

TAX SAVINGS THROUGH POSTMORTEM TAX PLANNING

SHELDON RICHMAN*

Tax planning does not cease with the decedent's death. Professional advisors are in a position to make certain decisions which can affect not only the estate tax return but the decedent's final return, the income tax returns of the fiduciary, and the income tax returns of beneficiaries for years to come. Through use of some of the techniques described in this article, the basic tax objective of postmortem tax planning—overall tax minimization for all parties concerned with the estate—may be achieved. After some general considerations, this article will deal with matters affecting, in turn, the decedent's final return, the estate tax return, and the fiduciary returns.

The basic tool of the tax advisor is knowledge—knowledge of the estate, the income of the fiduciary, the income tax brackets of the beneficiaries, and the cash needs of all parties. No advisor can minimize the human element of estate administration. In such periods, the emotional and personal problems of the beneficiaries must be considered. Great care must be taken in presenting alternative courses of action. Proposals which may have significant tax benefits may be rejected merely because of the emotional reactions of the heirs.

Forecasts

As soon after death as is practicable, a preliminary forecast including all of the assets and obligations of the decedent should be prepared. Similarly, the amounts and character of income to be realized, as well as the approximate time of receipt of such income, should be projected. Potential estate tax deductions and fiduciary income tax deductions should, of course, be considered in the forecasts. These few calculations will result in establishing an immediate frame of reference for further planning. A word of caution: The advisor must keep in mind that the information on which the preliminary forecasts were based is constantly changing; accordingly, the forecasts themselves must be revised in light of later information and changes in circumstances.

It is self evident that there must be complete understanding of the

* B.S. 1956, University of California, Los Angeles; LL.B 1961, University of Southern California. Member, State Bar of California. Licensed to practice as a Certified Public Accountant in California.

will and any related trust documents that are connected with the administration of the estate. Careful legal analysis is necessary in interpreting provisions of these documents.

Cash Requirements

The forecasts will provide data for projecting a cash-flow statement. This should take into account the amount of cash required by the family, the amount of cash needed to pay taxes and costs of administration, and the amount of cash and other property necessary to meet specific bequests. Generation of cash to meet all of these specific requirements may present serious problems.

While pre-death tax planning may have provided several vehicles for obtaining liquidity, post-death decisions will have to be made as to the exact manner in which funds are to be acquired. Possibilities exist that the estate may borrow funds from beneficiaries or third parties. The availability of future funds to repay the borrowings and the tax effect of the interest should be considered.

Sales of assets may provide a source of funds. In this connection, the valuation ascribed to the assets for estate tax purposes will control the amount of gain to be recognized. Here, the use of the alternative valuation date may affect the decision to sell. Satisfaction of pecuniary bequests by distributions of property¹ may also help conserve cash.

If the decedent's stock holdings in one company constitute either 35% of the gross estate or 50% of the taxable estate, such stock would qualify for redemption under section 303.² In such a case the estate may have redeemed an amount of stock equal to the estate and inheritance taxes plus the costs of administration. The redemption will not be a dividend but will be treated as an exchange of stock. Assuming the stock is valued for estate tax purposes at an amount equal to its redemption price, no gain or loss will result to the estate on the exchange.

Previously created section 306³ stock is often a good vehicle for

¹ See notes 94-97 *infra* and accompanying text. As to the possibility that gain or loss might be recognized by the estate, see sources cited notes 101 and 102 *infra*.

² If holdings in one corporation do not qualify, holdings in brother-sister corporations should be considered. If the estate includes more than 75% of the value of outstanding stock in each of two or more corporations, these holdings will be considered as the stock of a single corporation. INT. REV. CODE OF 1954, § 303 (b)2(B).

³ In general, section 306 provides that stock received as a non-taxable stock dividend (except common stock received with respect to common stock) and certain non-common stock received in a corporate reorganization become tainted. Sale or redemption of such tainted stock can result in substantial portions (specified in the Code) of the proceeds being taxed as ordinary income. The taint, however, is removed when the stock receives a new basis because of the shareholder's death.

Usually, section 306 stock is created by distributing preferred stock to the common stock shareholders. This has the effect of immediately reducing the value which can be ascribed to the common stock, thereby reducing the gift tax which would be applicable to gifts of the common.

redemptions and can be redeemed without the ordinary income taint generally associated with such stock. To provide funds for the estate without relinquishing any equity interest in future corporate earnings, section 306 stock might be issued after the decedent's death. Redemption of such stock would come within the shelter of 303.⁴ It may also be possible to accomplish this result through use of a redemption by a related corporation. Assume decedent owns 50% of both corporations A and B and that the holdings in Corporation A would qualify for section 303 treatment but the holdings in Corporation B would not. If a portion of the Corporation B stock is sold to Corporation A, the general rule of section 304 (treating the redemption as a dividend) would not apply. Rather, the transaction would be viewed as a redemption by Corporation A to which section 303 applies.⁵

Some caution must be exercised where preliminary distributions of the 303 stock have been made or where the 303 stock is included in the taxable estate but not in the probate estate. Redemption thereof directly from the beneficiaries may reduce the tax free potential of redemptions from the estate itself.⁶

It is also possible for the estate under section 302⁷ to have a complete or substantially disproportionate redemption qualify as an exchange and not as a dividend. In the event complete termination of interest is proposed, particular attention must be given to the problem of attribution of ownership from members of the family and related taxable entities. The rules of constructive ownership contained in section 318 deserve close attention. Because of the 1964 amendment⁸ to that section, the problem of sideways attribution has been eliminated so that it would now be possible to have a complete termination of interest without being hindered by attributions from an unrelated person through a partnership in which the decedent had an interest.

Another way out of the attribution problem might be first to discharge completely the beneficial interest in the estate of a person who also is a shareholder in the corporation that is redeeming the stock. So long as that beneficiary's interest in the estate is completely satisfied before the estate's stock is redeemed, there will be no attribution from

⁴ Treas. Reg. § 1.303-2(d) (1955).

⁵ Treas. Reg. § 1.304-2(a) (1955), as amended, T.D. 6533, 1961-1 *CUM. BULL.* 70.

⁶ INT. REV. CODE OF 1954, § 303, applies to all distributions with respect to the stock included in the gross estate whether or not such stock is held by the estate. See Treas. Reg. § 1.303-2(g) (1955).

⁷ Under the involved provisions of section 302, certain redemptions of stock are treated as exchanges and generally are taxable as capital gains. Redemptions which do not meet the requirements of this section will be treated as distributions and will generally be taxed as dividends.

Redemptions which completely terminate a shareholder's interest or which are substantially disproportionate with respect to a shareholder (specific rules are provided for this calculation) are treated as exchanges.

⁸ 78 Stat. 761 (1964).

the beneficiary to the estate which might destroy the exchange status of the redemption under section 302.⁹

Although the right is infrequently exercised, an executor, under certain circumstances, may recover portions of the estate tax from beneficiaries of non-probate assets (such as insurance policies¹⁰ and powers of appointment¹¹) which are included in the gross estate.

Other Matters Requiring Early Attention

Numerous other matters must be considered early in the administration. Particular attention should be given to timely filing of notices, elections, etc. Among these are the notice of intention to file an estate tax return,¹² notice of fiduciary relationship,¹³ election to continue subchapter S election,¹⁴ election to waive executor fees,¹⁵ and renunciation of bequests.¹⁶ Requirements for filing any gift tax returns should be noted. As part of the cash-flow management, it may be desirable to cease making payment with respect to the decedent's portion of a joint declaration of estimated tax.¹⁷ Certainly in states which, as does California,¹⁸ permit a discount if the state inheritance tax is paid within a prescribed period, the discount date should be clearly noted.

THE DECEDENT'S FINAL INCOME TAX RETURN

On or before the decedent's regular due date for filing, the final return must be submitted.¹⁹ Questions regarding the filing of a joint or separate return and regarding items to be included in the return must be resolved. Generally speaking, the filing of a joint return with the surviving spouse²⁰ will result in tax savings. Many of the same criteria normally used to determine the advantages or disadvantages of separate returns would be applicable. Even if a joint return is filed, the estate will not be permitted to claim the entire joint and several income tax liability as a debt of decedent.²¹ Rather, the deduction will be limited to that part of the joint return liability which is proportionate to the

⁹ Rev. Rul. 111, 1958-1 CUM. BULL. 173.

¹⁰ INT. REV. CODE OF 1954, § 2206.

¹¹ INT. REV. CODE OF 1954, § 2207.

¹² Treas. Reg. § 20.6036-1 (1958).

¹³ Treas. Reg. § 301.6903-1 (1957), as amended, T.D. 6585, 1962-1 CUM. BULL. 290.

¹⁴ Treas. Reg. § 1.1372-3(b) (1959).

¹⁵ Rev. Rul. 472, 1956-2 CUM. BULL. 21; Rev. Rul. 167, 1966 INT. REV. BULL. No. 25, at 7.

¹⁶ INT. REV. CODE OF 1954, §§ 2055, 2056(d).

¹⁷ Treas. Reg. § 1.6015(b)-1(c) (1957).

¹⁸ CAL. REV. & TAX. CODE § 14161.

¹⁹ Treas. Reg. § 1.6072-1 (1959).

²⁰ Treas. Reg. § 1.6013-1(d) (1959).

²¹ Treas. Reg. § 20.2053-6(f) (1958).

ratio of taxes calculated on the basis of separate returns. In subsequent years, use of the joint return tables by a qualified surviving spouse should be considered.²²

Items of Inclusion

The final return should report all income which the decedent would have reported had his taxable year ended on the date of death. Consequently, for the cash basis taxpayer this will generally mean all amounts *received* prior to death. Deductions will be claimed based on amounts *paid* prior to death. The final return will include the decedent's distributive share of partnership income only for partnership years which end with or within the period of the final return;²³ however, certain distributions would be taxed in the year of receipt.²⁴ (Similar rules apply to beneficiaries of trusts²⁵ and shareholders in subchapter S corporations.²⁶) Consider a calendar year decedent who is a member of a calendar year partnership. If the decedent dies on June 30, 1966, his final return for the six months then ended would not report his share of partnership income for the calendar year 1966; that amount would be reported in the fiduciary income tax return.²⁷

If there is income from community property, a decedent's final return should include only his share of the community property income to the date of death. Where a joint return is filed which includes the decedent's final period, the return should report the widow's share of income from community property for her entire year and the decedent's share for the period during which he was alive. The decedent's share of community property income arising after death will be reported by the fiduciary.

Medical expenses paid within one year after death may be claimed either as a medical deduction for income tax purposes in the year or years incurred²⁸ or as a debt of decedent on the estate tax return.²⁹ The choice, as for many items of deduction, depends on the effective tax rates for income and estate tax purposes. Where the decedent's will

²² Treas. Reg. § 1.2-2 (1956), as amended, T.D. 6792, 1965-1 CUM. BULL. 69.

²³ Treas. Reg. § 1.706-1(c)(3) (1956).

²⁴ Treas. Reg. § 1.736-1(a)(5) (1956). For example payments received prior to death in partial liquidation of a partnership interest (i.e. INT. REV. CODE OF 1954, § 736(b) payments) are treated as proceeds in liquidation for the year of receipt.

²⁵ Treas. Reg. § 1.652(c)-2 (1956); Treas. Reg. § 1.662(c)-2 (1956).

²⁶ Treas. Reg. § 1.1373-1 (1959); Treas. Reg. § 1.1374-1(b)(2) (1959).

²⁷ The full distributive share, regardless of partial distributions prior to death, constitutes income in respect of decedent. Treas. Reg. § 1.753-1 (1956). See discussion below. However, if the decedent's entire interest in the partnership is, pursuant to the partnership agreement, sold or exchanged on the date of death, partnership income through the date of death is reportable in the decedent's final return. Treas. Reg. § 1.706-1(c)(3)(iv) (1956).

²⁸ Treas. Reg. § 1.213-1(d) (1957).

²⁹ Treas. Reg. § 20.2053-4 (1958).

contains a maximum marital deduction clause or a charitable remainder, claiming deductions on the estate tax return may result in loss of benefit. Similarly, the effect of any credits against the estate tax must be considered in calculating an effective marginal estate tax rate. On the other hand, the three percent of adjusted gross income floor³⁰ may reduce any contemplated income tax benefit. Use of the medical expenditures as income tax items may require the filing of claims for refund if the expenditures were incurred in a prior year.

There appears to be no prohibition against claiming a portion of such qualifying expenditures on the estate tax return and the balance as an income tax deduction. A waiver of right to claim the same items as a debt of decedent is required to be filed if the income tax alternative is chosen.³¹

Tax Saving Opportunities

In some cases the decedent may have had capital losses or net operating losses in his final return period. These losses will not be available after the final return.³² If a joint return is filed with the surviving spouse, the capital losses may be utilized if the spouse takes offsetting capital gains during the remainder of her taxable year. Such gains should be taken on her separate property as there will be a change in basis for any community property owned at the decedent's death.³³

Similarly, where the decedent had net operating losses or distributive losses from partnerships or subchapter S corporations, every effort should be made to realize or accelerate income into the final return period to absorb the losses. For example, in the final return an election might be made to recognize in the final year all the accumulated discount on U. S. Treasury Series E bonds.³⁴ If there is a personal holding company involved, distributions to the widow might be timed to fall into the final return period.³⁵

Another way of bringing income into the final return period would be to have the fiduciary make taxable distributions from the estate to the surviving spouse who would file a joint return.³⁶ This is a general

³⁰ INT. REV. CODE OF 1954, § 213(a), provides that qualifying medical expenditures are deductible for income tax purposes only to the extent they exceed three percent of adjusted gross income.

³¹ Treas. Reg. § 1.213-1(d) (1957).

³² Rev. Rul. 207, 1954-1 CUM. BULL. 147.

³³ INT. REV. CODE OF 1954, § 1014(b)(6).

³⁴ INT. REV. CODE OF 1954, § 454(a).

³⁵ The amount of any excessive distributions would be available to the corporation via the dividend carry-over provisions. INT. REV. CODE OF 1954, § 564.

³⁶ In this connection it should be noted that a widow's family allowance is not taxable to the beneficiary unless the court order specifies that the distribution is from income. *United States v. James*, 333 F.2d 748 (9th Cir.), *cert. denied*, 379 U.S. 932 (1964); Treas. Reg. § 1.661(a)-2(e) (1956).

device which might be availed of even where there are no losses in the final return. It permits equalization among the income tax brackets in the decedent's final return, the income tax brackets of the fiduciary, and the projected income tax brackets of the widow in subsequent years.³⁷

THE ESTATE TAX RETURN

Based on pre-death planning (or the lack thereof), the executor must determine the composition of items in the gross estate as he finds them. However, he is in a position to best utilize the valuations to be ascribed to the particular properties and to claim deductions for maximum benefit.

The gross estate includes not only all property in which the decedent had an interest at death, but also includes the several statutory types of interests.³⁸ These assets will be reported at their fair market value at death unless the alternative valuation date is elected.³⁹

Usually, the alternative valuation date is selected only when a substantial portion of the gross estate has declined in value. It is suggested that the alternative valuation procedure may have great tax benefit in cases where the property has increased in value. The underlying concept is that the tax benefit (usually an income tax benefit) from using the higher valuation will exceed the tax cost of using the higher value.

A typical situation might be where the estate is in a 30% estate tax bracket but a beneficiary is in a 40% income tax bracket and the estate contains depreciable property which has increased in value from the date of death. In this situation it is quite apparent that the income tax benefits of the greater depreciation deduction could cancel the increase in estate taxes due to use of the alternative valuation date. This will be the result, of course, only if the property is not sold at capital gain rates prior to the claiming of substantial depreciation deductions. Where there is a marital deduction clause, the effective estate tax rate is approximately half of what it first appears. For example, suppose an estate in the 30% bracket (before marital deduction) and a beneficiary in the

³⁷ A final note. Shortening of the statutory period for assessment to eighteen months can be accomplished through a request for prompt assessment. *Treas. Reg.* § 301.6501(d)-1 (1956).

³⁸ *INT. REV. CODE OF 1954*, §§ 2034-42.

³⁹ *INT. REV. CODE OF 1954*, §§ 2031, 2032. It should be noted that the alternative valuation date can be elected only if the gross estate is at least \$60,000. *Treas. Reg.* § 20.2032-1 (b)(1) (1958). There are no provisions in the *CAL. REV. & TAX. CODE* or under the Arizona Statutes allowing an alternate valuation. Two different income tax bases will therefore result if the alternate valuation is elected.

20% income tax bracket:

Increase in valuation	\$10,000
Increase in marital deduction	5,000
Net increase in taxable estate	<u>\$ 5,000</u>
Income tax benefit of depreciation	2,000
Increase in estate tax	1,500
Savings through alternative valuation	<u>\$ 500</u>

Similarly, overall savings can be effected where there is a charitable remainder and a marital deduction. For example:

	<i>FMV at death</i>	<i>Alternative Valuation</i>
Property A	\$100,000	\$100,000
Property B	200,000	500,000
Total	<u>\$300,000</u>	<u>\$600,000</u>
Marital deductions	-150,000	-300,000
Charitable remainder	-150,000	-300,000
Taxable estate	<u>None</u>	<u>None</u>

Here, as in any other case where there is no taxable estate, increasing the valuations will result in income tax benefit.

This same technique can be used with respect to community property.⁴⁰ Here, while the estate tax bracket would not be reduced by any marital deduction, there may be a tax savings because of the step-up in basis of the surviving spouse's share of the community. Suppose a taxable estate of at least \$60,000 includes a community property capital asset which has doubled in value during the one year period. Assuming the estate or beneficiaries would use the alternative tax calculation provided by section 1201 on the sale of capital assets, electing a valuation one year after death may result in substantial overall savings.⁴¹

⁴⁰ It is well established that only the decedent's share of community property is included in the gross estate. See Thurman, *Federal Estate and Gift Taxation of Community Property*, 1 ARIZ. L. REV. 253 (1959). With respect to California community property acquired before July 29, 1927, 100% is includable in the husband's estate. *Camille R. Gump*, 42 B.T.A. 197 (1940), *aff'd.*, 124 F.2d 540 (9th Cir. 1941), *cert. denied*, 316 U.S. 697 (1942). Only one-half of community property acquired after July 28, 1927, is includable in the gross estate of the first to die. *Bank of America Nat. Trust & Sav. Ass'n. v. Rogan*, 33 F. Supp. 183 (S.D. Cal. 1940).

Some attention should be given "quasi-community property," created by CAL. PROB. CODE § 201.5. To oversimplify, that section converts some kinds of what otherwise might be separate property of the decedent created outside California into community property. The possible estate tax savings resulting from such property should be investigated.

⁴¹ This tax saving will not be available for taxable estates in excess of \$4,000,000 since the marginal net estate tax rate (estate tax less credit for state death taxes) exceeds 50% for the first time at that level. The maximum capital gains tax for the total of the spouse's half and the decedent's half cannot exceed two times 25%.

However, the loss of use of money due to the higher tax must be considered.

Along these lines, the potential uses of the property by the beneficiaries must also be considered in connection with electing the alternative valuation date. If the beneficiaries are advanced in age so that it is likely that the property passing to them will be subject to a second estate tax in a few years, some of the apparent income tax benefit to be gained through use of the alternative valuation might decrease.

If a large portion of the estate is represented by stock in a family corporation and the likelihood of the stock being sold is slight, there would be no apparent income tax benefits from using the higher valuations.

Use of the alternative valuation date may also permit security holdings to qualify for section 303 redemption or to permit the estate to pay the estate tax in instalments.⁴²

Gifts in Contemplation of Death

An executor may find the decedent has made a gift within three years preceding death and that the estate is faced with the problem of convincing the IRS that the gift was not in contemplation of death and should not be included in the gross estate.⁴³ Utilizing the same principles applied in deciding whether or not to use the alternative valuation date, the executor may find it advantageous to include the item in the gross estate and pay the estate tax on it. This situation could arise if the estate tax bracket is less than the income tax bracket of the beneficiary who will succeed to the property. In this connection, the tax advisor should consider the basis the beneficiary would have for the asset if the gift were not included in the gross estate. This will require a determination of the decedent-donor's basis in the property and the effect of the adjustment for gift taxes permitted by section 1015(d). Careful investigation should be made to determine if the decedent perfected any gifts prior to death as, for example, death-bed gifts. The double taxation—gift and estate—will result in an overall tax saving if there is little change in the value of the property, since the gift itself reduces the taxable estate and the amount of gift tax is permitted as a direct credit against the estate tax.⁴⁴

⁴² INT. REV. CODE OF 1954, § 6166, and discussion below.

⁴³ INT. REV. CODE OF 1954, § 2035.

⁴⁴ Treas. Reg. § 20.2012-1 (1958). In situations of this kind it will be advantageous not to claim the specific gift tax exemption provided by INT. REV. CODE OF 1954, § 2521.

Expenses During Administration

Much has been said regarding administration expenses. The income tax regulations provide that these particular expenditures—executor, attorney and accountant fees, and miscellaneous expenses⁴⁵—may be claimed on the estate tax return or on the fiduciary income tax return in any proportion the executor desires.⁴⁶ In any particular year expenses may be split so as to result in the best tax advantage.⁴⁷ In most cases, a comparison of the effective tax brackets of the concerned taxpayers will indicate that the expenses should be claimed on the fiduciary return. The presence of a marital deduction clause or a residual gift to charity will minimize the effect of claiming such expenses on the estate tax return.

Where it would be advantageous to claim the deductions on the estate tax return only if certain items are resolved in favor of the Government, the deductions should be claimed in both returns, proper disclosure of the fact being made. If it is finally decided to claim the expenses as income tax deductions, the estate tax return should be amended and a waiver of the right to claim the particular items on the estate tax return filed. In any case where administration expenses are claimed on the fiduciary income tax return, a waiver must be filed before the expiration of the statutory period for the income tax return.⁴⁸ It seems desirable not to file the election, and thereby be irrevocably bound, until the last possible moment.

With respect to California and Arizona estates containing community property, only those items⁴⁹ allocable to the decedent's share of community property (and any separate property) are deductible by the estate.⁵⁰ Such expenses are allocated in the ratio that the decedent's share of community property and his separate property bear to the total property subject to the expenses.

In some instances, expenditures of the kind deductible will be paid, not by the estate, but by a beneficiary succeeding to property which is

⁴⁵ If the family residence is subject to probate, it appears that the cost of maintaining the property during administration should be deductible.

⁴⁶ Treas. Reg. § 1.642(g)-2 (1956).

⁴⁷ For example, expenses applicable to exempt income are not deductible for income tax purposes. INT. REV. CODE OF 1954, § 265. However, such expenses are deductible for estate tax purposes. Rev. Rul. 32, 1959-1 CUM. BULL. 245. To the effect that commissions on assets sold to pay administration costs may be deducted under INT. REV. CODE OF 1954, § 2053, and offset against the sales proceeds for income tax purposes, see Estate of Bray, 46 T.C. No. 59 (1966).

⁴⁸ Treas. Reg. § 1.642(g)-2 (1956).

⁴⁹ Administrative expenses, funeral expenses and debts of the estate.

⁵⁰ It would appear that the portion of administrative expenses applicable to the surviving spouse's share of the community should be deductible, at least in part, by the spouse as INT. REV. CODE OF 1954, § 212, items.

included in the gross estate but not in the probate estate. Under the conditions described in Treasury Regulation section 20.2053-1, such amounts may be deductible by the estate.

Credits

In addition to the usual credit for state inheritance taxes,⁵¹ the estate may, subject to limitations, be able to claim credit for foreign death taxes,⁵² gift taxes paid (or payable) with respect to property included in the gross estate,⁵³ or federal estate taxes paid by another estate on property received by the decedent within ten years of death.⁵⁴ It should be noted that any beneficial interest transferred from a prior estate to the decedent qualifies for the credit for previously taxed property, even though such property is not included in the decedent's gross estate.⁵⁵ Accordingly, the decedent's interest in a life estate⁵⁶ (including a surviving spouse's interest in the decedent's share of community property), proceeds of life insurance, and survivor's annuities⁵⁷ constitute qualifying property.

Payment of Tax

Normally, the entire tax is due fifteen months from death.⁵⁸ Where the estate contains an interest in a closely-held business and the interest represents either 35% of the gross estate or 50% of the taxable estate,⁵⁹ that portion of the estate tax applicable to such interest may be paid in instalments over a ten year period.⁶⁰ An interest in a closely-held business includes an interest in a proprietorship. A partnership interest will qualify if the decedent owned at least a 20% capital interest therein or if there are fewer than eleven partners. Similarly, if the decedent owned 20% or more of the value of the voting stock of a corporation or if the corporation had less than eleven shareholders, the stock will meet the requirements of section 6166.⁶¹ The instalment privilege is automatic and is claimed by filing a notice with the District Director's office before the due date of the return.⁶² If there is a likelihood that

⁵¹ INT. REV. CODE OF 1954, § 2011.

⁵² INT. REV. CODE OF 1954, § 2014.

⁵³ Treas. Reg. § 20.2012-1 (1958).

⁵⁴ INT. REV. CODE OF 1954, § 2013.

⁵⁵ Treas. Reg. § 20.2013-1 (1958).

⁵⁶ Rev. Rul. 9, 1959-1 CUM. BULL. 232.

⁵⁷ Treas. Reg. § 20.2013-5 (1958).

⁵⁸ INT. REV. CODE OF 1954, §§ 6075, 6151.

⁵⁹ See discussion above regarding redemption under INT. REV. CODE OF 1954, § 303, from corporations which meet these criteria.

⁶⁰ Treas. Reg. § 20.6166-1(c) (1960).

⁶¹ Treas. Reg. § 20.6166-2 (1960).

⁶² Treas. Reg. § 20.6166-1 (1960).

the valuation of a business interest might be increased on audit, a protective election should be filed. Use of the alternative valuation to qualify the estate for section 6166 should be considered. If the requirements of section 6166 cannot be met, an estate may obtain an extension of time for payment by demonstrating, to the satisfaction of the District Director, that the scheduled payment will result in undue hardship. Such extensions are granted for one year at a time and in no event may payment be deferred more than ten years.⁶³ Interest on payments deferred under section 6166 or 6161(a) is calculated at 4%, rather than the usual 6%.⁶⁴

Where death is imminent, purchase of Treasury Bonds which may be redeemed at par in payment of estate taxes should be considered.⁶⁵ To the extent these obligations are purchased below par, there is an opportunity to generate tax free income.

Following payment of the tax, the executor should consider requesting a discharge from personal liability.⁶⁶ This has no practical effect on shortening the assessment period against the estate assets, whether or not distributed.

FIDUCIARY INCOME TAX RETURNS

In the area of income tax returns for the estate, the knowledgeable advisor can generate significant savings. These will result primarily from the proper choice of accounting period and the proper timing of deductions and distribution. A thorough understanding of the concepts contained in subchapter J is essential. Reliance on general principles regarding accounting for fiduciaries may result in unfortunate tax consequences.

Taxable Year Selection

Probably the most important election the estate will make will be with respect to the selection of a taxable year. The primary objectives are to equalize taxable income (including that of beneficiaries) during the fiscal periods, to defer the payment of income taxes, and to maximize the number of annual \$600 exemptions.

An estate may select any fiscal year so long as the first year does not cover a period of more than twelve months from the decedent's death.⁶⁷ Since the election is made in the first return (which is not due until three and one-half months after the end of the selected year),⁶⁸ a

⁶³ Treas. Reg. § 20.6161-1 (1959).

⁶⁴ INT. REV. CODE OF 1954, § 6601.

⁶⁵ Treas. Reg. § 301.6312-1 (1954) as amended, T.D. 6292, 1958-1 CUM. BULL. 476.

⁶⁶ INT. REV. CODE OF 1954, § 2204.

⁶⁷ Treas. Reg. § 1.441-1 (1957).

⁶⁸ INT. REV. CODE OF 1954, § 6072.

limited amount of hindsight will be available.⁶⁹ For example, suppose a decedent dies on June 30 and the estate receives substantial income by December 31. If it is expected that significant deductions will be available in a few months, the estate should not select a calendar year but should select a fiscal period which includes both income and off-setting deductions.⁷⁰

If there is a proper cutting-off of the estate fiscal year just prior to the receipt of substantial amounts of income, the tax on such income can be deferred almost a year. Suppose the decedent is a member of a calendar year partnership and dies November 15, 1965. If the estate elects a fiscal year ending November 30, 1965, that first return normally will include no portion of the partnership income for the calendar year 1965.⁷¹ Such partnership income will be included in the estate fiduciary return for the year ending November 30, 1966,⁷² thus deferring for eleven months payment of the tax on the partnership income.⁷³

Adoption of a fiscal year could also permit beneficiaries to defer reporting distributions. This can result since beneficiaries report distributions for their taxable year with which or within which ends the fiduciary's year.⁷⁴ This, as indicated below, is particularly successful where testamentary trusts are created.

Accounting Methods

Being a new taxpayer, the estate may, in its first return, elect whatever accounting methods are most advantageous.⁷⁵ Selection of the over-all cash method will usually permit the maximum flexibility. Particular attention should be given elections where the estate continues the decedent's proprietorship.⁷⁶

Gross Income of the Estate

Generally, the fiduciary will report all the income which is subject to probate.⁷⁷ However, it is well settled that only the decedent's one

⁶⁹ Care should be taken to establish the books and records on the selected fiscal year basis. Treas. Reg. § 1.441-1 (1957). Query: Does a check book stub record constitute sufficient books?

⁷⁰ Note that the income averaging provisions of INT. REV. CODE OF 1954, §§ 1301-1305, are not available to an estate.

⁷¹ Treas. Reg. § 1.706-1 (1956).

⁷² See note 27 *supra*.

⁷³ If the partnership interest is community property, the surviving spouse would report her share of the partnership income in her return (probably a joint return) for calendar year 1965.

⁷⁴ Treas. Reg. § 1.662(c)-1 (1956).

⁷⁵ Treas. Reg. § 1.446-1 (1957), as amended, T.D. 6584, 1962-1 CUM. BULL. 67.

⁷⁶ If depreciable property passing to the estate was previously used by the decedent, the estate may not use accelerated depreciation methods. INT. REV. CODE OF 1954, § 167(c)2.

⁷⁷ Treas. Reg. § 1.641(a)-2 (1956).

half interest in income from community property is to be included in the fiduciary income tax return although the estate administers the entire community.⁷⁸ The surviving spouse will report, in her return for the year in which the estate receives such income, her half of the community income. (Since the spouse must report the income whether or not any monies have been distributed by the estate, it is a good practice to distribute at least the amount of the spouse's taxes applicable to the income.) This same result will follow even if the widow exercises her election to take under the will.⁷⁹ Where property vests in the heirs at death but is nevertheless subject to administration, the income therefrom is taxable to the estate.⁸⁰

Income in Respect of Decedent

Particular problems arise in connection with income in respect of decedent. Section 691 contains some very specific rules dealing with this area. In broad terms, this is income to which the decedent had a perfected right at the date of his death but which he had not, because of his method of accounting, included in taxable income. Typically, any accrued income owing a cash basis taxpayer at death is income in respect of decedent.

Suppose there is accrued interest receivable on a bond which the decedent owned at date of death or that there are unbilled fees for professional services rendered prior to death. If the decedent had been on the cash basis, he would not have reported either type of income in his final return. Under the concepts laid down by section 691, whoever (fiduciary or beneficiary) receives the payment to which the decedent was entitled will report the amount as income.

Whatever character the income would have had in the decedent's hands carries over to the actual recipient.⁸¹ If the decedent had sold some capital assets but had not yet received the proceeds, the gain reportable by the recipient would be capital gain. Similarly, if the decedent had a right to ordinary income, such as salaries,⁸² collection of

⁷⁸ *Bishop v. Commissioner*, 152 F.2d 389 (9th Cir. 1945); Rev. Rul. 726, 1955-2 CUM. BULL. 24.

⁷⁹ *Wells Fargo Bank & Union Trust Co. v. United States*, 245 F.2d 524 (9th Cir. 1957).

⁸⁰ *Estate of Zellerbach*, 9 T.C. 89 (1947), *aff'd*, 169 F.2d 275 (9th Cir. 1948), *cert. denied*, 335 U.S. 903 (1949); *Estate of Cohen*, 8 T.C. 784 (1947).

⁸¹ Treas. Reg. § 1.691(a)-3 (1957), as amended, T.D. 6885, 31 Fed. Reg. 7789 (1966).

⁸² Any portion of salary due to the decedent which would have been excludable sick pay is not income in respect of decedent and is not gross income to the recipient. Rev. Rul. 64, 1959-1 CUM. BULL. 31.

the proceeds would be ordinary income.⁸³

So that there will be no question that the recipient of income in respect of decedent has taxable income to report, the basis of the property received from the decedent is determined, not by the estate tax valuation, but by reference to the basis which the decedent had for the item.⁸⁴ As a consequence, although accrued interest, for example, would be valued in the estate tax return of a cash basis decedent, the collector of the interest would have no income tax basis for such interest and the full amount thereof would be included in gross income.⁸⁵

A particular problem arises with instalment obligations and, more specifically, the collection of trust deed notes on which the decedent was reporting gain on the instalment method. Over a period of time, as the instalment notes are collected, the recipient will continue to report gain in just the same fashion as the decedent would have had he survived.⁸⁶ Such instalment obligations may be distributed by the estate to the ultimate beneficiaries without accelerating the unreported gain.⁸⁷ These must be distinguished from instalment obligations which the estate accepts pursuant to a sale by the estate. Distribution of these latter obligations would accelerate the reporting of income.⁸⁸

Since the accrued income is valued in the decedent's estate and since a collection of such income is a taxable event, it is apparent that income in respect of decedent is in effect subject to two taxes. Treasury Regulation section 1.691(c)-1 provides that the recipient of income in respect of decedent shall be allowed a deduction for the amount of estate tax attributable to the inclusion in the gross estate of such income in respect of decedent. Where instalment obligations are involved and the collections continue for more than the period of administration, each beneficiary who succeeds to the instalment obligations will be permitted to claim this type of deduction as collections on the instalment obligation — the income in respect of decedent — are reported. Where instalment obligations have passed through two or more estates, there

⁸³ But note that decedent's share of undistributed taxable income of a subchapter S corporation is not income in respect of decedent, Rev. Rul. 308, 1964-2 CUM. BULL. 176.

⁸⁴ INT. REV. CODE OF 1954, § 1014(c).

⁸⁵ That portion of salary owing the decedent which constitutes the surviving spouse's portion of community income does not get a step-up in basis but is fully taxable to the spouse. *Johnson v. United States*, 64-2 U.S. Tax Cas. § 9655 (N.D. Tex. 1964), *appeal dismissed*, 6 P-H 1965 FED. TAX SERV. § 56356 (5th Cir. 1965).

⁸⁶ Treas. Reg. § 1.691(a)-5 (1957), as amended, T.D. 6808, 1965-1 CUM. BULL. 257. If the instalment notes were community property, the surviving spouse will not get a step-up in basis with respect to her half. *Bath v. United States*, 211 F. Supp. 368 (S.D. Tex. 1962), *aff'd. per curiam*, 323 F.2d 980 (5th Cir. 1963).

⁸⁷ Treas. Reg. § 1.691(a)-5 (1957), as amended, T.D. 6808, 1965-1 CUM. BULL. 257.

⁸⁸ Rev. Rul. 159, 1955-1 CUM. BULL. 391.

will be a deduction for estate tax attributable to income in respect of decedent for each estate through which the instalment obligation has passed.⁸⁹

Other Gross Income Considerations

The character of income generated by the estate should be investigated. What might have been ordinary income in the hands of the decedent (*e.g.*, the sale of inventory) may be capital gain or loss to the estate in process of liquidating a business. Loss on the sale of the decedent's residence will be deductible as a capital loss since the prohibition of section 262 does not apply to an estate.

Deductions

With a few exceptions,⁹⁰ estates are permitted the same deductions allowed individuals.⁹¹ The question in which return administrative expenses should be claimed has been discussed above.⁹² These expenditures should be distinguished from items which may be deducted both for estate tax purposes (as a liability of the decedent) and for income tax purposes (as an expense incurred in connection with income producing property). Specifically, liabilities accrued at death—such as taxes, interest and expenses of rental property — are deductible for estate tax purposes under section 2053 and for income tax purposes under sections 164, 163, and 162 or 212, respectively. Whoever pays the obligation will be permitted the income tax deduction. These true "double deductions" are technically "deductions in respect of decedent"⁹³ and are analogous to income in respect of decedent.

Distributions By the Estate

The overall income tax brackets of the concerned parties—the widow, the fiduciary, the beneficiaries, and testamentary trusts—can be equalized to a great extent by distributions from the estate. As a general rule, distributions to a beneficiary (except certain distributions

⁸⁹ Treas. Reg. § 1.691(c)-1(b) (1957).

⁹⁰ For example, the standard deduction is not allowed to an estate, while an unlimited charitable deduction is. INT. REV. CODE OF 1954, § 642.

⁹¹ Treas. Reg. § 1.641(b)-1 (1956).

⁹² The executor should consider the economic effect from shifting deductions between the estate tax return and the fiduciary income tax return. Claiming administrative expenses on the income tax return tends to favor the life beneficiary at the expense of the remainderman. At least one California court has required a settlement among the heirs for tax differentials due to allocating deductions. *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (Dist. Ct. App. 1956). Similar settlements may be required as a result of allocating distributions by the fiduciary (and, accordingly, shifting the incidence of tax) among the beneficiaries.

⁹³ Treas. Reg. § 1.642(g)-2 (1956); Treas. Reg. § 1.691(b)-1 (1957). Deductions in respect of decedent must be considered in calculating the deduction for estate taxes attributable to income in respect of decedent. Treas. Reg. § 1.691(c)-1 (1957), as amended, T.D. 6887, 31 Fed. Reg. 8785 (1966).

which are in satisfaction of specific bequests)⁹⁴ are, to the extent that the estate has distributable net income, taxable to the beneficiary⁹⁵ and deductible⁹⁶ by the estate. Consequently, with a knowledge of the tax brackets of all the related taxpayers, the advisor can best decide on how to spread the income. One approach might include making distributions to low bracket beneficiaries throughout the period of administration, reserving distributions to high bracket taxpayers until the year of final distribution. At that time, hopefully, the estate would have little or no distributable net income and the tax to the high bracket beneficiaries would be minimal.⁹⁷

Good tax planning dictates the early establishment of testamentary trusts. In itself, each trust is a new tax entity and this presents an opportunity to further reduce the over-all tax brackets by spreading the incidence of tax. Suppose amounts transferred to a testamentary trust constitute corpus to the testamentary trust (notwithstanding the fact that the trust will be taxed on the distribution because the estate had distributable net income). The testamentary trust could then distribute to the ultimate beneficiaries portions of the amounts received and thereby spread the taxable income among several taxpayers. This can be illustrated as follows:

Taxable income of estate before deductions		\$10,000
Distributions of corpus to marital deduction trust	\$3,600	
Distribution of corpus to residual trust	3,600	7,200
Taxable income of estate		<u>\$2,800</u>
Income tax on estate without any distribution		<u>\$ 2,190</u>
Income tax on estate after distribution	\$ 462	
Income tax on marital deduction trust (assume no distribution to widow)	500	
Income tax on residual trust (assume no distribution)	500	
Total tax if distribution from estate		<u>1,462</u>
Net income tax savings		<u>\$ 728</u>

It should be noted that distributions of prior years' accumulations can be made by an estate without the throwback rule being invoked, as those provisions apply only to trusts.⁹⁸

⁹⁴ INT. REV. CODE OF 1954, § 663(a)1.

⁹⁵ INT. REV. CODE OF 1954, § 662(a).

⁹⁶ INT. REV. CODE OF 1954, § 661(a).

⁹⁷ See note 92 *supra*.

⁹⁸ INT. REV. CODE OF 1954, § 665.

In some cases it may be advisable to partially satisfy residuary bequests through distributions of property. To the extent the estate has distributable net income, such distributions of property will be taxable to the beneficiaries.⁹⁹ The basis of property in the hands of beneficiaries will be the fair market value of the property at the date of distribution, but limited to the amount of the estate's distributable net income. In the event that the fair market value exceeds the distributable net income, then the usual rules for determining the basis of property acquired from a decedent will be applicable.¹⁰⁰ It follows that distributions of appreciated property will result in an income tax benefit to the recipient because of the step-up in basis. Distributions of instalment obligations passing from the decedent may be advantageous.

Distributions to satisfy the marital deduction deserve special consideration. If the decedent's will contains a pecuniary formula clause (e.g., "maximum marital deduction allowable") it is the position of the Treasury that the bequest constitutes a fixed dollar liability of the estate. Satisfaction thereof with an asset which has appreciated in value will result in taxable gain to the estate; conversely, if the bequest is satisfied with property which has declined in value, there will be taxable loss to the estate.¹⁰¹ Distributions to satisfy a fraction of the residue clause (e.g., "50% of the residue") will not be taxable events for the estate.¹⁰²

Where the executor may satisfy pecuniary formula bequests to the spouse in kind at estate tax values, Rev. Proc. 19¹⁰³ lurks. It is the Treasury's position that the marital deduction will not be allowed in such cases unless either state law or provisions of the will require the fiduciary, in effect, to share any appreciation in value with the surviving spouse. As to wills executed prior to October 1, 1964, the effect of the damaging provisions may be mitigated if the fiduciary and the surviving spouse sign agreements to reflect a fair share of the appreciation. Assuming the Treasury's position is valid, the executor should have the agreements filed.

⁹⁹ INT. REV. CODE OF 1954, § 662(a).

¹⁰⁰ Rev. Rul. 314, 1964-2 CUM. BULL. 167, contains an example of how to allocate basis to the distributed property.

¹⁰¹ *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd. per curiam sub nom. Suisman v. Hartford-Connecticut Trust Co.*, 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 573 (1936); *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); Rev. Rul. 87, 1960-1 CUM. BULL. 286.

¹⁰² Rev. Rul. 117, 1955-1 CUM. BULL. 233. The same considerations are equally applicable to distributions in satisfaction of other pecuniary bequests. To the extent possible, such bequests should be satisfied in cash.

¹⁰³ 1964-1 (pt. 1) CUM. BULL. 682. The entire October 1964 issue of *TRUSTS & ESTATES* is devoted to this problem.

Problems of the Final Return

Eventually the administration of an estate will approach an end. Estates generally will be considered terminated when all assets (except those necessary to meet liabilities) have been distributed.¹⁰⁴ Thus, failure of the executor to perform ministerial chores (and thereby unduly prolonging the administration) will not prevent the estate income from being taxed to the beneficiaries.¹⁰⁵

Under the general rules of taxation of fiduciaries, final distributions from an estate, to the extent the estate has income (determined without the deduction for distributions), are taxable to the beneficiaries.¹⁰⁶ To the unwary, this could result in a fantastic pyramiding of income to beneficiaries.

For example, suppose the estate has a March 31 fiscal year and that the period of administration is concluded on March 31 when all assets are distributed to the beneficiaries. During the rest of the year the beneficiaries receive income on the property which has been distributed to them. As a consequence, a beneficiary would report in his tax return for the year of distribution his share of the estate's income for the twelve months to March 31 plus his own income generated from the distributed assets for the nine months subsequent to March 31 — in all, the equivalent of 21 months' income. Had the estate instead been distributed on April 1, the estate would have paid the tax on income through March 31, and there would have been no adverse effect on the beneficiary. From a tax-planning point of view, final distributions, if at all possible, should take place as soon after the close of the estate's preceding fiscal year as is possible.

One way of avoiding large amounts of income for the final year is to offset income by the payment of administration costs. It is possible, however, to get even greater benefit out of the administrative expenses by utilizing the provisions dealing with the carry-over of unused deductions. This might be accomplished in the following manner: Suppose that the estate's fiscal year ends March 31. Administrative expenses are then paid on April 1 and the final distribution is made. Since no income is received in April, the estate, without regard to the deduction for distributions to beneficiaries, has a taxable loss. This loss, which represents an excess of non-business deductions, is available to beneficiaries (generally, residuary legatees¹⁰⁷) succeeding to the property

¹⁰⁴ Treas. Reg. § 1.641(b)-3(a) (1956).

¹⁰⁵ *Lillie V. Kohn*, 16 B.T.A. 662 (1929).

¹⁰⁶ *Carlisle v. Commissioner*, 165 F.2d 645 (6th Cir. 1948); G.C.M. 24702, 1945 CUM. BULL. 241.

¹⁰⁷ Treas. Reg. § 1.642(h)-3 (1956).

distributed from the estate. The beneficiaries treat these "excess deductions" as deductions for calculating taxable income (*e.g.*, deductions from adjusted gross income in the case of an individual beneficiary) in their taxable year within which falls the final year of the estate.¹⁰⁸ By comparing the tax brackets of the beneficiaries and the fiduciary, a decision can be reached as to whether or not to create an excess deduction situation.

It should be emphasized that the beneficiaries benefit only from excess deductions in the fiduciary's final return. Excess deductions (as contrasted to a true net operating loss generated by business expenses) in any other return will not be available as a carry-over either for the fiduciary or a beneficiary.¹⁰⁹

Similarly, if the estate has net operating losses (including those from a subchapter S corporation) or capital loss carry-overs, beneficiaries succeeding to the distributed property may utilize such losses in their own returns.¹¹⁰ Any such distributed net operating losses may not be carried back by the beneficiaries but may only be carried forward. Existence of such losses suggests re-examination of the taxability of any distributions received from the estate in prior years.

Sometimes an estate has long-term capital gains in its final year. At the same time, it may also have large administrative expenses. These items would be shown broad in the beneficiary's return as follows:¹¹¹

Net long-term capital gains	\$8,000
Administrative expenses	7,000
Net	<u>1,000</u>
Long-term capital gains deduction	4,000
Net effect in beneficiary's return	<u><u>(\$3,000)</u></u>

With the exception of long-term capital gains, the character of the estate's income does not carry over to the beneficiaries if there are excess deductions in the final return.¹¹²

Payments

An estate, unlike a trust, may liquidate its tax liability in quarterly instalments.¹¹³ Failure to elect instalment payments and to invest the unremitted portion of the tax might constitute a breach of a fiduciary's

¹⁰⁸ Treas. Reg. § 1.642(h)-2 (1956).

¹⁰⁹ *Ibid.*

¹¹⁰ Treas. Reg. § 1.642(h)-1 (1956), as amended T.D. 6828, 1965-2 CUM. BULL. 264.

¹¹¹ Rev. Rul. 392, 1959-2 CUM. BULL. 163.

¹¹² Rev. Rul. 100, 1959-1 CUM. BULL. 165.

¹¹³ INT. REV. CODE OF 1954, § 6152(a)(2).

duty to conserve the estate.

For large estates which are likely to be audited in any event, the executor should consider requesting a prompt assessment,¹¹⁴ thereby cutting short the statute of limitations. The advantage of such action should be weighed against the possibilities of deficiencies which might arise from any examination.

As a final act the executor should file a notice of termination of fiduciary relationship.¹¹⁵

CONCLUSION

Application of the above and similar techniques can provide much personal gratification to the professional tax man. The interplay of the many facets of the tax law presents an interesting challenge. A truly professional performance may result in tax savings to be reflected over many future years.

¹¹⁴ INT. REV. CODE OF 1954, § 6501(d).

¹¹⁵ Treas. Reg. § 301.6903-1 (1957), as amended, T.D. 6585, 1962-1 CUM. BULL. 290.