Part III - Administrative, Procedural, and Miscellaneous

Material Limitation on Surviving Spouse's Right to Income

Notice 97-63

PURPOSE

This notice invites public comment concerning alternatives for proposed regulations that are being considered in light of the opinion of the Supreme Court of the United States in Commissioner v. Estate of Hubert, 520 U.S. ___ (1997), 1997-32 I.R.B. 8. The proposed regulations would amend § 20.2056(b)-4(a) of the Estate Tax Regulations by providing guidance regarding when there is a "material limitation" on a surviving spouse's right to the income from property when the income is used to pay estate administration expenses.

BACKGROUND

Under § 2056(a) of the Internal Revenue Code, a marital deduction is allowed to a decedent's estate for property passing from the decedent to the surviving spouse. Under § 2056(b)(5) and (b)(7), a marital deduction is allowed for property passing in trust for the benefit of the spouse if the trust satisfies certain requirements, including the requirement that the spouse be entitled to all of the income for life.

Under § 2056(b)(4)(B), where the interest or property passing to the surviving spouse is encumbered, the encumbrance is

taken into account in determining the amount of the allowable marital deduction. Section 20.2056(b)-4(a), which implements § 2056(b)(4)(B), provides that the marital deduction may be taken only for the net value of the interest passing to the surviving spouse. In determining the value of the interest, account must be taken of the effect of any material limitations on the spouse's right to the income from the property. The regulation indicates that this rule may apply in the case of a bequest of property in trust for the benefit of the spouse, when income from the property is used to pay estate administration expenses prior to distribution. The same rule applies in the case of a charitable bequest. Section 20.2055-2(e)(1)(i). However, the regulation provides no definitive guidance on when the use of income would rise to the level of a material limitation.

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

income from the bequest, which would reduce the marital deduction.

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

In the absence of a regulatory definition of material limitation, the plurality opinion suggested a test for materiality that applies present value principles to date of death estimates of income and expenditures. The concurring opinion suggested two additional tests using date of death estimates of income; one of these tests also applies present value principles.

The number of alternatives that exist to define material limitation, as pointed out by the Court in Estate of Hubert, underscores the need to provide guidance regarding when the use of income to pay expenses constitutes a material limitation on

a spouse’s or charity’s right to income. The Internal Revenue Service and the Treasury Department intend to promulgate regulations that provide guidance in this area, and this notice solicits comments on the alternative approaches outlined below.

ALTERNATIVE APPROACHES

One test for materiality under consideration would attempt to distinguish between administration expenses that are properly charged to principal and those that are properly charged to income. Under this test, there would be a material limitation on a surviving spouse’s right to income from property if income were used to pay an estate administration expense that is properly charged to principal. Expenses that are properly charged to principal would be those expenses described in § 20.2053-3 as well as other expenses commonly incurred in the administration and settlement of a decedent's estate. Such expenses would include, for example, attorneys' fees, appraisers' fees, brokers' commissions on the sale of property, and estate and inheritance taxes.

Expenses that are properly charged to income (and thus not material limitations on income) would be expenses incurred in the production of income during the period of administration including expenses of collecting and disbursing income and current taxes on income.

The regulation's designation of expenses as properly charged to principal or income would be determinative for purposes of § 20.2056(b)-4(a). Therefore, an expense could be characterized

as properly charged to principal even though applicable local law or the governing instrument permitted or directed an executor to charge the expense to income. To the extent that income is used to pay an expense that is properly charged to principal, the payment from income would be treated as having the same effect for purposes of the marital deduction as a payment made from principal. That is, in determining the marital deduction, the value of the property interest passing to the spouse would be reduced by an amount equal to the amount of that administration expense paid from income.

This test for materiality is intended to reflect reasonable estate administration practices and would generally be simple to apply.

Another approach under consideration is a test for materiality that provides for a de minimis safe harbor amount of income that may be used to pay administration expenses without constituting a material limitation on the surviving spouse's right to income. The safe harbor amount could be a cumulative amount determined by a percentage of gross income derived from the property during the period of administration, or a specified dollar amount, or some combination thereof. If more than the safe harbor amount of income were used to pay administration expenses, the marital deduction would be reduced dollar for dollar by the excess over the safe harbor amount of income so used.

The safe harbor approach provides a "bright line" material limitation test. However, if the safe harbor amount were based on the cumulative amount of income derived from the property during administration, the safe harbor amount would have to be recomputed yearly to reflect additional income earned during the year, which might make the test difficult to apply.

An additional approach would be to adopt a regulation stating that any use of income for the payment of administration expenses constitutes a material limitation on the spouse's right to income.

REQUEST FOR COMMENTS

The Service and Treasury invite comments on the tests for materiality described above and also welcome any suggestions for alternative approaches to the issue. In addition, the Service and Treasury are interested in receiving comments on (1) whether the test for materiality under § 20.2056(b)-4(a) should be a quantitative test based on a comparison of the relative size of the income and the expenses charged to income; (2) whether materiality should be determined based on projections as of the date of death rather than on the facts that develop afterwards; and (3) whether present value principles should be applied and, if so, how the practical difficulties of a present value computation can be overcome.

The Service and Treasury are also interested in receiving comments on whether post-death interest accruing on deferred federal estate tax should be treated as properly charged to

principal. Rev. Rul. 93-48, 1993-2 C.B. 270, holds that post-death interest accruing on deferred federal estate tax payable from a testamentary transfer does not ordinarily reduce the date of death value of the transfer.

Comments and suggestions are requested by February 4, 1998. An original and eight copies of written comments should be sent to:

Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5431 (P&SI:Br4)
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8:00 a.m. and 5:00 p.m.

to:

Courier's Desk
Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5431 (P&SI:Br4)
1111 Constitution Ave., NW
Washington, DC

Alternatively, comments may be submitted electronically via the Service's Internet site at:

http://www.irs.ustreas.gov/prod/tax_regs/comments.html

All comments will be available for public inspection and copying in their entirety.

DRAFTING INFORMATION

The principal author of this notice is Deborah Ryan of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Ms. Ryan on (202) 622-3090 (not a toll-free call).

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