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INCOME TAX CONSEQUENCES IN THE ADMINISTRATION OF DECEDENTS' ESTATES

John E. North*

I. INTRODUCTION

Post mortem decisions are an essential element in properly effectuating any estate plan. The client's death does not terminate the opportunity for tax savings.[1] Many testamentary dispositions, hopelessly inadequate from a tax standpoint, have been salvaged by prompt action after the testator's death. Consider the typical situation: a widow elects to take the statutory share of her husband's estate because the interest passing to her under the will is terminable and will not qualify for the marital deduction. This election has saved widows an untold number of federal estate tax dollars since 1948.[2] However, obvious decisions in connection with inartfully drawn estate plans are not the subject of present concern; nor will any emphasis be placed on the Federal estate tax. It is the less obvious that deserves attention; namely, the Federal income tax implications of a skillfully planned estate.

II. THE BASIC PATTERN

When an individual dies, his personal representative must file returns for two distinct taxable entities: (1) the decedent and (2) his estate.

A. THE DECEDENT'S FINAL RETURN

The executor, administrator, or other person charged with the property of a decedent is required to file a final lifetime income tax return (Form 1040) for the decedent,[3] covering the period beginning with the start of the decedent's taxable year and ending with the date of his death,[4] unless the decedent's gross income for

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1 See Price, *Post Morten Estate Planning,* 15 N.Y.U. INST. ON FED. TAX 1029 (1957).

2 See Brown, *The Widow's Election,* 96 TRUSTS & ESTATES 30 (1957), discussing the use of the widow's election as a tax savings device.

3 INT. REV. CODE OF 1954, § 6012(b)-1.

4 INT. REV. CODE OF 1954, § 443(a)-2.

this period is under $600.00 ($1200.00 if the decedent is over 65 years of age). This return, which must be filed by the 15th day of the fourth month after the date on which the decedent's taxable year would have closed had he lived,[5] in the Director's office for the district in which decedent resided,[6] should include only pre-death income computed according to the decedent's method of accounting.[7] If the decedent was on the cash basis, the cash, or its equivalent, which was actually or constructively received prior to death is included in his final return.[8] However, if the decedent is on the accrual basis, amounts accrued only by reason of his death are not includable in the final return.[9]

B. INCOME IN RESPECT OF A DECEDENT

1. *A Page of History*

For federal tax purposes, the income concept is, at best, extremely elusive.[10] Traditionally "realization" has been the core of the concept.[11] Income is taxed *if* and *when* realized. However, the operative effect of realization has, in many instances, been altered by statutory provisions for non recognition;[12] and the time of realization depends on whether the taxpayer uses the cash or accrual method of accounting. Naturally death complicates the problem. The succession of property by operation of law is at least suggestive of realization and presents intricate accounting problems.

An apt illustration of these problems is *Helvering v. Enright*,[13] involving a lawyer, on the cash basis, who was a member of a

[5] Treas. Reg. 118, § 39.53-1 (1939 Code).

[6] INT. REV. CODE OF 1954, § 6091 (b)-1.

[7] INT. REV. CODE OF 1954, § 451(a); Treas. Reg. § 1.451-1 (b)-1 (1957).

[8] *Ibid.*

[9] INT. REV. CODE OF 1954, § 451(b); Treas. Reg. § 1.451-1 (b)-1 (1957).

[10] *Compare*: Eisner v. Macomber, 252 U.S. 189 (1920); Plehr, *Income as Recurrent, Consumable Receipts*, 14 AM. ECON. REV. 1-12 (1924); SIMONS, PERSONAL INCOME TAXATION 50-1 (1938); Surrey & Warren, *The Income Tax Project of the American Law Institute*, 66 HARV. L. REV. 761, 769 (1953).

[11] See Eisner v. Macomber, 252 U.S. 189 (1920).

[12] See, *e.g.*, INT. REV. CODE OF 1954, §§ 1031 to 1036 incl.

[13] 312 U.S. 636 (1941).

partnership having an agreement providing that upon his death, his estate would be entitled to a fixed percentage of outstanding accounts and estimated receipts from unfinished business. At this time the Internal Revenue Code provided that the final return of a cash basis decedent had to include the income "accrued up to the date of death";[14] and the Court concluded that the income from the unfinished business, as well as from the accounts receivable, accrued at death.

The *Enright* decision was criticized because it "bunched" the decedent's income in the final taxable period, thereby producing an abnormally high surtax on sums which had not even been received.[15] To prevent this, Congress added Section 126 to the Internal Revenue Code of 1939, providing, in substance, that the income in respect of a decedent not properly includable in the taxable period preceding his death would be includable in income by his successor in interest in the taxable period *when received,* if the right to receive it is acquired by the decedent's estate from the decedent.[16]

The courts have been careful to construe Section 126 and its successor[17] so that no income is "missed." In *O'Daniel's Estate v. Commissioner,*[18] the decedent, a corporate vice president, participated in the company bonus plan. Decedent had no enforceable right under that plan to an allotment of a bonus for any year until the share was designated by the proper officer. Decedent died in 1943 and no share of the bonus was designated for that year until 1944. The Court held the bonus taxable as ordinary income to the estate on the theory that it was income in respect of a decedent *"acquired by the decedent's estate from the decedent."* A similar result was reached in *Commissioner v. Linde,*[19] in which a farmer had delivered grapes to a marketing association prior to his death and his widow, as sole legatee of his estate, received his share of the proceeds from sale of the grapes after his death. The Tax Court reasoned that since the grapes were not sold during the decedent's lifetime there could be no distributable proceeds due him when he died and the decedent's estate did not acquire the

[14] Revenue Act of 1938 § 42, 52 Stat. 473 (1938).

[15] S. REP. NO. 1631, 77th Cong., 2d Sess. 100-02 (1942); 2 CUM. BULL. 504, 579-81 (1942).

[16] Revenue Act § 126, 56 Stat. 882 (1942).

[17] INT. REV. CODE OF 1954, § 391.

[18] 173 F.2d 996 (2d Cir. 1949).

[19] 213 F.2d 1 (9th Cir. 1954).

right to this income from the decedent.[20] The Ninth Circuit disagreed, pointing out that the payments which the estate received were received under and in consequence of contracts and deals made by the decedent in his lifetime. Such payments had their source exclusively in the decedent's contract with the marketing co-operative, and consequently were income in respect of a decedent within the meaning of Section 126 of the 1939 Code.

The substance of the foregoing cases is simply that where gain is "realized" after a decedent's death as a result of affirmative action by the decedent during his lifetime the resulting profit is "income in respect of a decedent." The mere appreciation in the value of an asset prior to death does not give rise to income in respect of a decedent at death. In *Estate of Tom L. Burnett*,[21] the Commissioner sought to include in the income of a decedent the fair market value of livestock and crops which had a zero basis in the decedent's hands at his death. The Tax Court held that this was not income accrued at the date of death within the meaning of Section 42 of the Revenue Act of 1938. The property had not been sold or exchanged and no one was indebted to the decedent. The Commissioner acquiesced in the *Burnett* case, presumably upon the theory that the mere transfer of appreciated property at death does not give rise to taxable income.[22] A similar position has been taken by the Treasury Department in regard to inter vivos transfers. If a farmer gives cattle or other farm products to his son, he does not recognize taxable income at the time of the gift; he is simply required to adjust his inventory or his deductions for expenses so that the cost of the gift to him is not a deduction.[23]

The interesting facet of this problem is produced by Section 1014, which provides a stepped-up basis for property acquired from a decedent at death. The basis of such property to the recipient is its fair market value at the date of death;[24] and the appreciation inhering in the property wholly escapes income tax unless it is "income in respect of a decedent."

Against this brief historical background presenting the problems of "bunching" and "missing" income, the present provisions

[20] Rose J. Linde, 17 T.C. 584 (1951).

[21] 2 T.C. 897 (1944).

[22] See Commissioner v. Linde, 213 F.2d 1 (9th Cir. 1954).

[23] Rev. Rul. 55-531, 1955-2 CUM. BULL. 520, revoking I.T. 3932, 1948-2 CUM. BULL. 7.

[24] INT. REV. CODE OF 1954, § 1014.

of the revenue code taxing income of decedents and their estates may be more readily understandable.

2. *Present Status of Income in Respect of a Decedent*

Any "income in respect of a decedent" which is not includable in his final return must be reported by the estate or distributee when received.[25] "Income in respect of a decedent" includes compensation for services of the decedent payable to his estate in annual installments after his death;[26] renewal commissions of a deceased life insurance agent arising after his death;[27] magazine sales accounts receivable collected after the decedent's death;[28] bond interest collected by a co-owner after the death of the decedent, a cash basis taxpayer who was not required to report the interest accruing prior to death;[29] alimony arrears paid by a husband to the estate of his deceased wife;[30] and damages for patent infringement received by the decedent's estate as a result of litigation pending at the decedent's death.[31]

Where, prior to his death, a decedent executes a contract for the sale of property at an amount in excess of his basis, and after his death, his estate delivers the property and receives the purchasing price, it is not clear whether the total profit is income in respect of a decedent. The language of the *Linde* case would suggest that it is.[32] However, the following example taken from the proposed Treasury Regulations indicates that the *Linde* case will not be pushed to its logical conclusion:

> A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of $100 per share. During his lifetime A had entered into a contract with X Corporation or with other shareholders whereby X Corporation or other shareholders

[25] INT. REV. CODE OF 1954, § 691(a).

[26] Bausch's Estate v. Commissioner, 186 F.2d 313 (2d Cir. 1951); Treas. Reg. 1.691(a)-2, Example 1 (1957).

[27] Treas. Reg. 1.691(a)-2, Example 2 (1957).

[28] Dixon v. United States, 96 F. Supp. 986, *aff'd per curiam,* 192 F.2d 82 (6th Cir. 1951).

[29] Treas. Reg. 1.691(a)-2, Example 3 (1957).

[30] Estate of Narischkine v. Commissioner, 14 T.C. 1128, *aff'd per curiam,* 189 F.2d 257 (2d Cir. 1951).

[31] Rev. Rul. 55-463, 1955-2 CUM. BULL. 277.

[32] Commission er v. Linde, 213 F.2d 1, 4-5 (9th Cir. 1954). See also Miller, *Tax Problems in Administration of Estates,* 14 N.Y.U. INST. ON FED. TAX 333 (1956).

agreed to purchase and decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death the shares are sold by A's executor for $500 a share pursuant to the agreement. Since the sale of stock is consumated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death.[33]

Income in respect of a decedent received by his estate, or other person retains the same character in the hands of the recipient as it would have had if the decedent had lived and received it.[34] The benefits of the capital gains provisions,[35] retirement income credit,[36] dividend exclusion[37] and credit,[38] government bond interest credit,[39] the spreading provisions for "bunched" income and back pay[40] and the alimony[41] and military pay and allowances[42] provisions are all available to the recipient as they would have been to the decedent if he had lived to receive the income.

The term income in respect of a decedent also includes all income in respect of a prior decedent.[43] To illustrate: A widow dies before receiving the last of five annual renewal commissions bequeathed to her by her deceased husband. The last installment is inherited by her son. When he receives payment, he must include it in his gross income.[44]

If a right to receive income in respect of a decedent is transferred inter vivos, the transferror recognizes taxable income to the extent of the fair market value of the right at the time of transfer, or the amount of consideration received for it, whichever is greater.[45] This rule is inapplicable where the transferree has a right

33 Treas. Reg. 1.691(a)-2, Example 4 (1957).

34 INT. REV. CODE OF 1954, § 691(a)-3.

35 Treas. Reg. 1.691(a)-3(b)-1 (1957).

36 *Ibid.;* INT. REV. CODE OF 1954, § 37.

37 *Ibid.;* INT. REV. CODE OF 1954, § 116.

38 *Ibid.;* INT. REV. CODE OF 1954, § 34.

39 Treas. Reg. 1.691(a)-3(b)-2 (1957).

40 Treas. Reg. 1.691(a)-3(b)-3 (1957).

41 Estate of Narischkine v. Commissioner, 14 T.C. 1128, *aff'd per curiam.* 189 F.2d 257 (2d Cir. 1951).

42 I.T. 3857, 1947-1 CUM. BULL. 54.

43 INT. REV. CODE OF 1954, § 691(a)-1.

44 Treas. Reg. 1.691(a)-2, Example 2 (1958).

45 INT. REV. CODE OF 1954, § 691(a)-2.

to receive such amount by reason of the death of the decedent, or by bequest devise or inheritance from him;[46] *e.g.* where a decedent's testamentary trust terminates and the right to receive the income is transferred to the beneficiaries,[47] or where the right to receive income is transferred by the decedent's executor to a specific or residuary legatee.[48] Sale by an executor or administrator of the right to receive income in respect of a decedent will accelerate realization of this income and may in some instances "bunch" it into a single taxable period. On the other hand, if the fiduciary assigns the income right to discharge a specific legacy, the legatee is burdened with the income tax and an inequitable distribution may result.

Income in respect of a decedent includes the percentage of profit included in installment payments received after the decedent's death in connection with the sales of property which the decedent was reporting on the installment method[49] prior to his death.[50] The recipient of the installment payments includes in gross income when received the same proportion of any payment in satisfaction of the installment obligation as would have been included in the decedent's income if he had lived and received payment.[51] If the installment obligation is transferred to a person to whom the profit would not be considered income in respect of a decedent, the transferror recognizes income to the extent that the fair market value of the obligation, or the amount received for it, whichever is greater, exceeds its adjusted basis.[52]

When a partner dies his portion of the partnership income, which has not been withdrawn, for the period ending with his death is income in respect of a decedent.[53] Liquidation payments received for the deceased partner's interest in unrealized receivables and good will (not covered by an agreement) and payments for the deceased partner's interest in partnership assets to the extent these payments exceed the date of death value of such assets are treated as income in respect of a decedent.[54] However, the

46 Treas. Reg. 1.691(a)-4 (1957).

47 Treas. Reg. 1.691(a)-4(b)-3 (1957).

48 Treas. Reg. 1.691(a)-4(b)-2 (1957).

49 INT. REV. CODE OF 1954, § 453.

50 INT. REV. CODE OF 1954, § 691(a)-4.

51 Treas Reg. 1.691(a)-5(b) (1957).

52 Treas. Reg. 1.691(a)-5(c), Example (1957).

53 INT. REV. CODE OF 1954, § 753; Treas. Reg. 1.753-1(b) (1956).

54 Treas. Reg. 1.753-1(c) (1956).

difference between the deceased partner's basis for the partnership assets and their fair market value at the date of his death is not income in respect of a decedent.[55]

C. Deductions in Respect of a Decedent

All income tax deductions of an accrual basis decedent will be properly allowable in his final return. Only those items paid prior to death will be deductible on the final return of a cash basis decedent; however, trade or business expenses, interest, taxes, expenses for the production of income and the foreign tax credit, incurred by the cash basis decedent are allowable to the estate when paid by the executor or administrator, or, if the estate is not liable to discharge the obligation, are allowable to, if paid by, the person who by reason of the death of the decedent or by bequest, devise or inheritance acquires, an interest in property of the decedent subject to the obligation.[56] Deductions for depletion and depreciation of improvements with respect to natural resources (minerals, oil, gas, timber, etc.) are deductible by the person receiving the income to which the deduction relates, in the year in which the income is received.[57] Deductions for medical expenses, alimony and charitable contributions for which the decedent is legally liable will be lost if not paid by a cash basis decedent prior to his death.

D. The Fiduciary's Return

The executor or administrator of a decedent's estate is required to file fiduciary income tax returns (Form 1041) reporting the income of the decedent's estate for each taxable period following the decedent's death in which gross income is at least $600.00[58] (or any amount if an heir, legatee or devisee is a nonresident alien).[59] The fiduciary return must be filed with the Director in the District where the fiduciary resides[60] on or before the 15th day of the fourth calendar month after the close of the taxable period chosen by the fiduciary.[61]

[55] *Ibid.*

[56] INT. REV. CODE OF 1954, § 691(b)-1.

[57] INT. REV. CODE OF 1954, § 691(b)-2.

[58] INT. REV. CODE OF 1954, § 6012(a)-4.

[59] INT. REV. CODE OF 1954, § 6012(a)-5.

[60] INT. REV. CODE OF 1954, § 6072(a).

[61] INT. REV. CODE OF 1954, § 6091(b)-1.

An estate is a separate taxable entity, treated under the income tax in substantially the same manner as an individual[62] with this significant difference: income which is required to be distributed, or which is properly paid or credited to beneficiaries during the taxable year is deductible by the estate and taxable to the beneficiaries.[63] This affords an opportunity to reduce the impact of the graduated tax by properly allocating taxable income of the estate between it and the beneficiaries. As a general rule the taxable income received by the beneficiaries cannot exceed the taxable income of the estate[64] and such taxable income in the hands of the beneficiary retains the same character it had in the estate.[65]

Credits for partially tax exempt interest, foreign taxes and dividends received,[66] and deductions for depreciation, depletion and amortization of emergency facilities[67] are divided between the estate and beneficiaries according to the income allocable to each. Like an individual the estate is entitled to a personal exemption deduction of $600.00;[68] but unlike an individual, an estate can claim an unlimited charitable deduction for amounts of income paid or permanently set aside during the year for charitable purposes,[69] and an estate cannot claim the standard deduction.[70]

E. IMPLICATIONS OF THE TAX PATTERN

An executor or administrator is necessarily concerned with income tax consequences to at least three distinct taxable entities: the decedent, his estate and each beneficiary. Under the present system the decedent is taxed on income realized during his lifetime; his estate is taxed on the income in respect of a decedent collected by it and any other income which it earns that is not distributed, or required to be distributed to, the beneficiaries; and the beneficiaries are taxed on the income in respect of a decedent which they collect, the income of the estate which is distributed, or required to be distributed, to them and the income which they receive from

[62] INT. REV. CODE OF 1954, § 642.

[63] INT. REV. CODE OF 1954, § 661.

[64] INT. REV. CODE OF 1954, § 652(a).

[65] INT. REV. CODE OF 1954, § 652(b).

[66] INT. REV. CODE OF 1954, § 642(a).

[67] INT. REV. CODE OF 1954, §§ 642(e) and (f).

[68] INT. REV. CODE OF 1954, § 642(b).

[69] INT. REV. CODE OF 1954, § 642(c).

[70] INT. REV. CODE OF 1954, § 142(b)-4.

all other sources. Decisions made by the fiduciary during the administration of the estate may be beneficial to one entity and at the same time detrimental to another. The fiduciary's obligation to minimize income taxes, on the one hand, and to equitably distribute the decedent's estate according to his testamentary plan, or the laws of intestate succession, on the other, pose some intricate problems. In choosing the appropriate tax course to follow, the fiduciary may be confronted with an irreconcilable conflict of interest between the individual beneficiaries, each of whom is entitled to collective representation without discrimination. A consideration of the specific situations in which the executor or administrator must choose between two alternatives may best serve to illustrate the problem.

III. JOINT RETURN

An executor or administrator may join with the decedent's surviving spouse in filing a joint return for the taxable period encompassing the decedent's death if both spouses had the same taxable year and neither was a non-resident alien at any time during the taxable year.[71] When their taxable years begin on the same day but end on different days because of the death of either or both of them, their taxable years are considered to be the same unless the surviving spouse remarries before the close of his own taxable year.[72]

A joint return will include prior to death income of the decedent and the entire year's income of the spouse. Whether it will be advantageous to file a joint return depends primarily upon the relative incomes of the spouses, the method of allocating payment between the decedent's estate and the surviving spouse, and the surviving spouse's ability to pay her share of the joint tax.

Consider the following example. A husband dies shortly before the end of the taxable year after collecting $27,100.00 of his annual salary. His wife's income for the taxable year is $1,000.00. They have no dependents and claim the standard deduction. If separate returns were filed, the decedent's final income tax would be $10,740.00, and his wife's tax would be $60.00. If a joint return were filed, the combined tax would be only $7,617.00. Obviously there would be a tax saving to the decedent's estate if the fiduciary joined with the spouse in filing a joint return even if the estate were required to pay the entire tax.

[71] INT. REV. CODE OF 1954, §§ 6013(a)-1 and -3.

[72] INT. REV. CODE OF 1954, § 6013(a)-2.

Consider the converse situation. The husband lives but a short period during the taxable year and collects only $1,000.00 of his annual salary. His surviving spouse, however, realizes $27,-100.00 gross income during the taxable year. On separate returns the decedent's tax would be only $60.00 and the spouse's tax would be $10,740.00. By filing a joint return with the spouse, the fiduciary would expose the decedent's estate to a tax liability of $7,617.00, because liability for the tax (including any deficiencies) is joint and several.[73] Even assuming that the spouse is willing to pay her fair share of the tax, there still remains the problem of allocation. For at least one purpose (the estate tax deduction under Section 2053), the Treasury Department has indicated that the decedent's share is

> . . . that proportion of the joint tax liability determined for the period covered by the joint return which the amount of income tax for which the decedent would have been liable if he filed a separate return for that period bears to the total amount of income tax for which the decedent and his spouse would have been liable if both spouses had filed separate returns for that period.[74]

Under this method of allocation, the decedent's share of the tax would be

$$\frac{60.00}{10,800.00} \text{ x } 7,617.00 \text{ or } \$42.31.$$

This is $17.69 less than the decedent's tax on a separate return would have been. Thus, even in a situation where the decedent's income is substantially less than that of his surviving spouse, it will be advantageous to file a joint return if the tax is fairly allocated between the decedent and his spouse and the executor or administrator is adequately indemnified for payment of all, or any portion of, the wife's share of tax.

That a joint return involves possible pitfalls is illustrated by *Howell v. Commissioner*,[75] where the wife was held liable for the fifty per cent fraud penalty although the return was prepared solely by her husband. It is difficult to visualize how an executor could protect himself against the possibility of fraud by the surviving spouse.

The fiduciary and the surviving spouse must ordinarily join in the execution of a joint return. However, if the decedent's re-

[73] INT. REV. CODE OF 1954, § 6013(d)-3.

[74] Rev. Rul. 56-290, 1956-1 CUM. BULL. 445.

[75] 10 T.C. 859, *aff'd* 175 F.2d 240 (6th Cir. 1949).

turn has not been filed by the time it is due and no fiduciary has been appointed, the surviving spouse alone may file a joint return.[76] If within one year from the date the return was due, an after appointed fiduciary files a separate return for the decedent, the joint return will be treated as the separate return of the surviving spouse.

IV. CHOICE OF ACCOUNTING PERIOD AND METHOD

As a separate taxable entity which reports its income in substantially the same manner as an individual,[77] the decedent's estate may use either the cash or accrual method of accounting[78] and adopt either a calendar or fiscal year.[79] The cash method would seem to offer more leeway for tax planning during administration of the estate. But whatever method is adopted the fiduciary should be sure that his books and records conform to the method chosen.[80]

Careful selection of the accounting period can effectively minimize taxes. A *fiscal* year can be selected at any time before the fifteenth day of the fourth month following the close of the first such fiscal year;[81] and an estate which does not establish a fiscal year must make its return on a calendar year.[82] Although the first and last returns of the estate may be for periods of less than twelve months, a full $600.00 exemption may be claimed for each period and the income is not annualized.[83]

The estate deducts, and the beneficiaries report, distributable net income of the estate which is paid, credited, or required to be distributed to them.[84] Ordinarily, under local law, estate income is not required to be distributed to the beneficiaries until the final decree is entered. Thus, a beneficiary will report, and the estate deduct, only the estate's distributable net income for its last fiscal

[76] INT. REV. CODE OF 1954, § 6013(a)-3.

[77] INT. REV. CODE OF 1954, § 641(b).

[78] INT. REV. CODE OF 1954, § 446(c).

[79] INT. REV. CODE OF 1954, § 441(b).

[80] Treas. Reg. 1.446-1(a)-1 (1957).

[81] INT. REV. CODE OF 1954, § 6072; Treas. Reg. 1.441-1(b)-3 (1957).

[82] Treas. Reg. 1.441-1(d) (1957).

[83] INT. REV. CODE OF 1954, § 443; Treas. Reg. 1.443-1(a)-2 (1957). No tax benefit is derived in the final period because all income is distributed.

[84] INT. REV. CODE OF 1954, § 662(a)-1.

period. A widow's allowance under a court order would be a typical exception to this rule. If the order requires that it be paid monthly out of current income, it would be deducted by the trust and reported by the widow each year during administration.

Income which is, or is required to be, distributed to a beneficiary is reportable in the taxable year of the beneficiary in which the estate's fiscal year ends.[85] If the beneficiary and the estate have different taxable years it is possible that the beneficiary will be required to report the income of the estate for an eleven-month period together with his own income for a twelve-month period.

Each of the foregoing rules complicates the executor's selection of a taxable period. Consider the following situation: A dies on March 1, 1959, leaving an unmarried son, B, as sole heir. B's annual income is $12,000.00. It will take approximately eighteen months to administer A's estate which produces income at the rate of $2,000.00 per month. The chart below indicates the income tax consequences if the administrator chooses a fiscal year beginning March 1, and ending February 28:

Estate Income Taxes

	1st Period 3/1 to 2/28	*2nd Period* 3/1 to 7/31	*Total*
Gross Income	$24,000.00	$12,000.00	
Exemption	600.00		
Taxable Income	23,400.00		
Tax	9,206.00		$ 9,206.00

Heir's Income Taxes

Heir's Income	$12,000.00	
Trust Income (Distributable)	12,000.00	
Gross Income	24,000.00	
Standard Deduction & Exemption	1,600.00	
Taxable Income	22,400.00	
Tax	8,616.00	$ 8,616.00
Total		$17,822.00

The total income tax burden borne by the estate during the period of its administration and by the heir in the year of final distribution is $17,822.00. Because the administrator chose a fiscal year ending 12 months after death, the estate obtained only one $600.00 exemption and the income of the heir was pyramided by

[85] INT. REV. CODE OF 1954, § 662(c).

reason of the $12,000.00 distribution of distributable net income in the year the administration terminated.

The administrator could save over $2,500.00 in income taxes by choosing a fiscal year ending July 31, as is indicated in the chart below:

Estate Income Taxes

	1st Period 3/1 to 7/31	*2nd Period* 8/1 to 7/31	*3rd Period* 8/1 to 7/31	*Total*
Gross Income	$10,000.00	$24,000.00	$ 2,000.00	
Exemption	600.00	600.00		
Taxable Income	9,400.00	23,400.00		
Tax	2,436.00	9,206.00		$11,642.00

Heir's Income Taxes
1/1 to 12/31

Normal Earnings	$12,000.00	
Trust Income	2,000.00	
Gross Income	14,000.00	
Standard Deduction & Exemption	1,600.00	
Taxable Income	12,400.00	
Tax	3,572.00	3,572.00
Total		$15,214.00

By choosing a fiscal period ending July 31, the estate was able to obtain an additional $600.00 exemption during the eighteen-month administration period; the income of the estate taxable to the beneficiary in the year of distribution was reduced to $2,000.00 so that the heir's income was not "bunched" in the year of distribution; and an overall income tax saving of $2,608.00 was effected.[86]

Where a devisee, legatee or heir has substantial income independent of the estate, the impact of the graduated surtax may be lessened if the distributable net income of the estate for the final period is reduced. This can be accomplished by shortening the final period. Instead of procuring a final decree of distribution in the last month of the estate's second fiscal year, it would be better to procure it in the first month of the third fiscal year. However, the period during which an estate may be kept open

[86] Neither of the two computations take into account income earned by the estate property after the date of its distribution to the heir. This may be speculative. However, if it were taken into account, the heir's income in the period of distribution would be increased approximately $8,000.00 (4 months at $2,000.00) in each example and the tax saving would be even more than $2,608.00.

to accomplish this result is not unlimited. Treasury Regulation 1.641(b)-3 provides:

> The period of administration or settlement is the period actually required by the executor or administrator to perform the ordinary duties of administration, such as the collection of assets and payment of debts, taxes, legacies and bequests, whether the period required is longer or shorter than the period specified under applicable local law for the settlement of estates. . . . However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all duties of administration.

It is usually advisable, within the limitations of the foregoing, to prolong the period of administration if both the estate and the heirs have substantial income. For each fiscal year of the estate which terminates prior to the final decree, the estate income, unless actually distributed, will be taxed to the estate and not the heirs;[87] and whenever the same total income is effectively distributed between more taxpayers the graduated rate of tax is reduced. On the other hand, if the income of the estate is substantial, and there are many heirs who have low annual incomes, it would be advisable to distribute the estate as soon as possible so that the income of one taxable entity, the estate, would be divided among many taxable entities, the individual heirs who are low bracket taxpayers.

The administrator is faced with a knotty problem when some of the heirs are in a low income group and others are in a high income group. Expediting distribution would probably be beneficial to the low income group and detrimental to the high income group. Likewise, postponing distribution would be detrimental to the low income group and beneficial to the high income group. Because of his fiduciary obligations to each group, the administrator cannot favor either. Unless the interested parties agree otherwise, he must choose the course that is most beneficial to the estate. Since this course will not always produce the maximum tax benefit to the heirs as a group, it would be advisable in each case to work out an arrangement which imposes the least total tax on the group consisting of the estate and the heirs, even though the tax burden of certain heirs may be thereby increased. In connection with this arrangement, the heirs can agree among themselves to an equitable distribution of the tax burden, taking into account the tax burden they would have sustained if the administrator had effected the maximum saving for the estate.

[87] INT. REV. CODE OF 1954, § 662(c).

V. VALUATION OF ASSETS

Under Section 2032 of the Internal Revenue Code, the executor or administrator can elect to value the estate on the basis of values at the date of death or one year thereafter. This election is made on the estate tax return, which must be filed within fifteen months after the decedent's death unless an extension is granted.[88] Once the time for filing the return has expired, the option cannot be exercised or rescinded.[89]

The date elected by the executor or administrator for the estate tax valuation will also be used in determining the basis of the property under the income tax.[90] Consequently, in choosing the valuation date, the fiduciary must carefully weigh the estate tax benefit against the income tax detriment, and vice versa. A simple example will illustrate the implications of the election. A decedent dies leaving his wife securities which have a fair market value of $500,000.00 on the date of his death. These same securities are worth $600,000.00 one year later. The chart below indicates the effect of the fiduciary's election if the wife subsequently sells the securities for their appreciated market value:

Estate Tax
(With Marital Deduction)

	Date of Death	Optional Date
Gross Estate	$500,000.00	$600,000.00
Marital Deduction	250,000.00	300,000.00
	250,000.00	300,000.00
Exemption	60,000.00	60,000.00
Taxable Estate	190,000.00	240,000.00

88 Or "filed within any extention of time granted by the district director." INT. REV. CODE OF 1954, § 2032(c); Treas. Reg. 20.2032-1(b)-2 (1958).

89 Treas. Reg. 20.2032-1(b)-2 (1958). See also Henry S. Downe, 2 T.C. 967 (1943); E.T. 14 (1940-41); C.B. 221.

90 INT. REV. CODE OF 1954, § 1014. The estate tax valuation is presumptively correct for income tax purposes unless rebutted by clear and convincing evidence. Treas. Reg. 1.1014-3 (1957). See Klein, *Effect of Estate Tax Valuation on Basis,* 32 TAXES 659 (1954). The estate tax election conclusively fixes the *date* for valuation to determine the income tax basis; although the estate tax valuation on that date may be questioned for income tax purposes. See LOWNDES & KRAMER, FEDERAL ESTATE & GIFT TAXES 459 (1956).

Tax	47,700.00	62,700.00
Rate Bracket	30%	30%
Effective Rate in Bracket	15%	15%

Income Tax

Amount Realized	600,000.00	600,000.00
Basis to Legatee	500,000.00	600,000.00
Gain	100,000.00	.00
Tax	25,000.00	.00
Capital Gain Maximum Rate	25%	25%

By electing the optional valuation date the fiduciary has increased the estate tax only $15,000.00; although the estate tax valuation was increased $100,000.00 and the estate falls in a 30% rate bracket.[91] Where the maximum marital deduction will be obtained regardless of the size or value of the estate, only one-half of the increase in value will actually be subject to the estate tax. Since the rate of tax within the given bracket is cut in half by the marital deduction, the effective rate of the estate tax on the additional $100,000.00 is only 15%. The effective rate of the income tax on this same $100,000.00 would be at least 25%.[92] Consequently, by electing the optional valuation date in the illustration given, the fiduciary can effect an overall tax saving of $10,000.00 or ten cents on each dollar of appreciation between the date of death and the optional valuation date. Since the full marital deduction is necessary to obtain this tax benefit, the fiduciary must determine whether sufficient assets qualify for the marital deduction.

The importance of the full marital deduction can be demonstrated by altering the hypothetical situation slightly. Suppose, in the illustration given, that the decedent predeceased his wife, and the securties were left to his son who sold them for their appreciated value. These tax consequences would occur:

Estate Tax

(Without Marital Deduction)

	Date of Death	Optional Date
Gross Estate	$500,000.00	$600,000.00
Exemption	60,000.00	60,000.00

91 INT. REV. CODE OF 1954, § 2001.

92 This assumes that the gain is all recognized in one year and is not offset by losses in the same year. INT. REV. CODE OF 1954, § 1201(b).

Taxable Estate	440,000.00	540,000.00
Tax	126,500.00	159,700.00
Rate Bracket	32%	35%
Income Tax		
Amount Realized	600,000.00	600,000.00
Basis	500,000.00	600,000.00
Gain	100,000.00	.00
Tax	25,000.00	.00
Capital Gain Maximum Rate	25%	

If the fiduciary were to elect the optional valuation date, the estate tax increase would be $33,200.00 while the income tax decrease would only be $25,000.00. The effective rate of the estate tax on the $100,000.00 appreciation would be 33.2% (32% on $60,000.00 and 35% on $40,000.00),[93] while the effective rate of the income tax would be not more than 25%. By valuing the property at the date of death, the fiduciary would save 8.2 cents of each dollar of appreciated value.

In addition to the marital deduction, there are a variety of other factors the fiduciary should consider when choosing the estate tax valuation date. The probability or improbability that the appreciating assets will be sold by the recipient is very important. If the decedent devises a farm to his son who intends to farm it, not to sell it, there is little likelihood of an income tax saving by an election which increases the son's basis for the farm. The present and real impact of the increased estate tax produced by choosing the date on which values are higher could hardly be offset by speculation that the farm might be sold for a profit sometime in the distant future. A bird in the hand is worth two in the bush. Where an ultimate sale of appreciating property is unlikely, the estate tax valuation should be as low as possible.

The probability of loss is another factor to consider. The estate may consist of speculative securities which fluctuate substantially in value from day to day. Securities which have appreciated from $500,000.00 to $600,000.00 between the date of death and the optional valuation date elected by the executor, could conceivably drop back to $500,000.00 before the legatee sells. The tax benefit from this loss may be narrowly limited. Unless the devisee is a stock broker, the securities would be a capital asset[94] and the loss a capital loss.[95]

[93] INT. REV. CODE OF 1954, § 2001.

[94] INT. REV. CODE OF 1954, § 1221. *Cf.* INT. REV. CODE OF 1954, § 1236.

[95] INT. REV. CODE OF 1954, § 1222.

Capital losses only offset capital gains and $1,000.00 of ordinary income during the current[96] and each of five succeeding years.[97] In the absence of capital gains, the capital loss deduction would be limited to $6,000.00. Thus, the fiduciary's election would increase the taxable estate $100,000.00, but reduce taxable income only $6,000.00. In choosing the valuation date, the fiduciary should carefully consider the probability of loss and whether the loss will be a capital loss, an ordinary loss or a Section 1231 loss.

The likelihood of an installment sale by the legatees is another salient factor. The income tax rate is ordinarily reduced by installment reporting because the gain is spread over several taxable periods.[98] Finally, in making his choice, the fiduciary should be cognizant of the tax brackets and multiplicity of the heirs, devisees and legatees.

VI. ADMINISTRATION EXPENSES

An executor or administrator may elect to deduct administration expenses, and casualty and theft losses from either the gross estate[99] or gross income,[100] but not from both.[101] It is not required that the total of these deductions, or all of any one such deduction, be treated the same way. A portion of one deduction may be allowed for income tax purposes, and the balance for estate tax purposes.[102] For example, if uninsured property worth $10,000.00 is totally destroyed by fire during the administration of an estate, the administrator could deduct $5,000.00 from gross income and $5,000.00 from the gross estate.

Administration expenses include administrator's and executor's fees, attorneys' fees, accountants' fees, appraisers' fees, custodian expenses and court costs[103] as well as all other ordinary and necessary expenses for the production or collection of income, the management, maintenance or conservation of income-producing property or in connection with the determination, collection or refund

[96] INT. REV. CODE OF 1954, § 1211.

[97] INT. REV. CODE OF 1954, § 1212.

[98] INT. REV. CODE OF 1954, § 453.

[99] INT. REV. CODE OF 1954, §§ 2053(a)-1 and 2054.

[100] INT. REV. CODE OF 1954, §§ 165 and 212.

[101] INT. REV. CODE OF 1954, § 642(g).

[102] Treas. Reg. 1.642(g)-2 (1956).

[103] Treas. Reg. 1.212-1(i) (1957).

of any tax.[104] Casualty losses include losses arising from fires, storms, shipwrecks and similar sudden and unexpected causes.[105]

These items must actually be paid during the taxable year by a cash basis taxpayer to be deductible for income tax purposes.[106] However, for estate tax purposes, an estimated amount may be deducted on the return, even though the exact amount is not known, "if it is ascertainable with reasonable certainty and will be paid."[107] A vague or indefinite estimate will not suffice.

The treatment of these deductions in a given case may vary substantially the tax burden of the estate. Reflect on the following hypothetical facts: A testator bequeathes one-fourth of his $500,000.00 estate to A and the balance to B. The estate is on a cash basis and $20,000.00 in administration expenses are paid during the fiscal year in which the estate is closed. A, who is married, has a $5,000.00 annual income; and B, who is single, has a $20,000.00 annual income. The chart below illustrates the importance of the executor's treatment of administrative expenses:

Estate Tax

	Full Marital Ded.		*No Marital Ded.*	
	Expenses		*Expenses*	
	Claimed	*Not Claimed*	*Claimed*	*Not Claimed*
Gross Estate	$500,000	$500,000	$500,000	$500,000
Administration Expenses	20,000	—0—	20,000	—0—
Adjusted Gross Estate	480,000	500,000	480,000	500,000
Marital Deduction	240,000	250,000	480,000	500,000
	240,000	250,000	480,000	500,000
Exemption	60,000	60,000	60,000	60,000
Taxable Estate	180,000	190,000	420,000	440,000
Tax	44,700	47,700	120,100	126,500
Rate Bracket	30%	30%	32%	32%
Effective Rate	15%-	15%-	32%-	32%-
Estate Taxes Saved		3,000		6,400
Beneficiary A (1/4)		750		1,600
Beneficiary B (3/4)		2,250		4,800

[104] INT. REV. CODE OF 1954, § 212.

[105] INT. REV. CODE OF 1954, §§ 165(c)-3 and 2054.

[106] Treas. Reg. 1.446-1(c)-i (1957).

[107] Treas. Reg. 20.2053(b)-3 (1958).

Income Taxes

	Beneficiary A (1/4)		*Beneficiary B* (3/4)	
	Married		*Single*	
Normal Income	$ 5,000	$ 5,000	$ 20,000	$ 20,000
Trust Income (4%)	5,000	5,000	15,000	15,000
Adjusted Gross Income	10,000	10,000	35,000	35,000
Administration Expenses	—0—	5,000	—0—	15,000
	10,000	5,000	35,000	20,000
Stand. Ded. & Exemption	2,200	1,700	1,600	1,600
Taxable Income	7,800	3,300	33,400	18,400
Tax	1,636	660	15,370	6,412
°Rate Bracket	22%	20%	65%	53%
Income Tax Saved		976		8,958

By claiming the administration expenses as a deduction from the gross estate, the fiduciary could reduce federal estate taxes $6,400.00 if there were no marital deduction, and $3,000.00 if there were a full marital deduction. However, the income tax deduction would be lost to the estate and the legatees.

When an estate is closed, the income for the final fiscal year is "required to be distributed currently" to the legatees and devisees. The estate is entitled to a deduction equal to the distributable net income for the final period.[108] Consequently, there is no taxable income for the trust. However, on termination of an estate, if it has deductions for its last taxable year in excess of gross income, the excess is allowed as a deduction to the beneficiaries succeeding to the property of the estate.[109] Thus in the illustration given, A would receive the benefit of one-fourth and B, three-fourths of the deduction for administration expenses, if the executor did not claim these expenses as a deduction from the gross estate. A's income tax benefit from the deduction would be $976.00; and B's $8,958.00.

It is interesting to note that in the example given, B would profit by an income tax deduction whether or not the estate is entitled to a marital deduction. Yet A would profit from an income tax deduction only if there is a substantial marital deduction. In the absence of a marital deduction, A would be better off if the executor deducted the administrative expenses from the gross estate.

[108] INT. REV. CODE OF 1954, § 661.

[109] Exception: Deductions for exemptions and charitable contributions may not be carried over. INT. REV. CODE OF 1954, § 642(h).

The foregoing illustration may help to pinpoint some of the factors which the executor or administrator should keep in mind. The amount of the marital deduction, if any, the federal estate tax bracket of the estate, the income tax bracket of the estate and beneficiaries, the use of the optional valuation date all deserve serious consideration. The relative interests of the life tenants and remaindermen are also important. Estate taxes diminish the remainder while income taxes leave it undisturbed. Each of the foregoing factors must be carefully weighed before the fiduciary decides to take the deduction from the gross estate rather than gross income or vice versa.

Considerable latitude is given the fiduciary in formalizing his election. He must file a statement that the administration expenses or casualty losses have not been allowed as deductions from the gross estate, and that all rights to have such items allowed as deductions from the gross estate are waived. Although this statement should be filed with the income tax return for the year the deduction is claimed, the regulations expressly provide:

> The statement may be filed at any time before expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed.[110]

When the statement is filed, the fiduciary waives his right to claim the estate tax deduction. Therefore, the desirable procedure would be for him to claim the deduction on the estate tax return when it is filed and at any time within the statutory period for assessing an estate tax deficiency he can file a waiver for the estate tax deduction and be entitled to deduct the same amount on the income tax return of the estate.[111]

VII. CONCLUSION

Other elections affecting income taxes may be available to a fiduciary. He may select the method of depreciation;[112] elect to "capitalize" or "expense" payments for soil and water conservation and prevention of land erosion,[113] or for mining exploration or

[110] Treas. Reg. 1.6212(g)-1 (1957).

[111] Walker, *Planning to Reduce Income Taxes During Administration of Estate,* 1959 SO. CAL. TAX INST. 715.

[112] INT. REV. CODE OF 1954, § 167.

[113] INT. REV. CODE OF 1954, § 175.

development,[114] or for research.[115] He may choose to amortize bond premium on partially tax-exempt bonds.[116] He may have a voice in deciding whether a partnership takes a stepped up basis for the decedent's assets,[117] whether an unincorporated association should be taxed like a corporation,[118] or whether a corporation should be taxed like an unincorporated association.[119]

In view of the increasing number and growing complexity of the options, elections and choices available to a fiduciary today during the administration of an estate, one thing seems certain. The executor or administrator must "get organized" at the outset. Too often, the choice of a fiscal period is not even considered until a year has passed and the return is due. Substantial executor's and attorney's fees are "lumped" in a single period without the slightest thought of tax consequences. Unwittingly, assets are valued ridiculously low for federal estate tax purposes, only to produce unbearable income tax burdens. If costly blunders are to be avoided, early and careful planning is essential. Today, as never before, probate practice offers a real challenge to the lawyer who is interested in rendering *professional* service.

[114] INT. REV. CODE OF 1954, § 615.

[115] INT. REV. CODE OF 1954, § 174.

[116] INT. REV. CODE OF 1954, § 171.

[117] INT. REV. CODE OF 1954, § 754.

[118] INT. REV. CODE OF 1954, § 1361.

[119] INT. REV. CODE OF 1954, § 1371, *et seq.*