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REPORT BY THE ESTATE AND GIFT TAXATION COMMITTEE

MEMORANDUM IN RESPONSE TO NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE TECHNICAL MEMORANDUM TSB-M-15(4)(M)

This memorandum is offered by the Estate and Gift Taxation Committee of the New York City Bar Association in response to New York State Department of Taxation and Finance (the "**Department**") Technical Memorandum TSB-M-15(4)(M) (the "**October 2015 Technical Memorandum**") dealing, in part, with the treatment for New York estate tax purposes of certain deductions allowable for Federal estate tax purposes under Section 2053 of the Internal Revenue Code of 1986, with all amendments enacted on or before January 1, 2014 (the "**IRC**"), including deductions for funeral expenses, estate administration expenses, debts and other claims against property includable in a decedent's gross estate.

The October 2015 Technical Memorandum has been criticized by commentators, including those who have suggested significant revision or, in the alternative, legislative action, and observed how its approach towards the allocation of deductions disfavors New York residents relative to non-New York residents.[1] We respectfully suggest that the deficiencies in the October 2015 Technical Memorandum may result from an incomplete appreciation of highly technical Federal tax and property law rules governing the administration of decedents' estates, and request that the Department publish an updated technical memorandum reflecting the analysis and suggestions included below.

This analysis indicates that, for purposes of determining whether a deduction allowable under IRC Section 2053 relates to particular property for purposes of Section 955 and 960(b) of the New York Tax Law, additional consideration should be given to the sources from which the amount giving rise to the deduction is properly payable under laws governing the administration of the decedent's estate, giving effect to the terms of the decedent's Will and other relevant dispositive instruments (the "**Laws Governing the Administration of Includible Property**"), and the extent to which those sources of proper payment include the property at issue.[2]

We respectfully submit that a deduction under IRC Section 2053 cannot "relate" to a particular item of real or tangible personal property, within the meaning of Sections 955 and 960(b),[3] unless all or some portion of the amount giving rise to the deduction is properly payable from that property under the

[1] See, e.g., *Calculation of New York Estate Tax Deductions Under TSB-M-15(4)M*, PRACTICAL DRAFTING, Jan. 2016, at 12276-86.

[2] Although not fully addressed in this memorandum, we respectfully submit that this same approach should be applied to determine the extent to which additional deductions, including the Federal estate tax charitable and marital deductions under IRC Sections 2055 and 2056, relate to particular property.

[3] Unless otherwise indicated, section references in this memorandum are to the New York Tax Law.

Laws Governing the Administration of Includible Property. Moreover, without the further incorporation of this additional element into the methodology described in the October 2015 Technical Memorandum, many New York resident estates will be denied deductions under Section 955 for all or a portion of amounts deductible under IRC Section 2053 that cannot be properly paid from any source other than property subject to New York estate tax. Conversely, many non-New York residents will be permitted deductions for New York estate tax purposes for amounts deductible under IRC Section 2053 that could not have been properly paid from real and tangible personal property located in New York under the Laws Governing the Administration of Includible Property. [4]

To address this situation, we respectfully suggest that additional guidance be issued under which the methodology for determining the extent to which an amount deductible under IRC Section 2053 relates to property subject to New York estate tax would be determined by allocating the deduction to property subject to New York estate tax in the same proportion as (i) the value for Federal estate tax purposes of all of the property includible in the decedent's Federal gross estate that is subject to New York estate tax and which could appropriately bear that specific charge under the Laws Governing the Administration of Includible Property bears to (ii) the value for Federal estate tax purposes of all of the property includible in the decedent' Federal gross estate which could appropriately bear that specific charge under the Laws Governing the Administration of Includible Property.[5]

I. ILLUSTRATIVE PROBLEMS

The October 2015 Technical Memorandum, for example, includes as part of its guidance a scenario involving the estate of a New York resident with a $45 million federal gross estate, consisting of $25 million of New York real property, $10 million of Florida real property and $10 million in cash. The estate in this example incurred $1 million in executor's commissions during the estate administration. If the executor's commissions are not properly payable out of the Florida property – such as, for instance, if the Florida property was jointly owned by the decedent and another individual as joint tenants with rights of survivorship, was held in certain irrevocable trusts that might be included in the decedent's gross estate, or is specifically bequeathed in the decedent's Will – then the entire $1 million expense will be payable solely out of property subject to New York estate tax. In this scenario,

[4] We respectfully submit that additional refinement is also required to appropriately address the situation in which a fiduciary has discretion to determine the specific property to be used to fund a disposition qualifying for a charitable or marital deduction under IRC Sections 2055 and 2056.

[5] We respectfully suggest that this same methodology also should be applied to determine the property to which other deductions relate for purposes of Sections 955 and 960(b). For example, if a fiduciary is required under the Laws Governing the Administration of Includible Property to fund a disposition qualifying for a marital or charitable deduction under IRC Sections 2055 and 2056 from specific property, the full amount of the charitable or marital deduction (which should, in any event, be determined net of any amount payable from that same property that is deductible under IRC Section 2053) should be treated as relating to that property. On the other hand, if a fiduciary has discretion to select the property to be used to fund a disposition qualifying for a marital or charitable deduction, the deduction should be allocated to property subject to New York estate tax in the same proportion as (i) the value for Federal estate tax purposes of all of the property includible in the decedent's Federal gross estate that is subject to New York estate tax and which could appropriately be used by the fiduciary to fund that disposition under the Laws Governing the Administration of Includible Property bears to (ii) the value for Federal estate tax purposes of all of the property includible in the decedent's Federal gross estate which could appropriately be used by the fiduciary to fund that disposition under the Laws Governing the Administration of Includible Property.

however, and even though the Federal estate tax regime would permit a $1 million deduction for the executor's commissions payable entirely from property subject to New York estate tax, the methodology adopted in the October 2015 Technical Memorandum would disallow 22.22% – $222,200 – of the deduction for executor's commissions because, according to the October 2015 Technical Memorandum, such amount is deemed to "indirectly relate" to Florida real property that is not subject to New York estate tax and from which the commissions could not be paid under the Laws Governing the Administration of Includible Property. Accordingly, the New York resident decedent's estate would receive only $777,800 in deductions for the $1 million expended for executor's commissions paid entirely out of property subject to New York estate tax.

Conversely, the October 2015 Technical Memorandum includes a second illustrative scenario with the same facts as the above example, except that the decedent is a nonresident of New York. In this case, under the approach reflected in the October 2015 Technical Memorandum, the nonresident decedent's estate would, for purposes of calculating the decedent's New York taxable estate, receive a $555,600 deduction in respect of executor's commissions, none of which might in fact be payable from property subject to New York estate tax under the Laws Governing the Administration of Includible Property. Other possible outcomes under the approach reflected in the October 2015 Technical Memorandum are similarly flawed.

II. ADDITIONAL BACKGROUND

For New York estate tax purposes, a resident decedent's New York gross estate, within the meaning of Section 954, is reduced by certain deductions allowed under Section 955 to arrive at the resident decedent's New York taxable estate. The resident decedent's New York taxable estate is then subject to New York estate tax at the rates imposed under Section 952.

The New York gross estate of a resident decedent within the meaning of Section 954 is the resident decedent's gross estate for Federal estate tax purposes with certain modifications, including a reduction in the value of the decedent's Federal gross estate for the value of real or tangible personal property having an actual situs outside of New York.[6] Correspondingly, in arriving at a resident decedent's New York taxable estate, Section 955 permits a reduction in the value of a resident decedent's New York gross estate for any deduction allowable under Sections 2032(b), 2046, 2053, 2054, 2055 and 2056 of the IRC, except to the extent that such deductions relate to real or tangible personal property situsued outside of New York which, as noted above, are not part of the resident decedent's New York gross estate under Section 954.

Pursuant to Section 960(a), the portion of a nonresident's Federal gross estate subject to New York estate tax is, as a general matter, only that portion of the non-resident decedent's Federal gross estate consisting of real or tangible personal property having an actual situs in New York.

Correspondingly, under Section 960(b), the tax imposed under 960(a) is calculated in the same manner as the tax that would have been due if the decedent had died a resident of New York (which, as

[6] Section 954 also includes a modification increasing the New York gross estate by the amount of any taxable gift under IRC Section 2503 made within three years of the decedent's date of death, except for gifts made (1) when the decedent was not a New York resident, (2) before April 1, 2014 or (3) after January 1, 2019. N.Y. Tax L. § 954(a)(3).

described above, is calculated by excluding the value of real and tangible personal property located outside of New York *and the deductions relating to that real and tangible personal property located outside of New York),* except that the non-resident's New York taxable estate also does not include (i) the value of any intangible personal property that would have otherwise been included in the New York taxable estate if the decedent had died a resident of New York *and the deductions relating to that intangible personal property*[7] and (ii) gifts made within three years of death when the gifted property did not consist of real or tangible personal property located in New York or intangible personal property employed in a business, trade or profession carried on in New York.

IRC Section 2053 provides a deduction for certain funeral expenses, estate administration expenses, debts and other claims against a decedent's estate paid from property that is subject to claims, as well as for certain expenses incurred in administering property not subject to claims. Property passing under a decedent's Will as part of the decedent's probate estate is an example of property that is subject to claims within the meaning of Section IRC 2053(a), while property of certain irrevocable trusts which may be included in a decedent's Federal gross estate by reason of the decedent's retention of certain powers and interests with respect to those trusts, is an example of property not subject to claims within the meaning of IRC Section 2053(b).

III. THE TECHNICAL MEMORANDUM

The October 2015 Technical Memorandum, issued on October 27, 2015, divides related deductions into two different categories – "directly related" deductions and "indirectly related" deductions. Under this approach, a relevant Federal deduction directly related to property subject to New York estate tax is deductible for New York estate tax purposes in full, while the deductibility of indirectly related Federal deductions is to be determined by multiplying the amount of that deduction by a fraction, the numerator of which is the value of the property includible in the Federal gross estate that is subject to New York estate tax, and the denominator of which is the value of all property includible in the decedent's Federal gross estate.

The October 2015 Technical Memorandum also includes examples of directly and indirectly related deductions, as well as the two examples mentioned above illustrating how the guidance in the October 2015 Technical Memorandum would be applied.[8] As examples of deductions directly related to real and tangible personal property, the memorandum lists (i) charitable deductions for the donation of land that is included in gross estate, (ii) mortgages secured by real property, and (iii) the amount for any real or tangible personal property included as part of the marital deduction. As to deductions directly related to intangible personal property, the memorandum lists (i) broker fees, and (ii) the amount for stocks, bonds or cash included in the marital deduction. Finally, as to deductions indirectly related to

[7] The commentators in *Practical Drafting* have observed that certain references in the October 2015 Technical Memorandum to "'intangible personal property [that] is not includible in the New York gross estate of a nonresident individual' is technically inconsistent with Tax Law 960(b) . . . which refers to 'intangible personal property otherwise includible in the deceased individual's New York gross estate." *Calculation of New York Estate Tax Deductions Under TSB-M-15(4)M*, PRACTICAL DRAFTING, Jan. 2016, at 12280.

[8] The examples reflect expenditures in addition to the executor's commissions mentioned above, and their corresponding treatment under the October 2015 Technical Memorandum.

real property, tangible personal property or intangible personal property, the memorandum lists (i) executor's commissions, (ii) accounting fees, (iii) attorney fees, (iv) funeral expenses, and (v) deductions for unsecured debts of the decedent.

The October 2015 Technical Memorandum, however, does not expressly take into consideration whether the amount giving rise to a deduction under IRC Section 2053 is properly payable from property subject to New York estate tax under the Laws Governing the Administration of Includible Property. We respectfully suggest that this omission has resulted in guidance that, in our view: (i) erroneously concludes that a debt secured by a mortgage on real property always "directly relates" to that property (as opposed to, for example, directly relating to that property if the debt is a non-recourse obligation secured only by that property or a debt otherwise payable only from that property under the Laws Governing the Administration of Includible Property) and (ii) will often, as illustrated above, inappropriately apportion deductions under Section 2053 to property that could not be the proper source of payment of the amount giving rise to the deduction.

IV. IDENTIFYING PROPER SOURCES FOR PAYMENT OF AMOUNTS GIVING RISE TO DEDUCTIONS UNDER IRC SECTION 2053

IRC Section 2053 provides a Federal estate tax deduction under subsection (a) thereof for certain funeral expenses, estate administration expenses and claims against a decedent's estate paid from property includible in the decedent's Federal gross estate that is subject to claims, as well as a deduction under subsection (b) thereof for certain expenses incurred in administering property includible in the decedent's Federal gross estate that is not subject to claims. For purposes of IRC Section 2053, "property subject to claims" means any "property includible in the [Federal] gross estate of the decedent which, or the avails of which, would under the applicable law, bear the burden of the payment of such deductions in the final adjustment and settlement of the estate . . . ." I.R.C. § 2053(c)(2). Such property generally encompasses probate property, although property subject to claims is not limited to the value of a decedent's probate estate.[9]

As indicated above, a decedent's Federal gross estate (and, correspondingly, a decedent's New York gross estate) also may include property not subject to claims. For example, the value of transferred property with a retained life estate is included in a decedent's Federal gross estate. See I.R.C. § 2036. In that example, the transferred property would not bear the burden of paying funeral and estate administration expenses, or other claims against the estate. Instead, the life estate would terminate upon the decedent's death and the underlying transferred property, which may or may not be located in New York, would be owned solely by the transferee. Many other types of nonprobate property, such as property owned by a decedent that passes to a surviving joint tenant by right of survivorship and the proceeds of a policy of insurance on the life of the decedent owned by the decedents at death but

[9] See Estate of Snyder v. United States, No. 97–618T, 1999 WL 767110, at *3 (Fed. Cl. Aug. 20, 1999). See also Keller v. United States, No. V–02–62, 2010 WL 3700841, at *3 (S.D. Tex. Sept. 14, 2010) ("[W]hether property is 'subject to claims' under Section 2053 is not informed by whether property was part of the probate estate. The inquiry is whether [property] 'bore the burden of payment' of the claimed deductions."), aff'd, 697 F.3d 238 (5th Cir. 2012) (in affirming allowance of estate's §2053(a)(2) administrative expense deduction for all interest payable on loan used to pay estate taxes, Fifth Circuit did not specifically address probate/nonprobate property issue).

payable to a beneficiary other than the decedent's estate, may also fall within the category of property not subject to claims.

Pursuant to IRC Section 2053 and Treasury Regulation Section 20.2053-1, certain expenses—funeral expenses, administration expenses, claims against the estate and mortgages on an indebtedness in respect of property that is included in the gross estate—payable out of property subject to claims are deductible from the value of a decedent's Federal gross estate to arrive at the decedent's Federal taxable estate. In addition, if the total allowable amount of deductions for these expenses exceed the value, at the time of the decedent's death, of property subject to claims, such expenses may still be deductible if they are paid within 9 months after the decedent's death, or within any extension of time for filing the estate tax return. I.R.C. § 2053(c)(2); Treas. Reg. § 20.2053-1(c).

Different rules apply to expenses incurred in administering property included in a decedent's Federal gross estate but not subject to claims. These expenses are deductible only if such amounts would be allowable as a deduction if such property were subject to claims, and such amounts are paid before the expiration of the applicable limitation period for assessment. I.R.C. § 2053(b). These deduction rules reflect the fact that many types of property – indeed, most nonprobate property – are insulated from the expenses borne by a typical estate, such as executor's commissions, accounting fees, attorney fees, funeral expenses and payment of unsecured debts of the decedent. These rules effectively relate Federal deductions to property subject to claims, whereas property not subject to claims is generally undiminished by the expenses enumerated in IRC Section 2053(a).

We find it difficult to conclude that deductions under Section 2053 falling within the categories of expenses payable from property subject to claims can in any sense for purposes of Section 955 and 960(b) be deemed to relate to property not subject to claims (from which that amount is not property payable) or *vice versa*.

Moreover, by analogy to the Federal estate tax treatment of mortgages on U.S.-situs real property owned by nonresident individuals not citizens of the United States, we find it difficult to conclude that a mortgage should be fully deductible for New York estate tax purposes because it is a lien on real property located in New York (or not deductible because it is a lien on property located outside of New York) without taking into consideration additional information regarding the nature of the underlying debt and the proper source of the payment of that debt under the Laws Governing the Administration of Includible Property. If a debt of a non-resident not a citizen of the United States is secured by a mortgage on U.S. real property owned by that individual at death (i.e., if the debt was a personal obligation of the nonresident individual secured by a mortgage on the property), the property's total fair market value is includible in the nonresident's estate subject to U.S. Federal estate tax, and only a portion of the mortgage is deductible. Conversely, a nonrecourse obligation of a nonresident not a citizen of the United States secured by a mortgage on U.S. real property (a debt payable only from that property) is deductible in full and thus only the net equity value of the real property is subject to U.S. estate tax. I.R.C. §§ 2053(a)(4), 2106(a)(1); Tr. Reg. § 20.2053-7. While both types of debts are secured by mortgages on real property located in the United States, the different Federal estate tax treatment highlights the importance of identifying the sources from which the underlying debt is properly payable.

The source of payment of amounts deductible under IRC Section 2053 may be determined though an application of the relevant Laws Governing the Administration of Includible Property. For example, so long as a decedent's probate estate is not insolvent, specifically bequeathed real and

tangible personal property generally does not bear the costs of funeral expenses or of paying other administration expenses, such as executors commissions, even though that property passes under the decedent's last Will and Testament and therefore falls within the general category of property subject to claims within the meaning of IRC Section 2053.[10] Similarly, if a particular property that is subject to a mortgage is specifically bequeathed, it may be the case under applicable law that the recipient of the property must take that property subject to the obligation to repay the related debt,[11] in which case it would be appropriate to treat that debt as relating entirely to that particular property, even though the debt was not a non-recourse obligation during the decedent's lifetime.

V. SUGGESTED METHODOLOGY AND CONCLUSION

In light of the foregoing, we respectfully suggest that the Department issue additional guidance under which, for purposes of Sections 955 and 960(b) of the New York Tax Law, the extent to which an amount deductible under IRC Section 2053 relates to property subject to New York estate tax would be determined by allocating the deduction to property subject to New York estate tax in the same proportion as (i) the value for Federal estate tax purposes of all of the property includible in the decedent's Federal gross estate that is subject to New York estate tax and which could appropriately bear that specific charge under the Laws Governing the Administration of Includible Property bears to (ii) the value for Federal estate tax purposes of all of the property includible in the decedent's Federal gross estate which could appropriately bear that specific charge under the Laws Governing the Administration of Includible Property.

We believe it would be appropriate to adopt a similar methodology with respect to dispositions qualifying for the charitable and marital deductions under IRC Sections 2055 and 2056.[12]

The Committee would be pleased to provide additional assistance to the Department to develop additional guidance with respect to the issue of how deductions relate to particular items of property for purposes of Sections 955 and 960(b) of the New York Tax Law.

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[10] See N.Y. Est. Powers & Trusts Law § 13-1.3.

[11] See N.Y. Est. Powers & Trusts Law § 3-3.6.

[12] See supra note 5.