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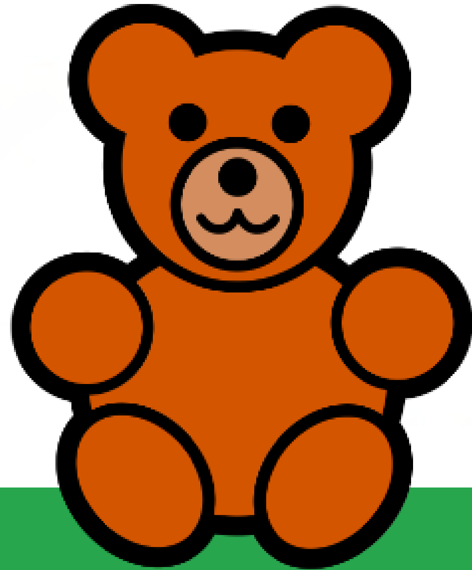
Ted 2 Inspires Analysis of Administrative Expense Deductions for Pre-Distribution Pet Care

by Keith Schiller



"The care and even the establishment of rights for pets have evolved in recent years. The extent to which pet care expenses may be deducted for federal estate tax purposes prior to distribution turns on a host of considerations not addressed in the relatively thin authority on point under the regulations for the deduction of administrative expenses. In one of the more ironic twists between the fantasy of film and mundane reality of federal estate tax deductions, the 2015 hit comedy Ted 2, written by Seth McFarland raises significant issues that may bear upon the deduction for administrative expenses in the context of pre-distributive pet care."

Keith Schiller has authored a host of **LISI** newsletters respecting federal estate tax law and the preparation of the Form 706, among them:

· Estate Planning At The Movies®: Jeremiah Johnson Marks the Final Portability Regulations (Estate Planning Newsletter #2316). Discussion of final portability regulations with cross-references to four other **LISI** newsletters by this author on portability elections from strategy to compliance.

· Estate Planning At The Movies®: Due to Technical Difficulties, Your New Statute on Consistency with Basis Reporting Cannot Be Viewed in Its Entirety (Estate Planning Newsletter #2346). How the basis reporting statute is inconsistent with well-established allowances under law for basis adjustment on death

· Estate Planning At The Movies®: Stepford Wives & IRC § 2053 Final Regulations. (Estate Planning Newsletter #1685). Review of final regulations governing the deductibility of debts and administrative expenses before payment and the implicit subjugation of the federal courts of appeal to the will of the regulatory authors.

In this newsletter, Keith reviews the deductibility of post-death expenses incurred in the administration of a trust attendant to pet care prior to the distribution of the pet to the beneficiary.

Keith Schiller, Esq., shareholder of the **Schiller Law Group**, a PLC, of Alamo California, has more than 40 years of experience with taxation, and estate and business succession planning. Keith works with clients and consults on estate planning, tax compliance, business succession and trust administration.

Keith is the author of the award-winning book, *Estate Planning At The Movies® — Art of the Estate Tax Return* ("*706 Art*"). The book reveals Keith's best practice pointers, his insights from co-teaching with the IRS for greater than thirteen years, and practical recommendations from over a dozen leading practitioners across the country who contributed to the book. The Second Edition of *706 Art* is published by Bloomberg, BNA Books and is available at http://www.bna.com/bnabooks/aetr. Keith is a member of the Advisory Board for Bloomberg BNA's *Estates, Gifts and Trusts Journal* and the Consulting Board for the *Leimberg Information Services, Inc.* ("LISI") Newsletter. He has taught 11 courses for the CalCPA Education Foundation and received the 2000 and 2010-2011 awards for Outstanding Course Materials. From passion, Keith chaired the Yosemite License Plate Campaign, during which he lobbied passage for the law approving the Yosemite License Plate and directed the state-wide marketing and sales campaign. The Yosemite License Plate has raised in excess of $28 million for the preservation of Yosemite and California conservation.

Now Available: In addition to the Second Edition of *Art of the Estate Tax Return* the 2015 Supplement to the Second Edition is now available through Bloomberg BNA (go to http://www.bna.com/bnabooks/aetr). Also, you can stay current on estate tax law by subscribing to the author's Update Service for 2016. To learn more and to subscribe, visit: www.EstatePlanningAtTheMovies.com.

The first supplement to the Second Edition of *706 Art* will be released by Bloomberg, BNA Books this summer.

Here is Keith's commentary:

EXECUTIVE SUMMARY:

Treasury regulations establish the standard for the deduction of administrative expenses on the federal estate tax return 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."[1] Animals within an estate may be assets with significant economic value, such as ranch or farm animals raised for commercial purposes, race horses, trained animals with entertainment value (such as circus performers, performers in television or movies), pets used for breeding and shows with substantial economic value, and household animals from just lovable pets with little or no traditionally measured economic value yet with great meaning and bonding to the owner or care taker to expensive purebreds who may also be adored by their owners.

The focus of this article is the deductibility of the costs of care and transportation of the decedent's pets prior to the distribution to the person entitled to the pet under the decedent's estate plan. Our focus will be on pets that are individually owned by the decedent (as opposed to ownership in a business entity such as a corporation, partnership or limited liability company) or other animals of substantial economic value in the traditional sense of fair market value.

Any of the three criteria under the regulations arguably support the deduction of actual and necessary expenses associated with pet care, namely "collection of assets," "payment of debts" and "distribution of property to persons entitled to it." No deduction is available for the distributive value passing to the beneficiaries. Thus, the estate does not receive a deduction for the value of an asset distributed in preliminary distribution. However, the estate can deduct the expenses associated with the distribution (such as transportation or…

pre-distribution management and preservation of the asset).[2]

A key assumption underlying the deduction for administrative expenses associated with pets is whether the pet is "property" or a beneficiary. *Ted 2* raises the related question whether the film's namesake is a person or property. Ted is a stuffed teddy bear who "came to life" when his best friend, John (portrayed by Mark Walhberg), was scared during a thunderstorm while John was a young boy.[3] John and Ted were best friends and their bond in the first *Ted* movie interfered with John's relationship with a girl friend, played by Mila Kunis (wow!). Ted can converse, drink, show emotion and do all sorts of things that cannot be repeated in a polite article. In *Ted 2*, Ted believes he is married to Tami-Lynn (played by Jessica Barth). Ted and Tami-Lynn want to adopt a baby. As a precondition, he must prove that he is a person. This leads to a court trial at which Ted is first declared to be property. As such, he can be bought and sold and exploited for commercial purpose without his consent. (An evil toy company has such designs.) Fortunately the story ends happily when Ted receives a new trial and he is declared a person.

Ted 2 raises in comedic parable the centuries-old conflict between personal rights and property rights. Is the subject at issue a person or property? Of course, there was nothing funny about this issue in the years leading up to the Civil War or the impact of the decision *Dred Scott v. Sandford*.[4] In that decision the Supreme Court declared that the children of slaves of African descent were property without the rights of citizens, including therefore no right to sue. During debate with then Senator Stephen Douglas in Acton, Illinois in 1858, candidate Abraham Lincoln remarked in the context of slavery and the *Dred Scott* decision:

> "It is the eternal struggle between these two principles -- right and wrong -- throughout the world. The one is the common right of humanity and the other the divine right of kings. It is the same principle in whatever shape it develops itself. It is the same spirit that says, 'You work and toil and earn bread, and I'll eat it.' No matter in what shape it comes, whether from the mouth of a king who seeks to bestride the people of his own nation and live by the fruit of their labor, or from one race of men as an apology for enslaving another race, it is the same tyrannical principle."

Of course, *Ted 2* is all Hollywood and a fantastically funny version at that. Yet, the film raises a fundamental issue relevant to the deduction of administrative expenses of the Form 706, namely, whether a pet is a beneficiary or property; and, if property whether the existence or absence of economic value determines whether expenses associated with the maintenance and care prior to distribution are deductible. If a beneficiary, preliminary distributions made to or for the benefit of that beneficiary cannot be deducted as administrative expenses.

Animals may be highly valued assets (or constituent parts) of a decedent's estate. That value may be of great economic significance (as in the case of race horses, performing animals and farm animals) or great emotional significance, attachment and personal connection which have priceless non-economic value. The estate tax deduction under Code § 2053 associated with the care and preservation of animals with economic value has been well established, at least when the care is associated with an eventual asset sale.[5] At issue with the administrative expense deduction associated with the pre-distribution care and transport of pets is the extent to which such expenses can be considered reasonable and necessary when the pet engenders a host of valued qualities that may not have traditional economic value, when the failure to care for the pet may create liability to the fiduciary (executor or trustee) and the evolution of state and local law in some jurisdictions that have expanded theories for recovery of value associated with the loss of a pet.

FACTS:

Pets may be included in the distribution of estate assets. State law generally treats animals, including pets, as property. While pets constitute a type of animal the term is referenced to include animals retained for care, comfort, pleasure or health rather than to…

support a business, support activities (such as guide dogs or horses) or farm animals generally. Some pets may have substantial economic value depending upon training or breed, in particular. The distribution of pets or animals may arise as part of the residue of the estate (such as when no particular reference is made to the disposition of the animal) or the pet may be given to an individual or the pet may be the beneficiary of a trust (if a pet trust is recognized under state law). According to the ASPCA, forty-six states and the District of Columbia have enacted laws governing pet trusts.[6] In addition, some states have enacted laws that enable the owners of pets to obtain damages beyond the economic value of the pets (which may be nominal notwithstanding great psychic value or personal attachment).[7] Cases referenced in Animal Legal & Historical Center, authored by Professor David S. Farve, of the Michigan State University College of Law discusses both the general limitations on liability and principles advanced by the statutes of some states or case law development to increase damages for the tortuous treatment of pets and animals.[8]

In addition, statutory laws in at least 46 states recognize the allowance for pet trusts. Both of these developments (the advancement of pet trusts and growing, though not universal acceptance, of damages for wrongful injury or death to pets and animals, have arisen since the issuance of TAM 8826003. That technical advice memorandum provides the most extensive discussion with respect to the deductibility of post-death administrative expenses pertaining to the care of pets. TAM 8826003 denied the estate tax deduction for such expenses under Code § 2053. However, the reasoning of that memorandum has been undermined by these recent developments in law, which developments can cause the expenditure of reasonable and necessary sums for a prudent time in the care of a pet to be estate tax deductible even if that pet does not have substantial economic value under traditional fair market value principles.

COMMENT:

Whatever allowances the federal estate tax law may grant for the deduction of expenses associated with the preservation and storage of pets between the death of the owner and time when distribution may occur will fall within the allowances of Code § 2053.

<u>Fundamental Tests Governing Miscellaneous Administrative Expense Deductions</u>

Regulation § 20.2053-3(a) states the general requirement that "administrative expenses" of the first category: 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." The majority of the circuit courts (Second, Fourth, Fifth, Six, Ninth, and Eleventh) have determined that the "actually and necessarily incurred" requirement applies regardless of whether a probate court has approved the expense.[9] The tax court follows the majority rule.[10]

First category expenses cover a wide range of administrative expenses.[11] Expenses in the first category includes: (1) funeral expenses; (2) administrative expenses; (3) claims against the estate (including taxes to the extent allowed by the regulations) and valid and binding charitable pledges allowed under Reg. § 20.2053-5; and (4) unpaid mortgages on, or any indebtedness with respect to, property, the value of the decedent's interest in which is included in the value of the gross estate undiminished by the mortgage or indebtedness.

Cases that consider the reasonableness of a deduction are highly fact-specific. For example, a trustee may want to charge long-term maintenance expenses against the gross estate to reduce estate taxes. Perhaps the market is down and the executor would like to sell the property. Is it possible to deduct expenses to maintain property for a considerable time? Yes, but the facts need to support the result. For example, in *Lockett v. Comr.*, the tax court allowed a $2 million administrative-expense deduction arising from expenses to graze cattle (maintenance expense and interest deduction), which were necessarily incurred to protect the value of the land and prevent it from turning into "muck and swamp."[12]

Estate of Papson v. Comr. [13] upheld the deduction of leasing in connection with an unexpectedly empty and financially underwater commercial property that was part of an estate tax deferral under Code §6166. The asset represented a substantial portion of the value of the estate and the lease of the prior tenant terminated abruptly. The deduction as an administrative expense of the brokerage commission "was necessary in order to preserve the estate."

If the property can be distributed to the heirs so it is their asset to handle, then it is less likely that expense of maintenance will be allowed as an administrative-expense deduction.[14] The following language from Marcus v. DeWitt,[15] may help set the stage for a deductible expense:

> "If the sale was made for the benefit of the estate, it is not significant that the beneficiaries are also benefited. The law is well established that such dual benefit does not affect deductibility. (*Pitner* citation omitted from which the following quote arises: 'We agree that the plaintiffs were acting in their own self interest but we reject the conclusion that the litigation they undertook was not at the same time essential to the proper settlement of the estate.') (Citations omitted.) Other options available to the fiduciary, and the reasonableness thereof, are relevant, (reference omitted), but must be tempered by the recognition that an executor obviously must have considerable discretion in making fiduciary decisions for the benefit of the estate. An executor has a fiduciary duty not only to collect assets, pay debts, claims and taxes, and distribute property to the legatees, but an executor also has a fiduciary duty during the limited period of administration to preserve the assets of the estate, to make the assets productive, and to invest same prudently where feasible and consistent with the testator's intention. "

Accordingly, under general principles governing the deduction of administrative expenses it would be reasonable for the executor or trustee to expend funds to preserve the pet until distribution can be made to the beneficiary entitled to receive the animal.

Unfavorable Result in TAM 8826003

Though not official authority, TAM 8826003 considers and rejects the estate tax deductibility of pet care expenses when a testamentary bequest was made to a pet animal. The decedent left her estate to her husband with the children as recipients, in trust, if the husband did not survive. The trust also provided that if the husband did not survive the testator-wife, that all pet animals owned or possessed by the couple at the time of the death of wife shall be fully provided for and kept in a manner consistent with the accustomed care during the lifetime of the wife. The wife was predeceased by her husband. As a result of post-death litigation, distribution of the estate was postponed. Pursuant to a written agreement, for eight years, the executor monthly compensated his granddaughter for taking care of the pet, for which the estate sought an administrative expense deduction from the death of the wife until the death of the pet.