

# Excise Tax Advisory

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**THIS DRAFT ETA IS TO BE USED SOLELY FOR DISCUSSION PURPOSES. UNDER NO CIRCUMSTANCES IS THIS DRAFT ETA TO BE USED TO DETERMINE TAX LIABILITY OR ELIGIBILITY FOR A TAX DEDUCTION, EXEMPTION, OR CREDIT.**

## Estate Tax Deduction for Selling Expenses Incurred in Administering an Estate

<b>Purpose and scope</b>	This Excise Tax Advisory (ETA) addresses the deductibility from the Washington gross estate of selling expenses that estates may incur during the administration of an estate, such as expenses from the sale of real estate. It does not address every type of selling expense that may be deductible from a gross estate.
<b>Definitions</b>	<p><b>Washington Taxable Estate:</b> Washington's estate tax is imposed on the value of the Washington taxable estate, at tax rates specified in RCW 83.100.040. "Washington taxable estate" generally means the federal taxable estate.<sup>1</sup> The Washington estate tax is a stand-alone tax that incorporates only those provisions of the Internal Revenue Code that do not conflict with Chapter 83.100 RCW.</p> <p><b>Federal Taxable Estate:</b> The gross estate less any applicable deductions.<sup>2</sup> The federal estate tax is imposed under I.R.C. § 2001 on the taxable estate and the amount of adjusted taxable gifts.<sup>3</sup></p> <p><b>Executor:</b> A person, who may include the personal representative, who is appointed by a testator or testatrix to carry out directions and requests in a will and dispose of property according to testamentary provisions.<sup>4</sup></p> <p><b>Liquid assets:</b> Cash or assets immediately convertible to cash.<sup>5</sup></p>

<sup>1</sup> RCW 83.100.020(15); RCW 83.100.040(3); WAC 458-57-105(2)(a).

<sup>2</sup> 26 U.S.C. § 2051. Deductions from the gross estate are further described in §§ 2053-2058. The Internal Revenue Code at 26 U.S.C. is abbreviated hereafter as I.R.C.

<sup>3</sup> Under Washington law, deductions under I.R.C. § 2058 are excluded. RCW 83.100.020(6).

<sup>4</sup> Black's Law Dictionary, 5<sup>th</sup> edition.

<sup>5</sup> *Id.*

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## Background

Washington estate tax law incorporates by reference, federal estate tax law as written in the 2005 Internal Revenue Code.<sup>6</sup> The federal estate tax is imposed on a decedent's taxable estate, which is determined by subtracting certain deductions from the sum of the gross estate, and adding back any gift tax paid on gifts within three years of the date of death.<sup>7</sup> The Washington taxable estate means the federal taxable estate and includes the following: the value of any property included under I.R.C. § 2044 marital property provisions, regardless of date acquired, and amounts adjusting the taxable estate under RCW 83.100.046, RCW 83.100.047, and RCW 83.100.048.<sup>8</sup>

Under Washington estate tax law, the Washington taxable estate is reduced by an amount defined by statute ("applicable exclusion").<sup>9</sup> The amount of the federal applicable exclusion from the taxable estate has historically been greater than the Washington applicable exclusion. Estates that are not required to file federal estate tax returns because the estate's value is smaller than the federal exclusion, may nevertheless be required to file a Washington estate tax return if the estate value is greater than the Washington exclusion.

As a result, Washington may review deductions from the gross estate that have not already been reviewed by federal authorities. This situation often occurs when no federal estate tax return is filed, or a simplified federal return is filed to preserve the portability exemption or deceased spouse unused exclusion under I.R.C. § 2010(c)(4). Additional review may occur with other estate tax returns because Washington law requires compliance with the Internal Revenue Code as written in 2005 and does not include many of the changes in the current Code.

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## Deduction for estate administration expenses

Among the expenses permitted as deductions against the value of the gross estate to obtain both the federal and Washington taxable estate are four general categories of expenses incurred during estate administration:

- 1) funeral expenses;
- 2) administrative expenses;
- 3) claims against the estate; and
- 4) unpaid mortgages or debt on property where the decedent's interest is undiminished and is included in the value of the estate.<sup>10</sup>

Treasury Regulation § 20.2053-3<sup>11</sup> provides details for expenses considered administration expenses for purposes of this deduction. In general, deductions for expenses of administering the estate are limited to such expenses that are **actually and necessarily incurred** in the administration of the decedent's estate. The expenses contemplated in the law are those that accompany the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to

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<sup>6</sup> RCW 83.100.020(8), (15); RCW 83.100.040(3); I.R.C. § 2001(a).

<sup>7</sup> I.R.C. §§ 2001(a), 2051, 2035(b).

<sup>8</sup> RCW 83.100.020(15).

<sup>9</sup> For federal estates, the applicable exclusion functions to exempt a certain amount of value from the estate, equivalent to an applicable credit amount. See I.R.C. § 2010(c)(3); RCW 83.100.020(1), RCW 83.100.040(3).

<sup>10</sup> I.R.C. § 2053(a).

<sup>11</sup> The Treasury Regulations are the administrative regulations that explain the Internal Revenue Code.

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a trustee. Any expenditure not essential to the proper settlement of the estate but incurred for the benefit of the heirs or devisees may not be taken as a deduction.

Deductible administrative expenses include executor commissions, attorney fees, and certain miscellaneous expenses. These deductible miscellaneous expenses are necessarily incurred in preserving and distributing the estate. They are expenses such as court costs, accountant's fees, appraiser fees, and include the cost of storing and maintaining property of the estate if it is impossible to effect immediate distribution to the beneficiaries.

Expenses for preserving and caring for property do not include expenses for additions or improvements, and expenses are not allowed for longer periods than the executor is reasonably required to retain the property.<sup>12</sup>

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**Deductibility of selling expenses as estate administration expenses**

Selling expenses incurred during estate administration may be deductible in some instances.<sup>13</sup> IRS regulations specifically describe expenses for selling property of the estate as deductible only when those expenses are necessary to the administration or preservation of the estate or to effect distribution, and not when they are incurred for the benefit of the beneficiaries or heirs, unless they are essential for the settlement of the estate.<sup>14</sup>

For selling expenses to be deductible, the *estate* must have a need to sell the property to settle estate obligations, preserve the estate, or transfer remaining property to the beneficiaries. If the estate is permitted to make distributions in kind and there is no compelling reason to sell the property other than for the convenience of the beneficiaries, the selling expenses will not be allowed as a deduction from the gross estate.<sup>15</sup>

If some selling expenses were incurred for the benefit of the estate and some were incurred for the benefit of the beneficiaries, only the expenses necessary for estate administration are deductible. Given the limitations, if the estate has sufficient liquid assets to meet its debt and tax obligations, the sale of property, while within the authority of the trustee or personal representative, will not be deemed necessary or deductible as an administrative expense.

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**Preserve or distribute the estate**

Treas. Reg. § 2053-3(d)(1) notes that expenses necessary for "preserving and distributing the estate" include "the cost of storing or maintaining property of the estate," but only "if it is impossible to effect immediate distribution to the beneficiaries." Expenses for the *preservation or maintenance of property* are only necessary to preserve the estate if it "is impossible to effect immediate distribution of a decedent's interest in the property to the beneficiaries."<sup>16</sup>

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<sup>12</sup> Treas. Reg. § 20.2053-3(d)(1).

<sup>13</sup> Treas. Reg. § 20.2053-3(d)(2).

<sup>14</sup> Treas. Reg. § 20.2053-3(a).

<sup>15</sup> See *Id.*; Treas. Reg. § 20.2053-3(d)(2). See, e.g., *Estate of Posen v. Comm'r*, 75 T.C. 355 (1980) (holding that selling expenses were not deductible for the sale of an apartment in which the beneficiary/administratrix did not wish to live and did not want to hold as an investment because sufficient alternative funds were available to pay the estate's expenses and because there were no obstacles to distributing the apartment in-kind).

<sup>16</sup> Treas. Reg. § 20.2053-3(d)(1).

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Such expenses are deductible as miscellaneous administration expenses from the value of the gross estate **only** if the following are true:

- (1) It must be impossible to effect immediate distribution of decedent's interest in the property to the beneficiaries, **and**
- (2) The expenses must be necessary in preserving the estate prior to distribution of property and **not** incurred for the individual benefit of the heirs, legatees, or devisees.<sup>17</sup>

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**Expenses must be necessary for the estate**

With respect to the deductibility of expenses related to the sale of property, the Department interprets § 2053 and related regulations to mean that an executor's determination that selling property is in the best interest of the estate does not, by itself, establish that selling the property was necessary to preserve the estate. An executor's decision to sell estate property may be reasonable and meet the duty of care. However, deductibility turns on necessity rather than reasonableness. It is not sufficient that the executor determined selling property was in the estate's interest, or that a probate court authorized the sale, or that there was general volatility in the market.<sup>18</sup>

The Department generally does not permit a deduction for selling expenses if the estate has liquid assets to pay the taxes, debts, and expenses of administration. Often, a deduction may be denied for selling expenses unless the sale is related to liquidation of an asset necessary to raise funds to pay an estate's debts or taxes or for other reasons provided in statute or the regulations. If an expense is incurred after the administration was completed, it is generally not deductible as an administrative expense.

In each case, the facts and circumstances are determinative. An executor or fiduciary's sole determination that a sale is in the best interest of the estate is not considered sufficient.

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**Examples**

*The examples found in this guidance identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax results of other situations must be determined after a review of all the facts and circumstances. If you have a question as to whether your activities qualify, you may request a binding ruling from the Department.*

**Example 1**

**Facts**

- David owned and managed a Christmas tree farm that generated cash during only three months of the year from the sale of Christmas trees.
- David also owned 500 acres of undeveloped land.
- David's estate was entirely comprised of illiquid assets.

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<sup>17</sup> *Estate of Holland v. Comm'r*, 73 T.C.M. 3236 (1997); Treas. Reg. § 20.2053-3(a), (d).

<sup>18</sup> *See Estate of Smith v. Comm'r*, 510 F.2d 479, 482-83 (2d Cir. 1975) (holding that commissions expenses for sales of sculptures subject to speculative and volatile market values were not deductible because their sales were not necessary to carry out the administration of the estate.).

- After his death, there were no liquid assets to pay estate taxes or attorney fees.
- Executor claimed selling expense deductions for expenses related to the sale of several parcels of land to pay estate administrative costs and taxes.

**Result:**

The selling expenses are deductible from the federal taxable estate as administration expenses because there were no liquid assets to pay the estate administration costs and taxes.

**Example 2**

**Facts**

- A sculptor died possessing various sculptures, valued at more than \$4,000,000.
- The sculptures could be distributed “in kind” to the beneficiaries.
- The Executor sold the sculptures and claimed they were sold to distribute the assets more fairly in the estate.

**Result**

Selling expenses will not be deductible because a sale was not necessary to distribute the sculptures. There was no necessity to sell the sculptures where they could be distributed to the beneficiaries in kind. A sale of property for the convenience or benefit of the beneficiaries is not sufficient to make the sale necessary to effect distribution.

**Example 3**

**Facts**

- Personal representative submitted a probate court order *permitting* him to sell real property for Tina’s estate.

**Result**

A deduction for selling expenses will not be allowed under Washington law without additional facts establishing the necessity for the sale.

**Example 4**

**Facts**

- Same facts as Example 3, except the probate court order *required* the sale of an asset.

**Result**

A deduction for selling expenses will be permitted. When either the governing instruments or a court order *requires* the sale of an asset, selling expenses are allowed as expenses necessary to the administration of the estate to effect distribution. Permission by the court means “can or may sell” but when the court ***requires the sale***, that means “must sell” and therefore necessary to effect distribution.

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**Example 5**

**Facts**

- An art collector died owning various precious art works, valued in excess of \$60,000,000.
- Executors decide to sell some of the art works to fund certain trusts established for the decedent's daughters.
- The items were sold due to the volatile nature of the art market, i.e., to avoid a loss in value.
- The proceeds from the sale of the art were used to fund the trusts.

**Result**

The fact that the nature of the art market was volatile did not make the sale necessary to "preserve the estate." The sale expenses will be disallowed. The executors made decisions to sell the art to fund the trusts, and thereby provide support money for the daughters while avoiding market volatility. Thus, they were acting on behalf of the trust beneficiaries and not on behalf of the estate. The sale was not necessary to pay estate expenses.

**Example 6**

**Facts**

- Decedent, Debra, had five daughters who were the primary beneficiaries of a residuary trust created at Debra's death.
- Each daughter was to receive a one-fifth share to be distributed to her when she attained age 40.
- Debra's daughters also separately received monetary bequests along with three other family members.
- Based on the estate inventory, there was sufficient liquidity to pay all taxes and other obligations of the estate.
- During the estate administration, the estate sold all the real property it held. The Executor, who was also the Trustee, claimed the real property was sold because it was not practical to transfer it to multiple beneficiaries.
- The estate claims the expenses for the sale of the real property were deductible administration expenses.

**Result**

The Department will deny the deduction for those expenses because the estate had sufficient liquidity to pay its taxes and other administration expenses. The fact that transfer of the properties to multiple beneficiaries would be impractical did not mean the sale was necessary to preserve the estate.

**Example 7**

**Facts**

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- Executor deducted expenses for the sale of two rental properties as necessary to effect distribution because the properties were part of the residuary estate to be distributed to a testamentary trust.
- The properties had been purchased by the decedent at a foreclosure sale and were very old and damaged.
- Both properties required maintenance and needed significant repairs to comply with local law.
- The trustee named in the will was a small community owned savings bank that was not able to provide those services. The bank's governing board declined the properties given restrictions under the bank's charter.
- The decedent's will did not provide for an alternate trustee and the Executor was given the power to sell.

**Result**

Selling expenses will be allowed as a deduction because, under these circumstances, it was impossible to effect immediate distribution of the decedent's interest in the properties to the beneficiaries based on directions in the governing instrument. Thus, the selling expenses were necessary in distributing the estate.

**Example 8**

**Facts**

- Daniel's estate included several parcels of real property that were devised to his two adult children, John, and Amy.
- Amy was Executor for the estate and paid property taxes, utilities, and maintenance costs for the properties while John was studying and traveling in Europe for eighteen months.
- Amy had a special power of attorney for John to execute all documents on his behalf while he was out of the country.
- Amy and John decided to wait until John returned from Europe to sell the properties.
- The estate deducted the holding costs on the properties as necessary to preserve the estate.

**Result**

The deductions will be denied because the expenses do not meet both requirements to preserve and distribute the estate. The requirements for deducting expenses to preserve the estate are 1) it must be impossible to immediately distribute the property to the beneficiaries; and 2) the expenses must be necessarily incurred in preserving the estate prior to distribution of property to the persons entitled to it and not be incurred for the individual benefit of the heirs.<sup>19</sup> In this example, Amy could have immediately distributed the properties and the children could have sold them afterward. The expenses were incurred in activities for the individual benefit of the heirs.

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<sup>19</sup> *Estate of Holland*, 73 T.C.M. 3236; Treas. Reg. § 20.2053-3(a), (d).