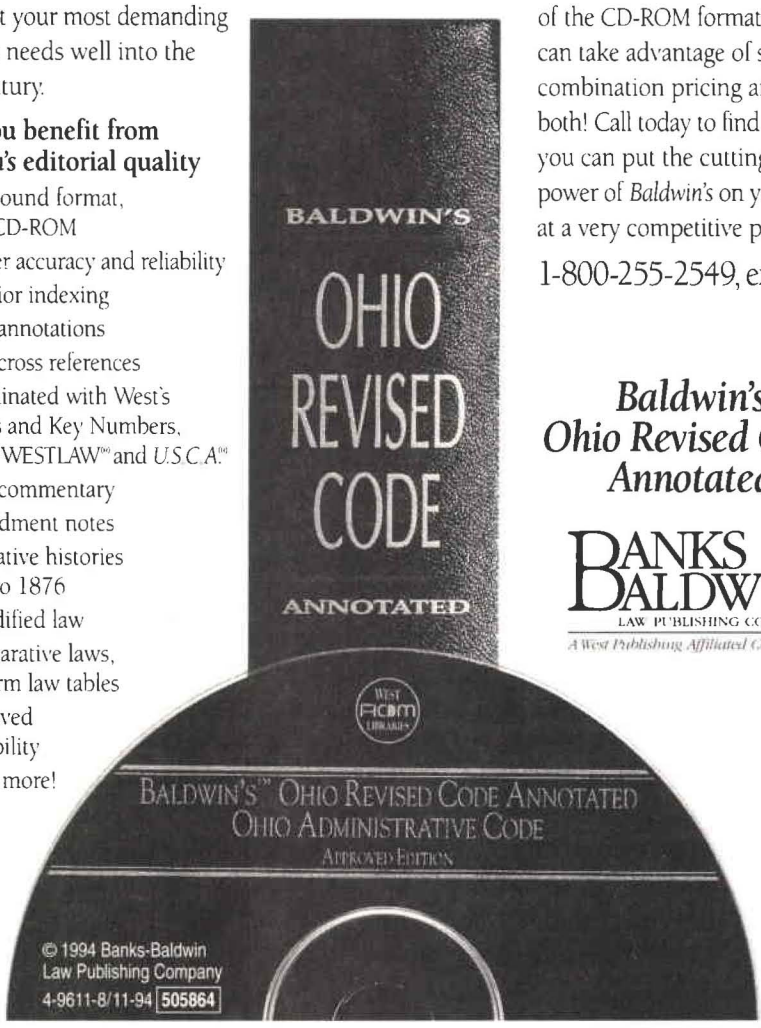

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