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Income Taxation of Estates and Trusts - Recent Developments and Planning Possibilities

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INCOME TAXATION OF ESTATES AND TRUSTS — RECENT DEVELOPMENTS AND PLANNING POSSIBILITIES

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The subject of income taxation of estates and trusts is always productive of new material to be studied. The past year has been no exception to the history of growth and proliferation in this area of tax law. A brief review is timely.

Chronologically, in the taxing plan, the first matter that must be disposed of by an executor or administrator is the decedent's last return; developments with respect to that return and the related problems of a joint return with the surviving wife are mentioned first. Then the estate's returns and those of the trusts which are created under the will are discussed. Finally, there are the problems of distributions to the beneficiaries and termination of the estate. This leaves aside problems of grantor-trust taxability and the peculiarities of taxation of inter vivos trusts except as these are mentioned incidentally.

I. The Decedent's Final Return

The decedent's final return is the first responsibility of the executor.[1] It covers the period from the first of the decedent's taxable year to the date of death and may or may not be made jointly with the surviving spouse.

If the decedent used the accrual method of accounting, all accrued income except that accrued solely by reason of his death is includible on this final return.[2] Similarly, all accrued deductions are allowable except those accrued solely by reason of death.[3] If his was the cash method of accounting, all income either actually or constructively received is includible.[4] Depreciation and depletion prorated to the date of death and all deductible items actually paid are

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[1] Depending on the date of death, there may be a return due for the preceding year. For the executor's own protection, he should notify the Commissioner of his appointment on form 56. Int. Rev. Code of 1954, § 6903; Treas. Reg. § 301.6903-1 (1961).

[2] Int. Rev. Code of 1954, § 451(b).

[3] Int. Rev. Code of 1954, § 461(b).

[4] Int. Rev. Code of 1954, § 451(a); Treas. Reg. § 1.451-2 (1957). This constructive receipt includes partnership income from the end of the last partnership fiscal year to the date of death *if* the estate sells its entire partnership interest as of that date, because that sale closes the partnership year as to the estate. Treas. Reg. § 1.706-1(c)(3) (1956).

allowable.[5] This is the last time to claim bad debts and worthless securities as a deduction if worthlessness occurred prior to death.[6]

Whether decedent had filed an individual or a joint declaration, payments of estimated tax are not required subsequent to death. However, if a joint estimate was filed, the surviving spouse must either amend or continue the payments.[7]

Usually it is advantageous to the estate and to the family to file a joint return because, if properly handled, a joint return can be used to reduce the amount of tax to be paid. The income splitting that has gone on during marriage may be continued for two taxable years following the death if the surviving spouse does not remarry and she lives in the home with minor children who are her dependents.[8]

The date of death in relation to the amount of income received will affect the distribution of income from the estate. If death occurs early in the year before much income has been received, the estate will want to distribute enough income to the surviving spouse to equalize the rates at which the spouse and the estate are taxed. The rule of thumb is that the estate distributes income to the spouse for inclusion in the joint return until the income shown in that return amounts to approximately twice the income retained in the estate. In that way, each half of the income in the joint return and the income remaining in the estate are taxed at the same rate.[9] Hence,

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[5] Treas. Reg. § 1.167(g)-1(c) (1956). Obviously, this is distinct from trying to deduct a decline in the value of the property as a capital gain or loss. Such a loss is not deductible. O.D. 219, 1 Cum. Bull. 180 (1919).

[6] Compare the treatment of theft losses. Treas. Reg. § 1.165-8(b) (1960). If decedent's death caused the loss or worthlessness, the deduction can not be taken on the decedent's last return. William C. Squier, 26 B.T.A. 1407, *aff'd*, 68 F.2d 25 (2d Cir. 1933).

[7] Treas. Regs. §§ 1.6153-1(a)(4) (1953), 1.6015(b)-1(c)(2) (1957).

[8] Int. Rev. Code of 1954, § 2(b).

[9] This is not the same as simply distributing to the surviving spouse what would have been her share of the community income. Such distribution does not take full advantage of the fact that two returns are now available for reporting the income with three personal exemptions instead of two.

For example, suppose the taxable income for the year would have been $20,000 if both spouses had survived. The tax would have been $5,280. If death occurs after $9,000 has come in you should not distribute to the wife one-half of the remaining $11,000, or $5,500. That would put a total of $14,500 on the joint return with a resulting tax of $3,470 and would leave $5,500 to be taxed in the estate at $1,074, utilizing the one new exemption. The total tax would thus be $4,544. Instead, following the rule of thumb, you should put $13,334 on the joint return leaving $6,666 in the estate. The joint return tax is then $3,120.20 and the estate's tax is $1,379.80, or a total of $4,500—a saving of $44.00.

If death occurs late in the year, nearly all of the income is on the joint return, and the rest should be retained in the estate for the best advantage. For example, if death comes after $15,000 of income has been received, again one does not automatically distribute one-half of the remaining $5,000 to the joint return, leaving the rest in the estate. This would produce a tax on the $17,500 in the joint return of $4,430 and a tax on the $2,500 in the estate of $380, or a total of $4,810. Instead, since the remaining during the two-year period while the joint return possibility lasts, larger distributions should be made to the wife to take full advantage of the lower rates.

One other way that income can be moved into the joint return is by exercising the election to report the accrued interest income on U.S. Savings Bonds on that return.[10] Paying the tax on decedent's final return rather than at the time the bonds are disposed of after death may effect a tax saving. Of course, the same tax benefit may be effected with a separately filed decedent's last return if the decedent died early in the tax year.

A capital loss carryover resulting from a capital loss incurred by a decedent is not deductible by his estate; the theory is that two separate taxpayers are involved. However, these losses can be used to offset gains of the surviving spouse reported in a joint return.[11] If the spouse might not otherwise know of the possibility, the executor may have a duty to inform that spouse of the potential offsets.

There are problems with joint returns. The tax liability must be equitably divided. The surviving spouse and the estate must watch their own ability to pay because the liability on such a return is joint and several.[12] Problems may arise concerning who is entitled to refunds for overpayment and who is to bear the burden of any penalties assessed.[13]

Another election on the decedent's last return is sometimes overlooked. Decedent's medical expenses that are paid within one year after death may be deducted on this return as if paid when incurred rather than when actually paid.[14] They are subject to the usual medical expense limitations. If not taken here, the medical expenses may be deducted on the estate tax return as a claim against the estate. This would produce no conflict between life tenant and remaindermen because these are charges to corpus in any event. However, leaving them out of an estate tax return which includes separate

income is less than one-third of the total income, it should be left in the estate. That way the tax is $3,620 on the joint return and $908 on the estate's return, or a total of $4,528—a saving of $282.00.

[10] Int. Rev. Code of 1954, § 454(a); Treas. Reg. § 1.454-1 (1957).

[11] Rev. Rul. 207, 1954-1 Cum. Bull. 147.

[12] Int. Rev. Code of 1954, § 6013(d)(3). These matters must be watched and provided for carefully at the time of divorce and separation also. See also Spanos v. United States, 212 F. Supp. 861 (D. Md. 1963), in which the court held that a husband and wife could legally file a joint return after it was due. The wife, after her husband's death, could not revoke her election and was subjected to a penalty for a fraud perpetrated by her husband, even though she had no income in her own right.

[13] See de Rham, *Joint Returns and Joint Declarations*, N.Y.U. 21st Inst. on Fed. Tax 237 (1963).

[14] Int. Rev. Code of 1954, § 213(d)(1); Treas. Reg. § 1.213-1(d) (1960).

property may affect a formula marital deduction gift because it increases the adjusted gross estate. Medical expenses may also be taken on the estate's income tax return. As in the case of the estate tax return, there are no limitations on the amount of the deduction.[15] The decision to take the deduction on the final income tax return or on the estate tax return is not purely a question of comparative tax rates. It must be remembered that non-deduction on the income tax return increases the income tax which in turn is a deduction on the estate tax return as a claim against the estate.[16]

There are very significant potential developments in the Congress with respect to the decedent's last return. The President in his Message on Taxation made the far-reaching recommendation that capital gains to the date of death be income taxable to the decedent.[17] Secretary Dillon's statement and the technical implementation make clear that this capital gain income will be reportable on the decedent's last return. The final return would be due fifteen months after death—the same time as the estate tax return. This proposal should be studied carefully.[18]

Briefly, under the proposal, gain to the date of death will be taxed on the basis of the fair market values reported for federal estate tax purposes at a thirty per cent rate, regardless of the holding period. Excepted will be personal and household effects, a personal residence, property transferred to a spouse or to charity, and a minimum of 15,000 dollars in every case. This will result in a stepped up basis to the transferee. The income tax on the gain at death will be deductible from the gross estate for estate tax purposes. Losses as a result of declines in value will be first applied against gains for the decedent's last taxable year and then backward for three prior taxable years' ordinary income to the extent of thirty per per cent—1,000 dollars of loss would thus offset 300 dollars of prior ordinary income. This proposal would be phased in over a three or five year period. Without going into more detail, it is apparent that if this proposal is enacted, a major revolution can be expected in tax planning and administration, and the decedent's last return will assume major importance.

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[15] If the expenses are taken on the income tax return, a specific waiver of estate tax deduction must be filed. Int. Rev. Code of 1954, § 642(g).

[16] Int. Rev. Code of 1954, §§ 2053(a)(3), 2053(c)(1)(B); Treas. Reg. § 20.2053.6(f) (1961). See Lentz, *Subchapter J Explored*, in Proceedings, 9th Annual U. of Texas Tax. Conference 87, 92 (1962).

[17] *Hearings on the President's 1963 Tax Message Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 24 (1963).

[18] *Id.* at 54-56, 128-140.

II. THE ESTATE'S FIRST RETURN

Although taxed almost like individuals, estates and trusts are just enough different to keep the tax man on his toes. Most individuals use the calendar year for their tax year, but with the estate's first return, there is a very important decision to be made. How long is the first tax year to be?[19] It must not be longer than twelve months from the date of death, but otherwise may end on the last day of any calendar month. Thereafter, the pattern is set until the last year when there is another election.

Setting the length of the first year is almost the only way to tax-plan for the beneficiary of a trust that requires all its income to be distributed currently. If anything, the choice has more graphic results in the case of an estate than with a trust because shortly after death there is a characteristic drop in income. The decedent's earning power has terminated, and the payments of compensation, deferred or accrued, are made. Payments come in from pension and profit-sharing plans, and there may be items of income in respect of a decedent. These are non-recurring items that swell income immediately after death, but are not truly indicative of the steadier flow anticipated. Also, as legacies are paid and assets are distributed for estate requirements, the income from them is lost to the estate. Depending on the schedule of anticipated receipt of these payments, the first year can be foreshortened to even the impact of the tax, and any accounting method may be selected.[20] Thus, the premium is to the one who plans the schedule of anticipated receipts of estate income with accuracy.

III. SUBSEQUENT RETURNS

Most of the incidents of estate and trust returns are common with the returns of individuals. However, estimates are not required,[21] and there is no self-employment tax.[22] Further, deductions must be itemized since the standard deduction can not be used.[23]

The Code provides that returns of estates and trusts shall be filed by the fiduciary.[24] This may be the executor who probates the entire will, the personal representative, or the heir for an estate, or the

[19] The election must be made on the first return filed by the fiduciary. Treas. Reg. § 1.441-1(b)(3) (1957). This return must be filed on or before the fifteenth day of the fourth month following the close of the taxable year. Int. Rev. Code of 1954, § 6072(a).

[20] Int. Rev. Code of 1954, § 446(c).

[21] Int. Rev. Code of 1954, § 6015(a).

[22] Int. Rev. Code of 1954, § 1401.

[23] Int. Rev. Code of 1954, § 142(b)(4).

[24] Int. Rev. Code of 1954, § 6012.

trustee for a trust. If gross income of the estate or trust is 5,000 dollars or over for any taxable year, a certified copy of the will or trust must be filed together with the fiduciary's statement indicating which provisions determine the extent income is to be taxed to the estate or trust, or to the beneficiaries.[25] An ancillary representative files a return for the gross income he receives, but the domicilliary representative files a return for the entire income and pays all the tax.[26]

IV. CLASSIFICATION OF ESTATES AND TRUSTS

Simple trusts are those in which all income is required to be distributed currently, and no distributions may be made to charities.[27] There can be no distribution of corpus.[28] Estates and complex trusts are essentially those in which corpus as well as income may be distributed or income may be accumulated.[29]

As the law now stands,[30] there is only one distinction between the taxation of simple and complex trusts. In the case of simple trusts, extraordinary dividends and taxable stock dividends allocated to corpus by the trustee are never taxed to the beneficiary. In complex trusts, they are included in distributable net income and, even though never distributed to the beneficiary, will be taxed to him if the trustee makes corpus distributions.[31] By contrast, gains from the sale of capital assets are not included in distributable net income unless they are distributed or required to be distributed.[32]

The most important category of income insofar as the taxation of estates, trusts, and beneficiaries is concerned is "distributable net income."[33] The importance stems from the fact that distributable

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[25] Treas. Reg. § 1.6012-2(a)(2) (1961).

[26] Treas. Reg. § 1.6012-3(a)(3) (1959).

[27] Int. Rev. Code of 1954, § 651.

[28] Int. Rev. Code of 1954, § 651(a); Treas. Reg. § 1.651(a)-3 (1956).

[29] Int. Rev. Code of 1954, § 661.

[30] There is a concerted effort to have all trusts classified as "simple" except special types. The recommendation of the Section of Taxation to this effect has been approved to the House of Delegates and will be submitted to the Congress. See A.B.A. Section of Taxation, Report of the Committee on Income of Estates and Trusts Program, at 135-38 (1962); XVI A.B.A. Section of Taxation Bull. No. 1, at 9-10 (Oct. 1962), No. 3, at 12 (April 1963); 8 American Bar News No. 2, at 5-6 (1963). See also A.B.A., *Simplification of Taxation of Income of Estates and Trusts,* Report of Special Committee of American Bar Association of Real Property, Probate and Trust Law (1961); Lauritzen, *We Must Simplify the Taxation of Estates and Trusts,* 49 A.B.A.J. 146 (1963).

[31] *Compare* Int. Rev. Code of 1954, § 651 *with* § 661. See Int. Rev. Code of 1954, § 643(a)(4); Treas. Regs. §§ 1.643(a)-4 (1956), 1.665(d)-1(b) (1956).

[32] Int. Rev. Code of 1954, § 643(a)(3)(A). A further minor distinction is in the personal exemptions which are $600 for an estate, $300 for a simple trust, and $100 for a complex trust. Int. Rev. Code of 1954, § 642(b).

[33] This phrase is defined in the Code. Int. Rev. Code of 1954, § 643.

Distributable net income must be distinguished from "income required to be distributed currently." See Treas. Regs. §§ 1.651(a)-2 (1956), 1.661(a)-2(b) (1956). The Code net income is the measure of the tax to the beneficiary and the measure of the deduction from income otherwise taxable to the estate or trust.[34] Recent cases have included in the category of distributable net income: farm rents received after death, for the year of death;[35] income of a life estate in which, by the terms of the will, the widow had the right to as much of the income or corpus or both as required for her reasonable support;[36] amounts set aside for distribution to charities in respect to the charities;[37] amounts designated for charity, although, at the end of the taxable year, specific charitable donees were not designated and the amount set aside unknown, only that it was to be the entire net income;[38] all net income under a particular trust including that set aside to fund a depreciation reserve.[39] One other item always included in distributable net income is "income in respect of a decedent." This is income accrued at death and income to which decedent had a contingent claim at the time of death.[40] This income is taxed for federal estate tax purposes;[41] however, a pro rata part of that tax is deductible by the ultimate recipients for the taxable year in which the income is actually received.[42] Familiar examples are the right of a life insurance agent to receive renewal commissions[43] and unpaid installments on a real estate sale.

Excluded from the category of distributable net income are: reserves for anticipated expenses (farm property repairs and trustee compensation);[44] delay rentals, royalties, and the proceeds of lease sales which the will allocated to corpus;[45] reserves for expenses;[46]

determines the income to be included in distributable net income. The will, the trust, and applicable local law determine the income required to be distributed currently.

[34] Int. Rev. Code of 1954, §§ 651, 652, 661, 662 and the applicable Regulations.

[35] National Bank of Commerce v. Mathis, ___ F. Supp. ___ (E.D. Ark. 1961).

[36] Koffman v. United States, 300 F.2d 176 (6th Cir. 1962).

[37] Bank of America Nat'l Trust & Sav. Ass'n v. United States, 203 F. Supp. 152 (N.D. Cal. 1962).

[38] Commissioner v. Leon A. Beeghly Fund, 310 F.2d 756 (6th Cir. 1962).

[39] Lambert Tree Trust Estate, 38 T.C. 392 (1962).

[40] Int. Rev. Code of 1954, § 691; Treas. Reg. § 1.691(a)-1(b) (1957).

The Committee on Income of Estates and Trusts of the American Bar Association Section of Taxation is working on a proposal to exclude such income where allocated to corpus under state law or the governing instrument and no distributions are in fact made. See A.B.A. Section of Taxation, Report of the Committee on Income of Estates and Trusts Program, at 140-42 (1962); XVI A.B.A. Section of Taxation Bull. No. 1, at 10 (Oct. 1962).

[41] Int. Rev. Code of 1954, § 2033.

[42] Treas. Reg. § 1.691(c)-1, -2 (1957).

[43] Two interesting recent cases on such life insurance commissions involve the amounts paid in settlement to a divorced wife of decedent, Helen Rich Findlay, 39 T.C. 580 (1962), and to his surviving spouse, Irving S. Wright, 39 T.C. 597 (1962).

[44] National Bank of Commerce v. Mathis, ___ F. Supp. ___ (E.D. Ark. 1961).

[45] Elizabeth S. Robinette, 21 CCH Tax Ct. Mem. 568 (1962); 31 P-H Tax Ct. Mem. 629 (1962).

[46] Whitfield v. Commissioner, 311 F.2d 640 (5th Cir. 1962).

amounts of income accumulated to pay debts, expenses, taxes, and specific bequests;[47] income set aside to charities by will is not distributable net income as to the remaindermen;[48] payments to trustee's mother in settlement of her claim against the estate are not distributable net income to the trustee who was the son and life income beneficiary;[49] and payments of household expenses in 1952-1956 on a home purchased by the executor in 1939 for decedent's wife and daughter.[50]

Under the 1939 Code, distributable net income is not reduced by legal fees chargeable to corpus,[51] whereas it would be under sections 652 and 662 of the 1954 Code. Trust expenses not specifically applicable to a particular class of income will be allocated pro rata to all classes (other than capital gain allocated to corpus) including nontaxable income.[52]

V. DEDUCTIONS

A. *Managing Deductions*

An election of great importance is that under which certain administration expenses may be deducted on the estate's income tax return, the estate tax return, or split between them.[53] A new election may be made each year during the administration.[54] For the most part, the question of election is answered by the application of simple arithmetic, but there are some limitations on the choice. For example, expenses allocable to tax exempt income can be taken only on the estate tax return.[55] Of course, the rules pertaining to the

[47] Baldwin v. United States, 214 F. Supp. 16 (E.D. Mo. 1963).

[48] Bank of America Nat'l Trust & Sav. Ass'n v. United States, 203 F. Supp. 152 (N.D. Cal. 1962).

[49] James F. Edwards, 37 T.C. 1107 (1962).

[50] Carson v. United States, __ Ct. Cl. __, __ F.2d __ (1963).

[51] Calvin Pardee Erdman, 37 T.C. 1119 (1962), *aff'd*, 315 F.2d 762 (7th Cir. 1963).

[52] Marcia Brady Tucker, 38 T.C. 955 (1962); *accord*, Manufacturers Hanover Trust Co. v. United States, __ Ct. Cl. __, 312 F.2d 79 (1963).

[53] Int. Rev. Code of 1954, §§ 642(g), 691(b); Treas. Regs. §§ 1.642(g) -1, -2 (1957), 1.691(b)-1 (1957).

This election is very important because it takes $100,000 of taxable estate, but only $6,000 of taxable income, to reach the 30% rate. It takes $1,000,000 of taxable estate to reach the 39% rate but only $12,000 of taxable income to move from the 38% rate to the 43% rate. Int. Rev. Code of 1954, §§ 1, 2001.

[54] To take the deduction on the estate income tax return, a statement must be filed to the effect that the items have not been allowed as deductions on the estate tax return and that the right to take the deductions on the estate tax return is waived. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Once the statement is filed, the item can not thereafter be allowed as a deduction on the estate tax return. Treas. Reg. § 1.642(g)-1 (1956).

[55] Int. Rev. Code of 1954, § 265; Treas. Reg. § 1.265-1 (1958); Rev. Rul. 32, 1959-1 Cum. Bull. 245, as clarified by Rev. Rul. 63-27, 1963 Int. Rev. Bull. No. 10, at 7.

methods of accounting are applicable. Thus, an estate using the cash method can deduct expenses only on the income tax return for the year in which they are paid.[56]

Executor's commissions and attorney's fees are perhaps the most flexible deductions for planning purposes. Because these fees are within the control of those most intimately concerned with the management of the estate, their payment can be shifted into the early years to offset the higher income received just after the decedent's death and before legacies have been paid and assets disposed of to meet liabilities. Also, payment can be postponed to meet later anticipated estate income or even until the end of the administration to be of benefit as deductions to higher bracket transferee beneficiaries.[57] With executors fees,[58] there is the added problem of fiduciary responsibility in balancing safety that funds on hand may be needed for unanticipated expenses against the tax saving to the estate in taking the deduction now to offset the probable higher income of the earlier years.[59]

Bright spots in the deductions picture are the double deductibility (on estate tax return and estate income tax return) of expenses in connection with income in respect of a decedent[60] and of business expenses, interest, taxes, and expenses incurred for the production of income, which are owed by the decedent at the date of death. These are deductible from the gross estate on the estate tax return and, when paid, are deductible on the estate's income tax return.[61] Recently, the Tax Court has held that trustees' fees are deductible both on the trust's income tax return as an expense of managing property held for the production of income and on the estate tax return as expenses incurred in administering property not subject to claims. This case involved a revocable inter vivos trust in which the fees were included in the gross estate but not in the probate estate. The court said section 642(g) prohibited double deductions if in-

[56] Treas. Reg. § 1.446-1(c)(1)(i) (1961).

[57] Of course, the tax problems of the executor or attorney must be considered. He may need the income now, need it in installments, or be able to await the estate's pleasure.

[58] The executor who desires to waive fees entirely must do so before he performs any substantial services, or it will be held that he received taxable income. Rev. Rul. 472, 1956-2 Cum. Bull. 21.

[59] There is also the problem of protecting the estate against loss if, by reason of death or disability, the fiduciary who took advance payment for services is unable to perform. Those interested in the estate should be on their guard to make sure that an apparent immediate income tax saving does not result in practical loss in the future because attorneys or fiduciaries must be changed.

[60] Treas. Regs. §§ 1.691(b)-1 (1957), 20.2053 (1962); Rev. Rul. 58-69, 1958-1 Cum. Bull. 254.

[61] Int. Rev. Code of 1954, §§ 691(b), 642(g); Treas. Regs. §§ 1.691(b)(1) (1957), 1.642(g)-2 (1956). See Practicing Law Institute, *The Planning and Administration of Estates* 229 (1961).

come of the *estate* were involved, but not if the income was that of a *trust*.[62]

B. *Effect On Beneficiaries Of Shifting Deductions*

For purposes of federal tax law, insofar as the Code permits, the executor can shift deductions back and forth to produce the best overall tax result. But there are certain state law consequences of his acts that he must consider. Does state law permit the shifting of expenses? Of course it does if the will expressly permits it. If the will is silent, the question arises as to what extent, if any, the executor can shift deductions. The problem relates to the effect on the beneficiaries since estate tax is paid out of corpus. Any increase in that tax occasioned by not claiming available deductions is at the expense of the remaindermen. The benefit is transferred to the income beneficiaries whose current tax is lowered. In Cailfornia, New York, and Pennsylvania, where the problem has been considered,[63] the fiduciary has been permitted to make the election, but has been required to make the remaindermen whole out of income.[64] Courts elsewhere will likely follow suit. The obvious solution is to include a provision in the will giving the executor power to shift deductions and then stating definitely whether or not the testator desires that the remaindermen be made whole.

Taking the deduction on the income tax return has these other collateral effects: (1) It decreases the income beneficiary's deduction for estate taxes paid on income in respect of a decedent. (2) It decreases the credit for taxes paid on prior taxed property. (3) If a charity shares in the residue, it decreases the charitable deduction. (4) In the case of a marital deduction formula pecuniary gift, it increases the adjusted gross estate by one-half of the expenses not deducted on the estate tax return.[65] (5) It does not affect a marital

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[62] Burrow Trust, 39 T.C. ___ (1963). See 1 Casner, Estate Planning 122 n.33 (3d ed. 1961); Lowndes & Kramer, Estate and Gift Taxes § 15.4, at 317 (2d ed. 1962). *Cf.* Treas. Reg. § 1.212-1(0) (1957), prohibiting all double deductions. The Tax Court in *Burrow* says, "there is no reasonable basis for such interpretation in any section of the 1954 Code." 39 T.C. at ___.

[63] The question has not been definitely settled in Texas or in any of the surrounding states.

[64] Estate of Bixby, 140 Cal. App. 2d 326, 295 P.2d 68 (1956); *In re* McTarnahan's Estate, 202 N.Y.S.2d 618 (Surr. Ct. 1960), *cf. In re* Estate of Dick, 218 N.Y.S.2d 182 (Surr. Ct. 1961); *In re* Estate of Inman, 196 N.Y.S.2d 369 (Surr. Ct. 1959); *In re* Levy's Estate, 167 N.Y.S.2d 16 (Surr. Ct. 1957); Estate of Warms, 140 N.Y.S.2d 169 (Surr Ct. 1955); Rice Trust, 6 Fiduc. Rep. 225, 8 Pa. D. & C.2d 379 (Orphan's Ct. 1956). See also Rev. Rul. 643, 1955-2 Cum. Bull. 386; Rev. Rul. 225, 1955-1 Cum. Bull. 460; Browning, *Problems of Fiduciary Accounting*, 36 N.Y.U.L. Rev. 931 (1961); Lewis, *Estate Administration Expenses—Shall They Be Taken as Income or Estate Tax Deductions?*, 40 Taxes 851 (1962).

[65] *In re* Estate of Inman, *supra* note 64.

deduction gift of a fractional share of the residue because such a gift is a net gift anyway.[66] These collateral problems must be analyzed by the fiduciary and faced squarely before the election can be made safely.

VI. Distributions

A. *Planned Distributions*

Distributions to the beneficiary are a special deduction on the estate's or trust's income tax return. The nature and timing of these distributions have important tax effects on the total tax burden of the family group. Hence they, too, form an important aspect of planning.[67]

It is important to arrange for income distributions to the beneficiary who has deductions available to apply against that income.[68] If the beneficiary's rate is higher than that of the estate and accumulation is permitted by the governing instrument or local law, all income should be retained in the estate.[69] The alert fiduciary will maintain a constant check on the income tax rates of the estate and of its beneficiaries and distribute income accordingly.

B. *Corpus Distributions*

With corpus distributions, the important ground rules are: (1) Corpus distributions are taxable income to the beneficiary to the full extent of distributable net income. (2) There is no tax on corpus distributions of withheld income on which the estate has already paid income tax, *i.e.*, the throwback rules don't apply to an estate. (3) Corpus must not be over-distributed because the estate may be lost as a separate taxpayer. Furthermore, if corpus is distributed to the point that there is not enough income from it to absorb the 1,000 dollar loss deduction, that deduction will be lost.

An estate-trust combination can be utilized to help the family. The testamentary trusts can be set up immediately rather than waiting until the end of the administration period. This has the effect of lowering the overall tax paid by creating more taxpayers. Further, the corpus distributions from the estate to the trust are deducted

[66] *In re* Levy's Estate, 167 N.Y.S.2d 16 (Surr. Ct. 1957).

[67] One important type of income distribution has already been mentioned—that from the estate to the joint return with the surviving spouse. See note 10 *supra* and accompanying text.

[68] The importance of coordinating income in the estate with available deductions has been mentioned. See notes 53-56 *supra* and accompanying text.

[69] Remember that with estates we do not have to worry about throwback rules when the time comes to make distributions. Those rules apply only to complex trusts. Treas. Regs. §§ 1.665(a)-(d) (1956).

from the estate's income,[70] and then held in the trust without tax. The income from the estate distributed to the trust is deducted from the estate's income. This income may then be distributed from the trust to the beneficiary and also deducted on the trust's income tax return. It is finally taxed to the beneficiary. Whether this hop-skip-and-jump routine is helpful depends on the tax rates of the taxpayers involved.

If both the beneficiary's and the trust's tax rates will be lower than the estate's rate after the operation is completed, then the income should be distributed all the way to the beneficiary. If only the trust's rate will be lower than the estate's, the process should be stopped with the distribution to the trust, and the trust will pay the tax on the undistributed income. Conceivably, the income could be distributed to a beneficiary in a lower tax bracket and accumulated for a beneficiary in a higher bracket.[71] Of course, the hop-skip-and-jump routine won't work if all the income of the trust is required to be distributed currently—in other words, if it is a simple trust. But if the trust can accumulate income—that is, a complex trust—early activation is a pertinent consideration. This is true in spite of the throwback rules, for even with them, the effective tax rate of the beneficiary may be less than the estate's rate.[72]

C. *Basis Problems On Distributions*

One unexpected tax danger lies in the satisfaction of cash legacies with property in kind. If the property used to satisfy the legacy is appreciated property—that is, appreciated during the period of administration—capital gain will result to the estate. Payment of that tax, since it is chargeable to corpus, will reduce the share of the residuary beneficiaries. The legatee gets the benefit of the resulting increased basis.[73] Occasionally, the Service tries to tax the beneficiary legatee. A recent interesting case[74] involved, instead, an executrix

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[70] To the extent of the lesser of the amount of the corpus distribution or the distributable net income.

[71] This requires careful accounting to assure that each beneficiary is treated fairly. See Joraanstad, *Planning estate distributions; many tax-saving opportunities available*, 18 J. Taxation 148, 150 (1963).

[72] If short beginning and ending taxable years for the trust are used, these years count as full years for the five-year throwback purposes; so this, too, should be carefully considered. Treas. Reg. § 1.683-1 (1956).

[73] This situation must be carefully distinguished from the more usual case in which the legatee gets an increased basis because a corpus distribution was included in his gross income for the reason that at the time of the distribution the estate had distributable net income. Int. Rev. Code of 1954, § 662. But see qualifier in Int. Rev. Code of 1954, § 663. The estate was not taxed because the entire distribution was deductible. The beneficiary's increase in basis is limited to the amount of corpus distribution included in his gross income.

[74] Paul A. Johnson, 39 T.C. 473 (1962).

who advanced money to the estate to pay administration expenses and taxes and was later reimbursed in stock which was an asset of the estate. The stock was transferred at the fair market value of the stock at the time the executrix agreed to accept such stock as reimbursement. The fair market value was higher on the dates the stock was actually transferred. The court held that the difference between the fair market value on the dates transferred and the amount of the advances constituted neither ordinary income nor capital gain to the executrix. The estate's income tax was not in issue.

VII. THE ESTATE AND THE PARTNERSHIP

One other special situation in which an understanding of the relationship between the decedent's estate and his surviving partners may point to tax saving possibilities should be mentioned. The estate will be taxed for the partnership income of the partnership year which ends after the death of a partner.[75] The length of the estate's first fiscal year, a choice made by the executor, determines whether this income is reported on the estate's first return or the second one. If a sale or liquidation of the decedent's entire partnership interest is to occur at the date of death, such as might be required by a buy-sell agreement, the partnership year will end, with respect to this partner, when he dies. This results in including on the decedent's last return his distributive share of partnership income for two partnership years.[76] However, if there is no automatic termination at the date of death (under a correctly-drawn buy-sell agreement), the partnership year continues, and the partnership income for the partnership year ending after the partner's death is included in the estate's income tax return.

The partnership also has considerable flexibility. The survivor and the executor or administrator of a deceased partner can amend the partnership agreement even after the partnership year has closed, during the period of three and one-half months before the partnership return is due.[77] It is thus possible to reallocate the payments by the surviving partners to the estate of the deceased partner, assigning more of the payments to good will if non-taxibility to the decedent's estate is desired or more in the form of an interest in partnership income which will be deductible to the surviving partners and taxable to the decedent's estate or to the ultimate recipient.[78] Even

[75] Int. Rev. Code of 1954, § 706(a); Treas. Reg. § 1.706-1(c)(3)(ii) (1956).
[76] Treas. Regs. §§ 1.706-1(c)(2), (3) (1956), 1.706-1(c)(3)(vi) example 2 (1956).
[77] Treas. Reg. § 1.761-1(c) (1956).
[78] Int. Rev. Code of 1954, § 736.

in the sale situation, if the buy-sell agreement permits alteration by the interested parties after death, the parties can change the agreement to avoid adverse tax effects.

This is not a one-way street. The surviving partners can help themselves and the estate by timing distributions of principal (payments for the partnership interest) and income to the estate. The executors can help the surviving partners by assisting them in obtaining a special basis for partnership property through the election to revalue assets.[79] As far as the estate is concerned, informed, careful bargaining may produce benefits and tax savings otherwise unattainable.

VIII. THE ESTATE'S FINAL RETURN

The most important consideration in the last return of the estate is the choice of the length of the last fiscal year. It can be any period of time ending with a calendar month not more than twelve months from the end of the next preceding taxable year.[80] Since the beneficiary must account for the income of the estate shown on this last return and since unused deductions will carry over to his return, the choice of a termination date will vitally affect him. It can effect postponement of tax payment for almost a full year with possible advantages of future offsetting losses, longer use of funds, or even additional distributees with which to divide. The danger that must be avoided is the bunching of income in the return of the recipient. Closing the estate or trust a month or so later may avoid the beneficiary's having to report the equivalent of two full years income in one year. The rule of thumb is to close the estate in the beginning of its fiscal year or in the same calendar year in which the fiscal year began.

Related to the question of choosing the length of the final fiscal year is the question of how long an estate may be continued. The Regulations say that the period of administration lasts until the personal representative has performed his usual functions as such.[81] The pressure to continue as long as possible comes because the estate is another taxpayer, the estate accumulations are not subject to the throwback rules, and by continuing the estate, the beneficiaries can be given maximum benefit from loss carry-overs and excess deductions.[82] On the other hand, early termination might be indicated if

[79] Int. Rev. Code of 1954, § 754. See the example in Treas. Reg. § 1.734-2(b)(1) (1956).
[80] Int. Rev. Code of 1954, §§ 441, 443.
[81] Treas. Reg. § 1.641(b)-3(a) (1960).
[82] Int. Rev. Code of 1954, § 642(h).

there are no substantial tax advantages in keeping the estate open, no substantial debts, and the beneficiaries want to get rid of the trouble of dealing with a separate entity. But assuming the desire is to continue the administration, how long may it last? Courts have allowed continuation in many instances,[83] but the estate may not remain open as a mere sham to avoid income taxes.[84]

In sum, a thorough knowledge based upon a continuing study of recent developments in the income taxation of estates and trusts, continues to be essential to efficient estate administration.

[83] Until all transfer taxes are paid and, if necessary, settled by suit for refund, McCauley v. United States, 6 Am. Fed. Tax R.2d 5977 (E.D. Ark. 1961); Edwin M. Petersen, 35 T.C. 962 (1961); until other major existing debts actively being discharged have been paid, see Laughlin's Estate v. Commissioner, 167 F.2d 828 (9th Cir. 1948); until disposition of pending litigation involving the estate, Edwin M. Petersen, 35 T.C. 962 (1961); during the period a business interest is continued under court order, Frederich v. Commissioner, 145 F.2d 796 (5th Cir. 1944); during the period a probate court remains in control pending a final accounting, however, a mere order of a probate court may not be sufficient if all taxes are paid and settled, all suits settled and only close corporation stock which could have been distributed remains, A. T. Miller, 39 T.C. ___ (1963); until the question of property ownership is settled, Brown v. Commissioner, 215 F.2d 697 (5th Cir. 1954); under a specific order of a probate allowing continuation of the estate for a valid purpose, Carson v. United States, ___ Ct. Cl. ___, ___ F.2d ___ (1963) (assets in close corporations, income sufficient to discharge the debts, estate kept open for eighteen years by probate court order); until a family corporation, a principal asset of the estate, could be liquidated, Stella Porter Russell, 21 CCH Tax Ct. Mem. 1178 (1962); 31 P-H Tax Ct. Mem. 1299 (1962).

[84] See Stewart v. Commissioner, 196 F.2d 397 (5th Cir. 1952); Joseph M. Roebling, 18 T.C. 788 (1952).