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ALTERNATIVE METHODS OF HANDLING ADMINISTRATION EXPENSES FOR INCOME AND ESTATE TAX PURPOSES[1]

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LEGISLATIVE HISTORY

For many years prior to 1942, a broad construction prevailed governing the nature of the deduction for "ordinary and necessary expenses paid or incurred in the taxable year in carrying on any trade or business." Undoubtedly many administration expenses incurred in the handling of an estate were successfully deducted as ordinary and necessary expenses. The circumstance that the same deduction was taken for both income and estate tax was not regarded as material.[2] A more critical approach and a more restrictive construction was adopted by the Supreme Court in a series of cases decided in 1941.[3] They held that not all expenses of every business transaction are deductible. Only those expenses are deductible which relate to the carrying on of a business.

The denial of expenses which were reasonably required to produce income on the ground that they were not technically "incurred in a trade or business" ultimately led to statutory reform, and in 1942 the law was amended to create a new deduction described by the statute in a not too revealing fashion as a "non-trade and non-business expense."[4]

At this point, administrative expenses incurred by an estate would have been deductible under the estate tax law as an administrative expense and under the income tax law as a non-trade or non-business expense. To circumvent the grant of a double deduction, section 161(a) of the 1942 Act added section 162(e) to the 1939 Code (now section 642(g) of the 1954 Code) to deny the income tax deduction for non-trade and non-business expenses in computing the net income of an estate, unless a waiver is filed giving up the right to take such expenses as a deduction for estate tax purposes.

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1. There is an increasing amount of literature on this topic. See particularly Cox, *Executor's Election to Claim Certain Deductions for Income or Estate Tax Purposes,* 20 OHIO ST. L.J. 23 (1959); Gradwohl, *Current Issues in Probate Estate Income Tax Allocation,* 37 NEB. L. REV. 329 (1958); Randall, *Consequences of Executor's Elections as to Administrative Expenses,* N.Y.U. 15TH INST. ON FED. TAX 1011 (1957).

2. Brown v. Commissioner, 74 F.2d 281, 286 (10th Cir. 1934), *reversing* 29 B.T.A. 1183; Robert Kleberg, 31 B.T.A. 95 (1934).

3. United States v. Pyne, 313 U.S. 127 (1941); City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941); Higgins v. Commissioner, 312 U.S. 212 (1941).

4. See § 121 of the 1942 Act adding § 23(a)(2) to the 1939 Code (now § 212 of the INT. REV. CODE OF 1954).

It should be noted at the outset that under our present scheme of taxing estate income, the benefit of the deduction does not necessarily inure to the benefit of the party bearing the expense. Administrative expenses in the normal case would be properly chargeable to the capital account and would, therefore, diminish the amount of the corpus of the estate. The deductions granted under the 1942 Act for income tax purposes, for those expenses of administration which can classify as non-trade or non-business expenses, are not limited to the expenses which are properly chargeable to income, and the deduction is allowable regardless of the source of the payment of the expenses. In other words, if the election is made by filing the waiver, the estate is given a deduction on its income tax return for certain payments, the benefit of which would in many cases inure to the life tenant or other income beneficiaries. Because of the specific provision of 642(g), where this right is exercised, the deduction for estate tax purposes is denied to the estate and, accordingly, the remainderman is left to bear not only the administrative expense, but also the increased estate tax brought about by the disallowance of such expenses as an estate tax deduction.

The paradoxical result of allowing the benefit of tax deductions for income tax purposes to parties not bearing the expenses and denying the benefit of the deductions for estate tax purposes to parties bearing expenses has not entirely escaped the attention of the courts and the beginnings of a system of case law requiring a more equitable sharing of tax burdens granted by the Code is now emerging.[5]

Nature of Administrative Expenses Involved in the Election

The term "administration expenses" is not used in the income tax statute. That term is an estate tax term, and only those administration expenses which fall within the statutory concept of "non-trade and non-business expenses" are deductible for income tax purposes, the prohibition of double deduction being for those amounts allowable under section 2053 as an administration expense. It was evidently the intent of Congress that in liberalizing the income tax provisions, it wished to make the increased estate tax revenues pay for part of the cost of income tax reform. In this they were not wholly successful, partly because of the form of the legislation and partly as a result of subsequent legislation. In some circumstances the effect of the election of the income tax deduction is to increase the amount of other estate tax deductions, such as the marital deduction, and in other cases Congress failed to prevent the double deduction.

5. See discussion p. 159.

In general, a liberal construction has been adopted by the Service, and its practice is to allow substantially all administrative expenses incurred in the normal administration of an estate as deductions for income tax purposes where the proper election is made; for example, executors' commissions and attorneys' fees, caretaker or custodian expenses paid during administration, court costs and appraisers' fees.[6] While section 642(g) only refers to deductions, the Service has adopted the position that expenses of sale which are not properly a deduction at all, but constitute an amount applied in diminution of the sale proceeds in determining the gain, are to be treated as deductions subject to the requirements of section 642(g).[7]

It is obvious that some administrative expenses, though properly deductible for estate tax purposes, would not fall within the classification of non-trade or non-business deductions as, for instance, the example given in the Regulations of fees paid in a suit to quiet title, which expenses have historically been treated as capital expenses.

Even though the general statutory intent is clear that an administrative expense is not to be deducted for both income and estate tax purposes, there are exceptions. An exception is explicitly made by section 642(g) allowing deductions for income in respect of a decedent to be deducted for both estate and income tax purposes.[8] Since the income in respect of a decedent is being subjected to both income tax and estate tax, it was appropriate to exempt these expenses from the election and to make it clear that they were deductible under both taxes. The second exception appears in the case of non-probate assets. Since the federal estate tax applies not only to the probate estate, but includes many items which are not in the probate estate, all of which have their share of administrative expenses, an interesting question is posed as to whether administrative expenses incurred with respect to such costs are deductible for income tax purposes. Such expenses are deductible as administration expenses for estate tax purposes, either directly as deductions, or indirectly by merely including the net proceeds, and there would appear to be no logical reason to distinguish such expenses from others which are subject to the restrictions imposed by the election. A reading of the pertinent parts of the Committee Reports on the 1942 Act would lead one to believe that the question never occurred to Congress. As noted above, the existence of a deduction for administration expenses under section 2053 for estate purposes and under section 212 for income tax purposes is

6. See letter dated May 24, 1954, signed by Lester W. Utter, Chief, Individual Income Tax Branch, reported in 4 P-H 1954 FED. TAX SERV. ¶ 76,782, and discussion in 4 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION 243 (1959).

7. Rev. Rul. 58-436, 1958-2 CUM. BULL. 336.

8. See discussion p. 147.

perfectly clear, and the expenses are deductible under both taxes unless specifically limited by the election requirement of section 642(g). Section 642(g) refers to a deduction allowable in computing "the taxable income of the estate." The omission of the words "or the trust" in section 642(g) is a significant one. It points up an important advantage in the use of *inter vivos* trusts since it should be possible to secure administrative expenses relating to such trusts, includible in the gross estate, as a deduction both for estate and income tax purposes.[9] A comparable case would be expenses of jointly held property.

Tax Factors to Consider in Making Election

Fortunately, the executor is not required to elect to take the entire deduction either for estate or for income tax purposes. The statute merely prevents the same dollar amounts being deducted for both taxes. A deduction, such as the one for executors' commissions, may be deducted in part for estate tax purposes and in part for income tax purposes. "One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes."[10].

Timing is obviously an important element in taking advantage of the income tax deduction since most estates report their income on a cash receipts and disbursements method of accounting. It may be of considerably greater advantage to spread the administrative deductions over the high income tax brackets of each year, or in a case where the income of the estate is not as great as the income of the beneficiary, it may be well to postpone the payment of the administrative expenses until the final year of the estate, at which time the portion of the deduction in excess of the income of the estate may be of substantial benefit to beneficiaries in a high income tax bracket.

Effect of the Deduction Upon the Marital Deduction

Where a marital deduction is involved in an estate, the situation is replete with uncertainties and complications. Looked at solely from a tax standpoint, the advantage of obtaining a deduction for administration expenses in the income tax return is a substantial one since income tax brackets are considerably higher than estate tax brackets. If the deduction of administration expenses for income tax purposes results in the disallowance of administrative expenses for estate tax purposes, as would be the case where an estate rather than a trust is involved, the effect of

9. See Casner, *Estate Planning — Avoidance of Probate,* 60 COLUM. L. REV. 110, 130 n.85 (1960).

10. Treas. Reg. § 1.642(g)-2.

the denial of the deduction for estate tax purposes would be to increase the adjusted gross estate. If the adjusted gross estate is larger, then the potential marital deduction is also larger, since the marital deduction is available up to a maximum of one-half of the adjusted gross estate. Therefore, the first step in dealing with an estate which involves a marital deduction will be to take the administration expense as a deduction on the income tax return. As a result, the estate tax will be increased since no deduction for administration expense will be allowed. However, approximately one-half of the deduction will be regained because of the increased marital deduction.

Whether the increased marital deduction is allowable to the surviving spouse depends upon whether she is entitled to receive the property up to the additional amount of the possible marital deduction. In a simple case where there is no will and the widow inherits an intestate share (one-half of the net estate where there is one child), a proportionate share of the administration expenses and the estate taxes are deducted in computing the amount receivable by the widow. If the administrator elects to deduct the administration expenses in the income tax return of the estate, the estate will be denied the deduction of administration expenses for income tax purposes under the provisions of section 642(g). It is true that since the estate becomes larger by reason of the disallowance of the deduction for administration expenses and, therefore, one-half of the adjusted gross estate is larger, there would be no increased marital deduction by reason of the increased adjusted gross estate, due to the fact that the widow is not entitled to inherit property up to one-half of the adjusted gross estate since she has to bear her proportionate share of the tax and the administration expenses.[11] The marital deduction cannot be greater than an amount equal to the value of property which passes to the surviving spouse.

If there is a will and the surviving spouse is entitled to one-half of the residue, *i.e.* the net estate after the payment of taxes and administration expenses, the situation is the same.[12] Where, however, the will contains a marital deduction formula clause, the extent of the interest passing to the surviving spouse becomes a question of interpretation under state law. For example, if the will provides that the surviving spouse is entitled to receive that amount of property which will equal the maximum marital deduction obtainable under the provisions of the Internal Revenue Code, it is clear that the effect of the election to deduct administrative expenses in the income tax return would be to increase the amount

11. Campbell v. Lloyd, 162 Ohio St. 203, 122 N.E.2d 695 (1954); Estate of Newton B. T. Roney, 33 T.C. No. 89 (Jan. 29, 1960); *cf.* Estate of Edward H. Luehrmann, 33 T.C. No. 32 (Nov. 18, 1959).

12. See Rev. Rul. 55-643, 1955-2 CUM. BULL. 386; Rev. Rul. 55-225, 1955-1 CUM. BULL. 460.

of the adjusted gross estate, and, therefore, to increase the amount of the maximum marital deduction. Since it is clear that the testator intended the surviving spouse to have this amount, the additional marital deduction would be obtained.

A comparable case would be a bequest of one-half of the adjusted gross estate, as finally determined for federal estate tax purposes, where the administration expenses were actually deducted for income tax purposes.[13] Where the form of the bequest to the surviving spouse is an amount equal to the maximum possible marital deduction and where the executor fails to exercise his election of deducting the administration expenses in the income tax return, it does not necessarily follow that the surviving spouse is only entitled to receive an amount equal to the actual marital deduction, which was in fact allowed in the case. She could very well contend that her inheritance was fixed at the maximum amount which could have been obtained as a marital deduction, taking into consideration the provisions of the entire Code, including the provisions of section 642(g), and that the clear words of the grant should not be frustrated by the failure of the executor to exercise his statutory rights. In addition to this, she would also be in a position to complain about the conduct of the executor in failing to obtain significant tax savings. The wording of the bequest to the surviving spouse is obviously crucial. If, for example, the provision in the will gave to the surviving spouse an amount equal to one-half the adjusted gross estate, as defined by section 2056 of the Internal Revenue Code, it might very well be argued that the disallowance of the administrative expenses for estate tax purposes, due to the operation of section 642(g), does not increase the marital deduction since the computation of the adjusted gross estate, as defined by section 2056, is actually made after the deduction for administration expenses allowed by section 2054.

A less technical interpretation of a comparable provision is adopted by the court in *In re Inman's Estate.*[14] In that case, the bequest was "an amount which shall be equal to one-half (½) in value of my 'adjusted gross estate', as that term is defined in section 812(e)(2) of the United States Internal Revenue Code." The court refused to reduce the widow's share of the estate and concluded that the purpose in using the terms of the Internal Revenue Code indicated an intent to obtain the fullest tax benefit and not merely to create a trust of one-half a residuary estate. This interpretation would be more readily acceptable if a reference had been made to the Internal Revenue Code in its entirety rather than to a specific provision of it. The *Inman* case is difficult to reconcile with *In*

13. *In re* McTarnahan's Estate, 202 N.Y.S.2d 618 (Surr. Ct. 1960).
14. 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Surr, Ct. 1959).

re Levy's Estate,[15] where the bequest referred to a sum equivalent to one-half of the adjusted gross estate. Here the court stated "the election permitted by the Internal Revenue Code does not authorize the executors to vary the interest of the legatees."

The form of the marital deduction clause frequently makes the matter turn on the marital deduction as finally determined for estate tax purposes. In this type of case, the bequest is dependent upon what is actually done by the executor in exercising or failing to exercise the election.[16] If the election to deduct the expenses in the income tax return is chosen, the marital deduction is increased because the gross estate is greater. If, however, the deduction is not taken for income tax purposes, the adjusted gross estate is necessarily reduced by the administration expense, and the surviving spouse would be entitled to the lesser amount.

Allocation of Benefits and Burdens Where Election is Exercised

The fact that the executor chooses to deduct administration expenses against the income of the estate pertains solely to the question of federal income tax law and does not affect the normal rule of probate accounting which would make the estate tax a proper charge against the corpus. Considered solely from a tax standpoint, the effect of the exercise of the election would be to prefer the income beneficiaries against the remaindermen, since the income beneficiaries receive the benefit of the deduction without having the expenses charged against income, thus giving them an estate income *pro tanto* tax free. The remaindermen have the burden of the estate tax to pay, bearing an increased estate tax because of the provisions of section 642(g) which prohibit the deduction for estate tax purposes where the election has been made.

The question confronting fiduciaries is, briefly, should the problem be left at this point, leaving the beneficial interests to be determined by the actual tax liabilities? It is a dilemma for fiduciaries since the remaindermen have a cause for complaint if the tax saving of the income beneficiaries is produced in part at their expense. Many fiduciaries feel that the remaindermen are entitled to be reimbursed by the income beneficiaries to the extent of their loss of the benefit of the estate tax deduction for administrative expenses. If the remainderman is so reimbursed, the life tenant is benefited solely at the expense of the government and not at the expense of both government and the remainderman. There is little authority on this subject, but there have been sufficient decisions to date to indicate a settlement along these lines.

15. 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Surr. Ct. 1957).

16. *In re* McTarnahan's Estate, 202 N.Y.S.2d 618 (Surr. Ct. 1960).

The matter is by no means settled, however, and the suggestion has been made that the solution of merely leaving the remaindermen unscathed is insufficient, on the theory that the tax saving should belong to the entire estate and not be preempted by the income beneficiaries or the surviving spouse. The early decisions, *In re Warms' Estate,*[17] *In re Bixby's Estate*[18] and *In re Rice's Estate,*[19] considered the question as between the remaindermen and the income beneficiaries, no marital deduction being involved. The conclusion of the courts was that the income beneficiaries were required to repay the damage done to the remaindermen through the exercise of the election, out of their savings. In *In re Levy's Estate,*[20] the court, on the issue as between the life tenant and the remainderman, followed the *Warms, Bixby* and *Rice* cases.

It is obvious that the dilemma presented to the fiduciaries could be avoided by the foresight of the draftsman. It is not, however, always possible to determine whether the administrative expense deduction would result in greater tax savings in the income tax return or in the estate tax return, and in such cases it would be well to leave the matter to be decided at the discretion of the executor. The relationship of the executor to the beneficiaries would be greatly simplified and litigation avoided if the will spelled out the decedent's intention as to the rearrangement of property interests arising out of the exercise of the election.

This is particularly important where the marital deduction is involved since the adjusted gross estate, which is the basis for the computation of the marital deduction, is directly affected by the exercise of the election and also because the judicial doctrine requiring a contribution from the life tenant to meet the increased estate tax, resulting from the exercise of the election, affects the amount of property passing to the surviving spouse and thus may act as an additional limitation upon the marital deduction.

17. 140 N.Y.S.2d 169 (Surr. Ct. 1955).
18. 140 Cal. App. 2d 326, 295 P.2d 68 (1956).
19. 8 Pa. D. & C.2d 379 (Orphans' Ct. 1956).
20. 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Surr. Ct. 1957).