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POST-MORTEM ESTATE PLANNING: An Update After the 2017 Tax Act

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AN UPDATE AFTER THE 2017 TAX ACT

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Marc has served in a variety of capacities for the Real Property, Trust and Estate Law Section of the American Bar Association, including as the former chair of its advisory committee for the Skills Training for Estate Planners program, former co-chair of the Skills Training for Estate Planners program, a member of its Council, as chair of its standing committee for Community Outreach, as vice-chair of its standing committees for Continuing Legal Education and Communications, as a member of its standing committee for Planning, and as its Liaison to the Section Officers Committee on Continuing Legal Education. Marc is a Member of the Bloomberg BNA Tax Management Estates, Gifts and Trusts Advisory Board and formerly served on the New York State Bar Association's Standing Committee on Legal Education and Admission to the Bar.

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Marc is a frequent lecturer for the American Bar Association, New York State Bar Association, New York County Lawyers Association, Suffolk County Bar Association, Nassau County Estate Planning Council, Nassau County Bar Association, Notre Dame University, Practicing Law Institute, BNA Tax Management and other professional organizations on a variety of topics related to trusts and estates.

POST-MORTEM ESTATE PLANNING – AN UPDATE AFTER THE 2017 TAX ACT

By Marc S. Bekerman

INTRODUCTION

The author has often presented on post mortem planning for a number of organizations including this committee. This session is intended to review the current issues associated with post-mortem planning after the significant changes made to the Internal Revenue Code by the 2017 Tax Act.

There are a number of tax consequences to a person's death. The most notable are the estate tax considerations (estate tax being an excise tax on the transfer of wealth) and income tax considerations (both finalizing the decedent's personal income tax liabilities as well as the estate's fiduciary income tax consequences during the process of settling the estate). However, the 2017 Tax Act significantly increased the federal estate and gift tax exemption to a point where very few estates will have any estate tax implications. As such, while this discussion will focus on techniques available to reduce one or both of these tax liabilities while noting the connection between the taxes where appropriate, special emphasis will be given to the income tax ramifications as those will be more usual for the average practitioner.

1. Use of Alternate Valuation to Reduce Estate Taxes

Each asset includible in the decedent's gross estate for estate tax purposes must be separately valued. The general rule is that the valuation is done as of the decedent's date of death. Internal Revenue Code ("IRC") §2031. However, in certain situations, such valuation may be inappropriate, e.g., when the assets diminish in value shortly after the decedent's death. IRC §2032

allows for an election on the estate tax return to value each asset on an alternate valuation date. There are a number of rules associated with such election:

- The election must be made for all assets reported on the estate tax return;
- There is no change in the valuation of assets whose value change due to the mere passage of time (e.g., interest on bank account);
- Alternate value of cash is always the same as date of death value;
- The election must reduce the estate tax due.

As the election must reduce the estate tax due, and most estates will now owe no estate tax due to the available estate tax exemption, it will be rare that alternate valuation will be a consideration for an estate. However, if alternate valuation is available and the election is made, the value for estate tax purposes will be as of six months after date of death unless the asset is sold or distributed before six months, in which case valuation will be as of date of sale or distribution. The value reported on the estate tax return will become the basis of the property in the hands of the estate for all income tax purposes.[1] IRC §1014(f) requires the basis of property acquired from a decedent to be consistent with the basis reported on the estate tax return. The basis of property under IRC §1014 cannot exceed that property's final value for purposes of the federal estate tax imposed on the estate of the decedent, or, if the final value has not been determined, the value reported on Form 8971 (Information Regarding Beneficiaries Acquiring Property From a Decedent).

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[1] Absent the requirement that an election of alternate valuation must reduce the amount of estate tax due, such an election could be a valuable method for increasing the basis of the assets in the hands of the beneficiaries at little or no estate tax cost. One common situation where this could occur would be on the death of a first spouse where the marital deduction will eliminate the estate tax regardless of the size of the gross estate.

Although an election of alternate valuation is usually in the best interest of the beneficiaries since it will reduce the estate tax payable, there are several possible detriments. One possible downside to alternate valuation is the need to revalue certain assets by requiring additional appraisals, such as real estate, business interests, and discounts. Such additional appraisals will cause additional expense to the estate and likely extend the amount of time needed to complete the settlement of the estate. Further, it is possible that an election of alternate value will reduce the basis of assets in the hands of certain beneficiaries who were not going to bear estate tax. For example, a beneficiary who receives a specific bequest may have a lower basis which will increase the gain on the sale of the asset. However, if the estate tax is apportioned against the residuary estate, there is no estate tax savings to this beneficiary.

2. Estate Distribution – Timing and Funding Issues

A. Distributable Net Income - Distributable Net Income, commonly known as DNI, is defined by IRC §643. Essentially, DNI is the amount of income that can be distributed to the beneficiaries of an estate or trust, and is computed by calculating the taxable income of the entity without considering any deduction for distributions or personal exemption, nor any capital gains or losses. DNI is a key concept since it will be the maximum amount that will qualify for the distribution deduction under section 651 or section 661 of the IRC.[2] The effect of the distribution deduction is that it

[2] Section 651 allows for a distribution deduction for simple trusts (trusts that must distribute all of its income on an annual basis). Section 661 allows for a distribution deduction for complex trusts (all non-simple trusts) and estates.

transfers the income tax consequences from the estate or trust to the beneficiary.

There are several rules which govern the reporting of DNI:

1. Under section 663(a), no DNI is carried out from an estate by a distribution of either a specific bequest, or a general legacy that is properly paid in not more than 3 installments;

2. DNI is usually carried out of the estate by distributions to residuary beneficiaries. These distributions can be of either "income" or "principal";[3]

3. The allocation of DNI among beneficiaries is provided for and discussed fully in the Treasury Regulations (hereinafter "Treas Reg") promulgated under Section 661.

B. 65 Day Rule - IRC §663(b) allows an estate to elect to treat a distribution made within the first 65 days of any taxable year as having been made on the last day of the preceding taxable year. This election allows the fiduciary to better estimate, if not actually compute, the actual DNI for the recently concluded taxable year. In turn, this allows for better planning in optimizing the tax consequences for the estate and its beneficiaries.

C. Fiscal Year Elections - One method of generating tax savings for the estate is through an election of a fiscal year. The fiscal year for most trusts is the calendar year, which is similar to all individual taxpayers. IRC §644. However, an estate is allowed to choose a fiscal year, and under IRC §645, an election can be made to tax a qualified revocable trust as part of the

[3] In other words, the estate cannot change the income tax effect of a distribution by characterizing it as a principal distribution, as opposed to an income distribution.

estate, and not a separate trust. An election of a fiscal year can be important for several reasons:

1. Maximum deferral - All distributions made during a taxable year are treated for income tax purposes as having been made on the last day of that fiscal year.[4] Individual taxpayers are treated as having received all of the distributions from an estate on the last day of the estate's fiscal year since they are on the cash basis for taxation.

   Example - Assume that an estate selects a January 31st fiscal year. A distribution made on February 1, 2018 will be treated for income tax purposes to the beneficiary as having been made to the beneficiary on January 31, 2019. Any income tax due on this distribution will be due on April 15, 2020 since the taxpayer received the distribution in 2019 for income tax purposes. This timing can amount to an interest free loan to the beneficiary of the income tax due on the distribution for over 2 years.[5]

2. Grouping of income and deductions - It may be to the estate's advantage to select a short, or long, first fiscal year. This may allow an estate to have little to no income tax liability for its first taxable year, while giving the entity sufficient time to generate deductions to offset income in the second taxable year.

   Example – Assume that a decedent died on September 19, 2017 and that the executors are aware of a large amount of income in respect of a decedent ("IRD") that will be collected by the estate once they are appointed. However, there may be a delay in the payment of certain expenses that will be

[4] An exception to this general rule exists when a 65 day election is made for a particular distribution, in which case it is treated as having been made on the last day of the prior taxable year and not in the tax year of the actual distribution.

[5] An estate beneficiary should consider the effect of the rules regarding estimated tax payments to avoid any potential penalties on their personal income tax return.

used as income tax deductions. An election of a December 31st or January 31st fiscal year could cause a problem in that the first fiscal year will have a large amount of income with relatively few expenses; meanwhile, the second fiscal year may have significant deductions with relatively little income. The fiduciary may choose to elect a September 30th fiscal year (the shortest possible first year based upon the date of death) that will have all of the IRD recognized in the second fiscal year along with the anticipated expenses. Alternatively, the fiduciary may choose an August 31st fiscal year (the longest possible year) hoping to group all of the IRD with the anticipated expenses.

3. Use of Administration Expense Deductions

The IRC allows an estate to reduce its gross income for fiduciary income tax purposes by permitting certain deductions in the estate's calculation of its taxable income. One type of permissible deduction is for administration expenses paid during the taxable year. Examples of administration expenses that are valid income tax deductions include fees paid to fiduciaries (executors and administrators)[6], attorneys, and accountants as long as the amounts are reasonable in amount and the expenses are incurred in the ordinary and necessary administration of the estate.[7]

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[6] If an estate generates tax-exempt income, the fiduciary income tax deduction for commissions paid to the fiduciary must be reduced proportionately.

[7] General administration expenses that are necessary in the administration of the estate are not subject to the 2% floor on miscellaneous administration expenses imposed by IRC §67. See Knight v. Commissioner of Internal Revenue, 128 S.Ct. 782 (2008). This decision was made of further import by the 2017 Tax Act as any expense which would have been a miscellaneous itemized deduction is no longer an allowable deduction (the 2017 Tax Act repealed the deduction for all miscellaneous itemized deductions).

Similarly, the IRC allows an estate to reduce its taxable estate for estate tax purposes by permitting a deduction for administration expenses. However, it is vital to note that a deduction that is utilized in computing a decedent's taxable estate for estate tax purposes under IRC §2053 cannot also be used as a deduction for fiduciary income tax purposes. IRC §642(g). Therefore, each situation should be analyzed to determine where the available deductions provide maximum benefit.[8] We will quickly review two common results in a frequently occurring scenario[9]:

- **Credit shelter/Marital trust situation** - Although this is a fairly easy and common estate plan, facts and circumstances may make the decision to treat the utilization of deductions extremely sensitive. Assume the following facts:
  - Gross estate of $25,000,000;
  - Applicable federal estate tax exemption amount of $11,000,000;
  - Administration expenses of $1,000,000;
  - Estate plan has two beneficiaries, a pecuniary credit shelter trust and a residuary marital trust with the overall plan looking to eliminate estate taxes;
  - Fiduciary has sufficient discretion, either under the instrument or under state law, to allocate the payment of the expenses between the two beneficiaries.

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[8] Such analysis should identify how an allocation of the deductions between the estate tax return and the income tax return will shift benefits among the estate's beneficiaries. For example, under New York law, estate taxes are apportioned against every beneficiary unless there is an overriding provision in the instrument. However, the income tax liability will likely be borne by the residuary beneficiaries as the recipients of the estate's distributable net income.

[9] We will not consider any state estate tax created by the decoupling of federal and state estate taxes.

If the administration expenses are taken on the estate tax return:

- $11,000,000 goes to credit shelter trust;
- $1,000,000 is deducted on Schedule J of the estate tax return and is paid for administration expenses[10];
- $13,000,000 is deducted on Schedule M on the estate tax return and goes to the marital trust;
- None of the administration expenses will be available for use as a deduction on the estate's income tax returns.

If the administration expenses are taken on the income tax return:

- $10,000,000 goes to credit shelter trust;
- $1,000,000 is paid for administration expenses, but none are available for use as deductions on Schedule J of the estate tax return;
- $14,000,000 is deducted on Schedule M on the estate tax return and goes to the marital trust;[11]
- $1,000,000 will be available as income tax deductions in the taxable year in which the expenses are actually paid.[12]

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[10] For now we will assume that all expenses are payable from principal. However, as will be discussed subsequently, there may be some planning opportunities under the Hubert regulations if some of the expenses are payable from income.

[11] Often Schedule M will be shown as $15,000,000 so as to "zero out" the estate tax return. However, the author has frequently questioned this approach as the reporting position would seem to imply a marital deduction for property not actually passing to the surviving spouse (i.e., being paid to persons and entities for administration expenses).

[12] A fiduciary should take particular care when reserving expenses for use on the income tax return that the estate will have sufficient income to utilize the deduction. This is very important since, as will be discussed further below, the excess deductions which could be reported out to the beneficiaries in the final year of the estate are no longer deductible in the hands of the beneficiaries after the 2017 Tax Act as they were among the miscellaneous itemized deductions which are no longer permitted deductions.

Note that although there is zero estate tax under both examples, the tradeoff is a smaller credit shelter trust for an income tax deduction. This can be a complicated decision to make if the surviving spouse has no interest in the credit shelter trust, or even more so if the beneficiaries of the credit shelter trust have no relationship to the surviving spouse (such as children from a prior marriage).

> • **Fully taxable estate** – If an estate is large enough, there may be an estate tax liability.[13] In these cases, the determination of whether to utilize the allowable administration expense deductions on the estate tax return or the estate's fiduciary income tax returns is largely a review of the highest marginal estate tax rate applicable to the estate versus the highest marginal income tax rate for the estate and its beneficiaries. For many years, the default was to simply take all available deductions on the estate tax return since the highest marginal federal estate tax rate was 55%, while the highest marginal federal income tax rate was 39.6%.[14] However, the highest federal estate tax rate of 40% is now very close to the highest marginal federal tax rate of 37%.[15] In addition, many states now assess an estate tax in estates where no federal estate tax is due as a result of decoupling.[16] As such, a review should be done to ensure that the deduction is being used against the larger potential tax liability. See "Flipping Out – A Review of Some Changes Created by the Reduction in the Highest Estate Tax Rate Below the Highest Income Tax Rate by the 2010 Tax Act", by Marc S. Bekerman published by BNA Tax Management in March 2011.

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[13] If the decedent's gross estate is less than the available applicable exemption amount (for example, approximately $11,000,000 in 2018), all available deductions should likely be utilized on the estate's fiduciary income tax returns.

[14] Keep in mind that the entire taxable estate is subjected to the estate tax once, while the annual taxable income of the estate is subjected to the income tax every year.

[15] Although 37% appears to be the highest marginal income tax rate under IRC §1, the actual highest effective marginal rate actually paid by a trust or estate may be higher when taking into account certain other tax considerations such as the Net Investment Income Tax.

[16] For example, a New York decedent who died on January 1, 2018 with a taxable estate of $11,000,000 has no federal estate tax liability but will owe over $1,000,000 of New York State estate tax.

Assuming that an estate is on the cash basis of taxation, the estate is only entitled to take an income tax deduction for an expense in the taxable year in which the expense is paid. As such, the timing of payments of administration expenses by an estate is more important after the 2017 Tax Act due to the combination of the higher estate tax exemption (few estates will need to utilize the administration expenses as an estate tax deduction) and the repeal of the deduction for miscellaneous itemized expenses (so excess deductions distributed in the final year of the estate are no longer deductible in the hands of the beneficiaries).[17]

4. Executor Commissions

A fiduciary of an estate is compensated for his or her services through the payment of commissions. Under New York law, the commissions of an executor or an administrator are calculated based upon a sliding scale pursuant to section 2307 of the Surrogate's Court Procedure Act ("SCPA"). The general rule is that a fiduciary is only entitled to payment of commissions at the conclusion of the estate administration unless the fiduciary receives permission to take an advance payment of commissions. See SCPA §§2310, 2311.

The commissions paid to a fiduciary are considered compensation for services rendered to the estate. As a result, the commissions received from the estate are included as gross income by the fiduciary on his or her personal income tax return. See IRC § 61. Further, since most executors are individuals on the cash method of accounting, an executor recognizes this income in the year of receipt.

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[17] Although it will continue to be in the estate's best interest to match income and expense on an annual basis, there will likely still be excess deductions in the final year since there are usually commissions and legal expenses to be paid at the close of the estate, while the estate may have had a relatively small cash reserve generating income in the final year.

An estate is entitled to deduct the commissions paid to an executor on its tax returns. However, the estate must choose whether to take the deduction on its estate tax return, on its fiduciary income tax return, or some combination of both. IRC § 642(g). It should be noted that, to the extent an estate chooses to utilize the deduction on its fiduciary income tax return, the deduction is only permitted for the year in which the commission is paid (assuming the estate is on the cash basis of accounting as well).[18]

There are certain situations where the executor may not seek compensation for his or her services. The circumstances are usually emotional (such as where the decedent was a family member or a long-time friend) or financial (usually where the executor is the primary beneficiary of the estate[19]). In these cases, it is important to identify early in the estate administration process whether the fiduciary might seek to waive his or her commissions. From the estate's perspective, such a determination is vital in calculating and raising the estate's anticipated cash requirements (i.e., the amount of liquidity an estate will require to complete its administration). From the fiduciary's perspective, a fiduciary who is not clear on this point runs the risk of the Internal Revenue Service determining that he or she has constructively received the commissions allowable under SCPA §2307 and then made a gift of such commissions to the residuary beneficiaries. This is usually a horrible result for a fiduciary in that they will owe income tax on the phantom income

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[18] Based upon the changes in the tax law after the 2017 Tax Act, it may be more common in New York for applications to the Surrogate's Court for permission to pay commissions prior to the conclusion of the estate administration since proper planning of the timing of the payment of commissions might generate a tax savings to the residuary beneficiaries. See SCPA §2311(1).

[19] While an executor's commission is considered gross income to the executor under IRC § 61, a bequest to a beneficiary is usually not gross income. See IRC § 102. As such, an executor who is also the sole residuary beneficiary of the estate may maximize the after-tax amount they receive by considering a waiver of their commission when the estate does not owe any estate tax.

and have possible negative consequences on their personal estate planning due to the imputed taxable gift.

Revenue Ruling 66-167 is instructive in this area. This ruling clarified Revenue Ruling 56-472 which had left open the question on whether a waiver of commissions was required before the executor commenced the administration of the estate. Although it was held that it is not necessary to effectuate a waiver of executor commissions prior to the start of rendering services to the estate, the ruling cautioned:

> "The crucial test of whether the executor of an estate or any other fiduciary in a similar situation may waive his right to receive statutory commissions without thereby incurring any income or gift tax liability is whether the waiver involved will at least primarily constitute evidence of an intent to render a gratuitous service. If the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof, and at the same time, has also effected a taxable gift by means of any resulting transfer to a third party of his contingent beneficial interest in a part of the assets under his fiduciary control".

Based upon the author's experience, such waiver should be done within six months from appointment and must certainly be done no later than the filing of the estate tax return. Further, such waiver should be in writing and clearly state the extent of the waiver.

5. Estate Duration

An estate usually has a short duration. Generally, the estate can last as long as required for the fiduciary to complete the duties of administration (obtaining probate, identifying and collecting assets, ascertaining and paying claims, including debts and taxes, paying all legacies and making distributions). An estate's duration may not be unduly prolonged. If an estate has been unduly prolonged, the Internal Revenue Service may ignore the estate as a separate entity. Treas Reg

1.641b-3(a).[20] In the timing of final distributions, it should be noted that an estate's final fiscal year ends upon termination of the estate.

6. Allocating Appreciation

During the course of estate administration, the assets may appreciate or depreciate in value. In making distributions to the residuary beneficiaries, an executor will usually have the ability to make distributions in kind, and may also have the ability to make non-pro-rata distributions. If the executor is able to make non-pro-rata distributions, and the beneficiaries are agreeable to the proposed distribution, the executor may be able to allocate more appreciation (or depreciation) to one beneficiary over the other.[21] This may make sense if Beneficiary 1 has unused capital loss carryforwards or unrecognized capital losses that can be used to offset the built in capital gain.

Example: An estate making final distributions has the following assets available for distribution in kind to the two residuary beneficiaries:

- 100 shares of ABC Corp. with a basis of $10,000 and a market value of $20,000;
- 100 shares of XYZ Corp. with a basis of $20,000 and a market value of $20,000.

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[20] Previously there could be an income tax incentive to keep an estate open longer than necessary as it would give the beneficiaries an additional entity and an additional "run up the brackets". However, given the current compressed income tax brackets for estates under IRC §1, there is usually little incentive currently to keep an estate open for income tax purposes. It is doubtful that this continues to be an area of perceived abuse and the author has heard little of the IRS administratively closing an estate despite its power to do so.

[21] Keep in mind that the residuary beneficiary who receives an in-kind distribution takes the same basis as the estate had in the asset (a transferred basis).

Assuming that the executor has the authority under either the governing instrument or local law to make a non-pro-rata distribution in kind, and that the beneficiaries agree to the proposed distribution, the 100 shares of ABC can be distributed to Beneficiary 1 while the 100 shares of XYZ can be distributed to Beneficiary 2. In such a distribution, the executor has essentially allocated all of the appreciation remaining in the estate to Beneficiary 1.

7. Gain Realization

There are three ways that an estate can realize a capital gain:

- Sale or disposition of a capital asset (such as selling stock to raise cash);
- Satisfaction of a legacy for a specific dollar amount by making a distribution of appreciated property (such as satisfying a general legacy in the amount of $5,000 with $5,000 worth of stock that had an estate tax value of $4,000);
- The executor elects under IRC section 643(e)(3) to recognize gains and losses on all distributions in-kind made to residuary beneficiaries for the taxable year (this election treats the distribution as a sale to the beneficiary for the fair market value of the property).[22]

Often there is no advantage for the estate to recognize a capital gain since it will likely pay the same rate of capital gain tax as the beneficiaries. However, each estate should be reviewed to determine whether there are any advantages, or disadvantages, for the estate to recognize gain versus distributing assets to beneficiaries with built-in gains that they can recognize in the course of their own planning.

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[22] Since the estate will recognize gain or loss, the beneficiary's basis in the asset is the fair market value of the asset at the time of distribution.

8. IRD Acceleration

Income in Respect of a Decedent, frequently known as IRD, is income that the decedent was entitled to receive at the time of his death.[23] An estate will have to pay income tax on IRD items on the cash basis (i.e., once the income is collected). The best planning for minimizing IRD is before the decedent's death. However, there are certain post-mortem planning opportunities that an estate may use depending on the type of IRD involved.[24] We will quickly review a few techniques for minimizing the tax consequences associated with IRD:

- Savings Bonds – An estate can elect to report the accrued interest not previously reported on the decedent's final personal income tax return. This may have the advantage of the interest being taxed at a lower rate, or providing income to utilize deductions and exemptions that might otherwise go unused.
- Retirement Accounts
  - Pre-death: Analyze whether the client may be better served by reducing or foregoing a contribution to a retirement plan, and instead make a gift of the after-tax dollars to the beneficiaries. Additionally, beneficiary designations may be helpful in many instances in providing the maximum benefit to the beneficiaries.
  - Post-death – It may be in the interest of the beneficiaries of retirement accounts to withdraw the balances over the period of time allowed by law, as opposed to withdrawing the entire amount immediately after the decedent's death.

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[23] Some examples of IRD include unpaid salary, retirement plan benefits, dividends that were declared but not paid prior to the decedent's death, and interest due to the decedent (including accrued interest on U.S. Savings bonds not reportable by the decedent prior to their death).

[24] As a general rule of income tax planning, taxpayers seek to avoid or defer income taxes where possible. However, an executor may choose to accelerate IRD as part of a post-mortem tax plan if there are expenses being paid in a particular taxable year that would qualify as deductions and it is in the best interest of the estate to offset these deductions.

- Disposition of IRD Items at Death – Consider specifically bequeathing IRD items to beneficiaries in lower income tax brackets, or to a tax exempt entity, especially if the client has charitable desires.[25] It may reduce the overall income tax bite to the estate and its beneficiaries.

9. Hubert Regulations

The Hubert regulations were promulgated by the Internal Revenue Service in response to the decision of the United States Supreme Court in Commissioner v. Estate of Hubert (500 U.S. 93 (1997)). The final regulations were released as T.D. 8446 on December 2, 1999 and were effective December 3, 1999.

Hubert should be reviewed when there are marital or charitable interests in an estate which will qualify for the applicable estate tax deduction. Hubert relates to the effect of certain administration expenses on the valuation of property that qualifies for either the estate tax marital deduction or the estate tax charitable deduction.

There are certain basic concepts which must be introduced to review Hubert:

- Estate management expenses – These expenses are incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration. These expenses do not generally reduce the value of the property in computing the marital or charitable deduction. Examples of estate management expenses may include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

- Estate transmission expenses – These expenses are those that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it.[26] These expenses will typically reduce the value of

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25 See "The Intersection of Income in Respect of a Decedent, the Separate Share Rule and Making Charitable Bequests – Be Sure to Look All Ways Before Crossing" by Marc S. Bekerman published by Tax Management Estates, Gifts and Trusts Journal in May 2009

26 Any expense that is not an estate management expense is an estate transmission expense.

the property in computing the marital or charitable deduction. Examples of estate transmission expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation and maintenance of the assets), probate fees, appraisal fees, expenses incurred in construction proceedings and expenses incurred in defending against will contests.

- Charitable share – The property or interest in property that qualifies for the charitable deduction.[27]

- Marital share - The property or interest in property that qualifies for the marital deduction.[28]

The effect of the Hubert regulations can be summarized as follows. If an estate management expense is payable from income (based upon either the governing instrument or state law), and is in fact paid from income, that expense can be used as an income tax deduction without reducing the applicable marital or charitable deduction. The payment of an estate management expense from principal, or the payment of any and all estate transmission expenses, will reduce the allowable marital or charitable deduction.

Example: If the residuary beneficiary of an estate is a QTIP trust which qualifies for the marital deduction, and the estate incurs transmission expenses of $200,000, the marital share must be reduced by $200,000 resulting in a reduction of the marital deduction by $200,000. Also, as these expenses have been used on the estate tax return, they are not available to be used as deductions on the estate's fiduciary income tax returns.

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[27] This interest in property may include the income produced by the property or interest in property if the income is either payable to the charitable organization, or is to be added to the principal of the property interest passing in whole or in part to the charitable organization.

[28] As with the definition of the charitable share, this interest in property may include the income produced by the property or interest in property if the income is either payable to the surviving spouse, or is to be added to the principal of the property interest passing to, or for the benefit of, the surviving spouse.

Example: If the residuary beneficiary of an estate is a qualified charitable remainder unitrust, and the estate incurs transmission expenses of $400,000, the charitable share must be reduced by $400,000 and by the federal and state estate taxes due before the present value of the remainder interest can be computed.[29]

Planning to utilize the Hubert regulations for the benefit of an estate and its beneficiaries must generally occur as part of the pre-death estate planning process as New York law allocates most estate expenses against principal. As such, the Hubert regulations will often be inapplicable as the payment of expenses will be from principal and not income. However, a draftsman should take care in overriding statutory defaults and do so only after great consideration of the possible consequences.[30]

CONCLUSION

The 2017 Tax Act increased the importance of proper post-mortem tax planning and increased the value of the knowledgeable and skillful practitioner to our clients.

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[29] Recall that it is this present value of the charity's remainder interest that is the amount that can be deducted as a charitable deduction on the estate tax return.

[30] For example, even if an instrument allocates various expenses against income, an estate will only generate so much income that can be used to pay expenses. It might be an interesting consideration to permit an executor to allocate expenses to principal or income in his or her discretion, although there are clearly perils with such an approach as well.