

Estate Administrative Expenses and The Personal Representative

by *Harmon S. Graves*

Reluctant to surrender any federal fisc to probate courts, federal courts have closely examined the personal representative's decision to sell assets during administration when an administrative expense deduction is claimed on an estate tax return. An assault on the validity of the applicable regulation¹ imposing a standard of "necessity"² not found in 26 U.S.C. § 2053(a) has failed.³ Therefore, personal representatives are confronted with the axiom that, when dealing with the government on tax matters, they "must turn square corners to achieve literal compliance"⁴ with 26 U.S.C. § 2053 and related regulations. However, the route is marked so that some rounded corners may be taken to meet deductibility requirements.

This article addresses estate tax return deductibility of administrative expenses incurred in the sale of assets by the fiduciary during administration. The author concludes that a refusal by a beneficiary to accept a distribution in kind may qualify a sale of assets as necessary to effect distribution of the estate, which otherwise might be assailed as a sale for the individual benefit of a beneficiary and therefore may be nondeductible.

Applicable Statute and Regulations

IRC § 2053(a) provides, in pertinent part:

... For purposes of the tax imposed by section 2001, the value of the taxable es-

tate shall be determined by deducting from the value of the gross estate such amounts . . . for administrative expenses . . . as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

No definition of "administrative expenses" is given in IRC § 2053, but reference is made to expenses that are allowable under applicable state law. Colorado recognizes expenses of administration as claims of the second class⁵ that are permitted under the Allowance of Claims statute.⁶ Moreover, the personal representative is authorized to engage persons to perform specialized services in the administration of the estate for reasonable compensation.⁷

It is clear, however, outside the Seventh Circuit,⁸ that notwithstanding the straightforward language of IRC § 2053, allowability under state law of administrative expenses associated with the sale or property held by the personal representative alone will not satisfy deductibility requirements on the estate tax return.⁹ Treas. Reg. § 20.2053-3 requirements also must be met. In pertinent part, this regulation provides:

Deduction for expenses of administering estate.

(a) In general. The amounts deductible from a decedent's gross estate as 'administration expenses' . . . are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it.

(d) Miscellaneous administration expenses. . . .

(2) Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's

debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale. . . .

From the Commissioner's construction of "administrative expenses" through this regulation, a two-part test for deductibility has emerged.

Two-Part Test for Deductibility

First, the expenses must be allowable as administrative expenses under the applicable state probate law. Second, such expenses must include only those actually and necessarily incurred in the administration of the decedent's estate.¹⁰ As one court observed, "[T]he state law may be relied upon as a guide to what deductions may reasonably be permitted for federal estate tax purposes."¹¹ Another court observed that deductibility is "ultimately a question of federal law."¹²

Under Treas. Reg. § 20-2053-1(b)(2), a determination as to the amount and allowability made by the state probate court may be accepted "if the court passes upon the facts upon which deductibility depends." Two factors can impede effective application of this section of the regulations: (1) claims for administrative expenses are uncontested or the propriety of such expenditures is not ruled upon (this is typically the case in informal probate proceedings under CRS §§ 15-12-301 through

Column Editor: David Kirch, a sole practitioner in Aurora—(303) 671-7726; Column Eds. for Elder Law: Melissa Sugar, (303) 873-7579, and Michele Lawonn, (303) 337-2400, sole practitioners in Denver

This column is prepared by the CBA Trust and Estate Section. This month's article was written by Harmon S. Graves, of Tilly & Graves, P.C., Denver—(303) 321-8811.

-311), or (2) a suggestion is made that the expenses are for the benefit of beneficiaries rather than the estate.¹³ The reality is that the probate court's determination is not conclusive.

Major stumbling blocks regarding deductibility are Treas. Reg. § 20.2053-3's requirements that such expenses be "necessarily incurred in the administration of the decedent's estate" and not be "incurred for the individual benefit of the heirs, legatees, or devisees." Incidental benefit to the estate's beneficiaries does not bar deductibility.¹⁴ However, when the personal representative is the sole beneficiary of the estate, the absence of compelling reasons to sell rather than distribute estate assets leaves deductibility vulnerable to successful attack by the Commissioner.¹⁵ Treas. Reg. § 20.2053-3(d)(2) acknowledges necessity when a sale is undertaken "to pay the decedent's debts, expenses or administration, or taxes." More difficult justifications arise when deductibility is based on a sale to preserve the estate or to effect distribution.

Expenses to Preserve the Estate

Although a property may be unproductive and expensive to maintain, deductions for expenses of sale during administration supported by the contention that the sale was necessary to preserve the estate have been denied on the basis that losses to the estate could have been avoided by prompt distribution in kind.¹⁶ Uncertainty regarding estate tax liability may allow reservation of assets to cover a tax audit and possible deficiency. Where uncertainty exists as to liability, the deductibility picture brightens.¹⁷

Expenses to Effect Distribution

Expenses of sale "to effect distribution"¹⁸ have encountered mixed treatment. In *Estate of William H. Carson*,¹⁹ expenses of sale of a residence held in joint tenancy (which passed to the surviving joint tenant by operation of law and was sold by the survivor months after the decedent's death) were held to have been incurred for the benefit of the surviving joint tenant rather than the estate when no justification other than the joint tenant "no longer needed the property" was asserted.

In *Estate of Smith v. Comm'r*,²⁰ expenses were incurred during the sale of hundreds of pieces of abstract sculpture sold gradually over the course of administration of the estate to avoid depressing the market with a flood of such works. These

expenses were denied deductibility to the extent they were not related to sales necessary to pay debts, administration expenses, or taxes. The tax court's ruling that additional sales were not necessary to preserve the estate or to effect its distribution was held to be not clearly erroneous and therefore was affirmed.

"The refusal of a beneficiary to accept a distribution in kind may qualify a sale of assets as necessary to effect distribution, . . ."

A Trustee's Refusal to Accept Distribution in Kind

Notwithstanding the ruling in *Smith*,²¹ some interesting turns may be taken down the deductibility road, particularly if the personal representative is not the sole beneficiary. For example, consider *Estate of Joseph Vatter v. Comm'r*,²² which involved a testamentary trust to which the decedent bequeathed his residuary estate consisting of rental real estate. The properties were old and required maintenance, which the nominated corporate trustee was neither equipped nor willing to provide. Exercising her power of sale, the personal representative sold the properties, distributed net proceeds to the trustee, and deducted expenses of sale on the estate tax return. The court held that the sale of real estate was necessary to effect the distribution of the estate, in view of the trustee's refusal to accept distribution in kind.

Personal Representative As Sole Beneficiary

If the number of parties in an administrative scenario is reduced to an administratrix who also is the sole heir or beneficiary, a different result can be expected. In *Estate of Posen v. Comm'r*,²³ the administratrix sold a cooperative apartment because, as sole heir, she did not want to be burdened with a property in which she did not wish to live and which required high maintenance payments. Recognizing that other assets were available to pay taxes (even though premature withdrawal of funds held in time deposits would trigger penalties) and that the fiduciary had the power to distribute in kind, the court held that the sale was not necessary to effect distribution of the estate.²⁴

In synthesizing *Vatter* and *Posen*, one may point to the presence of a third party in a key role whose reluctance to accept a distribution in kind might lead to further expense to the estate (possibly litigation in the probate court), thus justifying the sale. Some opportunities may flow from the presence of such a distributee who may raise an objection to a distribution in kind.

Beneficiary's Objection to A Distribution in Kind

A personal representative may administer a residuary estate consisting of publicly held debt and equity securities of varying quality, some of which are not readily divisible and distributable, to: (1) a residuary beneficiary, who is not acting as the fiduciary, or (2) more than one such beneficiary, one of whom may be the fiduciary. The personal representative has the power to make a distribution in kind.²⁵ Procedurally, however, the fiduciary must jump through some preliminary hoops to effect such a distribution.

The personal representative should present a written proposal for distribution to the residual beneficiaries under CRS § 15-12-906(2)(c), which calls for a distribution in kind. Such a proposal might provide that one beneficiary will receive his or her share of the residuum in company stock A, and another beneficiary will receive company stock B. A block of evenly divisible stock might be a candidate for distribution in equal shares. However, if one beneficiary timely objects²⁶ to the proposed distribution and the personal representative is faced with a volatile market, the fiduciary may seek court approval of the proposed distribution, but risk a substantial market downturn in the process.

Drawing on the rationale of *Vatter*, the objection of one beneficiary may be enough to justify an immediate sale of the portfolio. Although the broker's fees on liquidation of a large portfolio may be substantial and could invite scrutiny, an estate tax deduction for the expense of sale should pass muster under Treas. Reg. § 20.2053-3(d)(2). When there is no reason to sell and the distributees request distribution in kind, such a distribution should be made.²⁷ However, an uncooperative beneficiary may offer an attractive tax-saving alternative to the fiduciary and interested beneficiaries, who may be contemplating an immediate sale should a distribution in kind be made.

In determining whether the expense of sale is necessary to effect distribution, the

totality of the facts and circumstances will be taken into account by the court.²³ The uncooperative beneficiary's objection to a distribution in kind is one such circumstance.

Conclusion

Although the Commissioner is entitled to second guess the personal representative's decision to incur expenses to preserve the estate or to effect distribution, the fiduciary may depart from a square-cornered course in dealing with estate tax deductions when armed with sufficient facts. The refusal of a beneficiary to accept a distribution in kind may qualify a sale of assets as necessary to effect distribution, which otherwise might be established as a sale for the individual benefit of a beneficiary and therefore may be nondeductible.

NOTES

1. Treas. Reg. § 20.2053-3.
2. *Id.* "[S]uch expenses as are actually and necessarily incurred in the administration of the decedent's estate. . . ."
3. See *Estate of Posen v. Comm'r*, 75 T.C. 355, 368 (1980); *Estate of Smith v. Comm'r*, 510 F.2d 479, 482 (2nd Cir. 1975); *Pitner v. U.S.*, 388 F.2d 651, 659 (5th Cir. 1967); *Estate of Millikin v. Comm'r*, 125 F.3d 339, 344 (6th Cir. 1997); *The Hibernia Bank v. U.S.*, 581 F.2d 741, 747 (9th Cir. 1978); *Hefner v. U.S.*, 880 F.Supp. 770 (W.D.Okla. 1993). *But see Estate of Jenner v. Comm'r*, 577 F.2d 1100, 1106 (7th Cir. 1978). The Seventh Circuit ruled that deductibility was determinable under Illinois law (which only permits sales by executors "when . . . necessary for proper administration of the estate") without resorting to Treas. Reg. § 20.2053-3 (d)(2).
4. *George H. Baldwin et al. v. U.S.*, 15 A.F.T.R. 1028, 1030 (D.C.S.D.Fla. 1934).
5. CRS § 15-12-805(1)(b).
6. CRS § 15-12-806. See also *Canady v. Kauffman*, 342 P.2d 1027, 1029 (Colo. 1959) (dealt with the personal representative's percentage allowance under an earlier statute).
7. CRS § 15-1-804(2)(k). See also *U.S. Fidelity and Guaranty Co. v. People*, 98 P. 828, 833 (Colo. 1908); *Ingham v. Ryan*, 71 P. 899 (Colo. App. 1903).
8. *Jenner, supra*, note 3 at 1106.
9. *Smith, supra*, note 3 at 482 [implies overruling of *Estate of Sternberger v. Comm'r*, 18 T.C. 836 (1952)]. See also *Estate of Joseph Vatter v. Comm'r*, 65 T.C. 633, 639 (1975); *Millikin, supra*, note 3 at 344; *Estate of Joslyn*, 500 F.2d 382, 385 (9th Cir. 1974); *Posen, supra*, note 3 at 359; *Marcus v. DeWitt*, 704 F.2d 1227, 1230 (11th Cir. 1983).
10. *Millikin, supra*, note 3 at 344; *Posen, supra*, note 3 at 361; *Vatter, supra*, note 9 at 638-

39; *Smith, supra*, note 3 at 482. Expenses incurred in the sale of property to effect distribution are "transmission expenses" under the final regulation issued under 26 U.S.C. §§ 2055 and 2056 in response to *Comm'r v. Estate of Hubert*, 520 U.S. 93, 117 S.Ct. 1124, 187 L.Ed. 235 (1997), and are now properly deductible under IRC § 2053(a)(2).

11. *Pitner, supra*, note 3 at 659 (dealt with attorney fees as a deductible administrative expense).
12. *Smith, supra*, note 3 at 482 n.4.
13. *Id.* at 482; *Posen, supra*, note 3 at 362.

14. *Posen, supra*, note 3 at 365; *Marcus, supra*, note 9 at 1232.

15. *E.g., Posen, supra*, note 3 at 364. The administratrix did not want to be burdened with an apartment distributable to her and was not compelled to sell the same to pay taxes, effect distribution, or avoid a financial drain on the estate's assets because distributions in kind were permitted under New York law. *Id.* at 362.

16. *E.g., Posen, supra*, note 3 at 363. Under CRS § 15-1-804(2)(u), fiduciaries have the power to make distributions in kind at fair market values on the effective date of distribution.


Our strength is in your Trust!

COUNSELORS: Have you recently reviewed corporate fiduciaries to determine the quality of services they provide to your clients? Are your clients' trust departments at their "local" banks actually out-of-state service centers with a 1-800 telephone number? Are your clients satisfied doing business with people whom they have never met and who don't know them?

To fulfill your due-diligence obligations, you owe it to yourself and your clients to look into Colorado State Bank and Trust for local professional service and immediate answers. Ask about our unique investment services utilizing many of Denver's top independent money managers.

While other banks are de-emphasizing their trust departments by downsizing or consolidating them out-of-state, Colorado State Bank and Trust continues to strengthen and expand our personalized trust service to better accommodate our trust customers. We have recently added the word *Trust* to our bank name to demonstrate our commitment to this important service!

Trust in Colorado State Bank and Trust to be near at hand . . . for more than ninety years, a locally owned, independent financial institution.




COLORADO STATE BANK and TRUST
A Tradition of Service and Trust Since 1908


A proud supporter of COLTAF with no fees charged.

16th & Broadway • Denver, Colorado 80202


303-861-2111 303-318-6000 303-318-6040
Downtown Cherry Creek Highlands Ranch




Aaron Azari




Carole Layden



Deborah Reeres



Leonard P. Rice



Deborah Barcus

17. *Millikin, supra*, note 3 at 345 (case remanded for factual determinations relative to need to retain assets or proceeds therefrom against potential tax liability); *Estate of Papson v. Comm'r*, 73 T.C. 290, 296 (1979); *Marcus, supra*, note 9 at 1230 n.2. Pursuant to CRS § 15-12-709, the personal representative has a duty to "pay all taxes on and take all steps reasonably necessary for the management, protection, and preservation of the estate in such representative's possession."

18. As this phrase is used in Treas. Reg. § 20.2053-3(d)(2).

19. 35 T.C.M. 330, 333 (1976). Expenses in dealing with property that is not subject to claims (nonprobate assets), but is included in the gross estate for estate tax purposes, may be deductible under 26 U.S.C. § 2053(b) to the same extent as is allowable under 26 U.S.C. 2053(a). This is subject to a time limit within which the expenses must be paid.

20. *Smith, supra*, note 3 at 479.

21. *Id.* at 483.

22. *Vatter, supra*, note 9 at 633.

23. *Posen, supra*, note 3 at 355.

24. *Id.* at 362.

25. CRS §§ 15-1-804(2)(u) and 15-12-906(2)(c); *In re Estate of Hoffman*, 414 N.Y.S.2d 863, 865 (1979).

26. CRS § 15-12-906(3) (a beneficiary may object to the proposed distribution within thirty days after mailing or delivery of the proposal).

27. *Virginia Trust Co., Executor v. Arthur Armitage Evans, et al.*, 69 S.E.2d 409, 432 (Va. 1952).

28. *Marcus, supra*, note 9 at 1231. ■



PLEASE
WELCOME
OUR NEWEST
RESOLUTION
EXPERT

Elaine A. Wohlner, Esq.

We are pleased to announce that Elaine Wohlner has joined JAMS and is now available to help you solve your most challenging and important cases.

In private practice and as a mediator for the Colorado Judicial Branch Office of Dispute Resolution in the Eighteenth Judicial District, Ms. Wohlner has mediated more than 500 civil disputes since 1994. She has successfully resolved cases involving business contract, personal injury, insurance bad faith/coverage, professional liability, property/real estate, construction, health care and employment matters. With a background in nursing and law, Ms. Wohlner is known for her persistence, sensitivity and creative approaches to conflict resolution.

To schedule a case with Elaine Wohlner, please call 303-534-1254.



THE RESOLUTION EXPERTS

410 17TH STREET • SUITE 1600 • DENVER, CO 80202 • 303.534.1254 • www.jamsadr.cc

**Rocky Mountain Mineral Law
Foundation to Co-Sponsor
"International Oil and Gas
Law, Contracts and
Negotiations"**

**September 25-29, 2000,
in Dallas, Texas**

The five-day intensive course, "International Oil and Gas Law, Contracts, and Negotiations," co-sponsored by the Southwestern Legal Foundation, Rocky Mountain Mineral Law Foundation, and Association of International Petroleum Negotiators, will be held September 25-29, 2000, in Dallas, Texas. The program is designed to provide a sound understanding of the legal, contractual, economic, and policy aspects of the international minerals exploration and production industry. The program will be useful to lawyers, landmen, negotiators, executives, and consultants involved in the negotiation, preparation, and administration of international oil and gas exploration/production and mining agreements. CLE credit for the program includes 1.25 hours of ethics. For more information or to register, contact the Southwestern Legal Foundation by phone at (972) 664-3461, by fax: (972) 699-3870; or by e-mail: cburkel@swlegal.

**Tuesdays at the Bar
Are Back!
See page 118.**