

1983

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## Recommended Citation

Carrico, Michael D. and Bondurant, John T., "Equitable Adjustments: A Survey and Analysis of Precedents and Practice" (1983).  
*Articles by Maurer Faculty*. Paper 1735.  
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# EQUITABLE ADJUSTMENTS: A SURVEY AND ANALYSIS OF PRECEDENTS AND PRACTICE\*

Michael D. Carrico\*\*

John T. Bondurant\*\*\*

An equitable adjustment is a reallocation of assets from the account of one beneficiary, or from some other person beneficially interested in a trust or estate, to the account of another to compensate for disproportionate sharing of a tax burden. Generally, reallocations are made when tax elections by trustees, executors, administrators, and other fiduciaries otherwise would have disparate impacts on beneficiaries.<sup>1</sup> Since the enactment of the Internal Revenue Code of 1954, there has been increasing discussion and debate concerning this concept.<sup>2</sup>

## I. INTRODUCTION TO EQUITABLE ADJUSTMENTS

### A. Sources in Fiduciary Duty

At least three aspects of fiduciary duty justify equitable adjustments:

#### 1. *The duty to minimize the overall tax burden on a trust or estate and its*

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\* This article was a project of the American Bar Association Section of Taxation's Committee on Income of Estates and Trusts, and was based in part on a paper written in 1978 by Robert Barlow. The authors wish to acknowledge the editing of Frank S. Berall and the permission of the American College of Probate Counsel ("ACPC") to publish the equitable adjustment chart appearing as Appendix.

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<sup>1</sup> See *infra* note 15 (listing various tax elections and nonelective procedures discussed in this article); see also Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms*, 65 IOWA L. REV. 103, 104, 106-07 (1979) [hereinafter cited as Dobris I].

<sup>2</sup> For early commentary on equitable adjustments required by the changes in estate and trust income taxation made by the 1954 Code, see Craven, *Suggested Revisions of Estate and Trust Income Taxation*, 44 VA. L. REV. 887, 888 (1958). See also Browning, *Problems of Fiduciary Accounting*, 36 N.Y.U. L. REV. 931, 948-53 (1961); Metzger, *The Deduction of an Estate's Administration Expenses: Section 642(g) of the Internal Revenue Code and Its Impact*, 21 TAX L. REV. 459, 487-93 (1966). See generally J. PRICE, *CONTEMPORARY ESTATE PLANNING: TEXT AND PROBLEMS* §§ 12.1-12.43 (1983) (note especially § 12.16; E. SCOLES & E. HALBACH, *PROBLEMS AND MATERIALS ON DECEDENTS' ESTATES AND TRUSTS* 722-806 (3d ed. 1981). For practice oriented discussions, see Houghton & Lavelle, *Important Elements of a Tax Clause*, 8 Prob. Notes 154, 158-63 (1982); Moore, *Conflicts in Post-Mortem Planning After the Tax Reform Act*, 12 INST. ON EST. PLAN. ¶¶ 600-609 (1978) [hereinafter cited as Moore, *Conflicting Interests* 1978]; Moore, *Conflicting Interests in Postmortem Planning*, 9 INST. ON EST. PLAN. ¶¶ 1900-1924 (1975) [hereinafter cited as Moore, *Conflicting Interests* 1975]; Weigel & Trost, *Tax Elections: When and How To Make Compensatory Adjustments*, 6 EST. PLAN. 130 (1979). See also Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 IOWA L. REV. 273 (1981) [hereinafter cited as Dobris II]; Dobris I, *supra* note 1.

*beneficiaries*. This duty is derived from the duty to conserve trust or estate property and to make the property reasonably productive.<sup>3</sup>

2. *The duty of impartiality*. A fiduciary has a duty to treat all beneficiaries fairly and cannot sacrifice the interest of one beneficiary by making a tax election to favor another.<sup>4</sup> Unless the trust settlor, testator, or other transferor<sup>5</sup> specifically expresses, in a dispositive instrument, his<sup>6</sup> intent that the fiduciary elect in a particular manner, relieving the fiduciary to that extent from the duty of impartiality, the fiduciary generally must allocate tax burdens proportionally among all beneficiaries.<sup>7</sup> Impartiality problems most often arise between present and future interest holders and have given rise to a range of principal and income allocation rules,<sup>8</sup> including the Uniform Principal and Income Act and the Revised Uniform Principal and Income Act, one of which has been adopted by almost every state.<sup>9</sup>

3. *The duty not to deal with one's self*. This duty bars the fiduciary who is also a beneficiary from making any tax election unfairly favoring his beneficial interest over that of another beneficiary.<sup>10</sup>

#### B. *Lack of Uniform Approach to Equitable Adjustments*

Although often discussed and written about by experts in estate planning and

<sup>3</sup> G. BOGERT & G. BOGERT, *HANDBOOK OF LAW OF TRUSTS* § 101 (5th ed. 1973); 2 A. SCOTT, *THE LAW OF TRUSTS* § 181 (3d ed. 1967); RESTATEMENT (SECOND) OF TRUSTS §§ 174, 176 & 181 (1957). See Taggart, *Fiduciary's Liability in Utilizing Post Mortem Estate Planning Techniques*, in *POST MORTEM ESTATE PLANNING* 393, 398 (P. Asofsky ed. 1981); see also *id.* at 403-10 (discussing fiduciary liabilities to beneficiaries arising from postmortem estate planning). See generally Conway & Hale, *After Death Tax Planning—Tax Options*, 301 T. M. PORTFOLIO A-2 (BNA 1974)(supplemented through 1981—portfolio withdrawn for revision, November 16, 1981); Dobris I, *supra* note 1, at 113-16.

<sup>4</sup> G. BOGERT & G. BOGERT, *supra* note 3, § 106; E. SCOLES & E. HALBACH, *supra* note 2, at 802; A. SCOTT, *supra* note 3, § 183; RESTATEMENT (SECOND) OF TRUSTS, § 183 (1957); see also Conway & Hale, *supra* note 3, at A-2 (discussing problem of tax election that shifts tax burden from one beneficiary to another). See generally Dobris I, *supra* note 1, at 107-08, 111-13 and 116-18; Taggart, *supra* note 3, at 399.

<sup>5</sup> Hereinafter any settlor, grantor or trustor, testator, intestate, donor or other transferor will be referred to simply as a "transferor."

<sup>6</sup> Whenever the words "he," "him," "man" or comparable words appear in this article (other than with obvious reference to named male individuals), they have been used solely to produce a smooth reading text and are intended to be read in their generic sense (i.e., to include all of mankind, whether male or female).

<sup>7</sup> See 3 A. SCOTT, *THE LAW OF TRUSTS* § 232 (3d ed. 1967)(duty of trustee to respective beneficiaries may be controlled by terms of trust); see also Dobris II, *supra* note 2, at 283-84 (discussing benefits of express remission or setting aside, in part, of duty of impartiality in dispositive instrument).

<sup>8</sup> See A. SCOTT, *supra* note 7, § 232. See generally *id.* at §§ 233-241A.

<sup>9</sup> See UNIF. PRINCIPAL & INCOME ACT, 7A U.L.A. 464 (1931); REV. PRINCIPAL & INCOME ACT, 7A U.L.A. 429 (1962) [hereinafter cited as REV. UNIF. PRINCIPAL & INCOME ACT]. References to general principles of principal and income allocation in this article will be to the Revised Act. See generally Bogert, *Uniform Principal and Income Act Revised*, 101 Tr. & Est. 787 (1962).

<sup>10</sup> While this prohibition on self-dealing is widely accepted (e.g., G. BOGERT & G. BOGERT, *supra* note 3, § 95; A. SCOTT, *supra* note 3, §§ 170-170.25; RESTATEMENT (SECOND) OF TRUSTS § 170 (1957)), it has not been widely referred to in discussions of equitable adjustments. *But see Moore, Conflicting Interests 1975, supra* note 2, ¶¶ 1916, 1920.

fiduciary administration,<sup>11</sup> equitable adjustments have received surprisingly little attention from legislatures, courts, and lawyers not specializing in this field and, consequently, no uniform practice exists. Commentators have seemed suspended between the horns of the basic equitable adjustment dilemma: to maximize fairness to beneficiaries, should equitable adjustments be made whenever possible, or to maximize simplicity in administration, should they be avoided in the absence of gross inequities?<sup>12</sup> To determine equitable adjustment practices, the American College of Probate Counsel sent a questionnaire to selected attorneys in each state and the District of Columbia, and compiled a chart from their responses.<sup>13</sup> It dramatically confirms the absence of any uniform practice.

### C. Purpose and Scope of This Article

This article sets forth and analyzes the precedents and practice in each potential problem area relating to equitable adjustments and covers the following aspects of each: (a) the tax law source of the election or nonelective procedure, and how it works, (b) how the election or procedure affects different beneficiaries' interests—i.e., hurting some and benefitting others, (c) legislative and judicial

<sup>11</sup> See, e.g., Barton, *Post-1976 Tax Clauses: Drafting Burdens and Planning Assignments*, 13 INST. ON EST. PLAN. ¶¶ 900–904 (1979); Cornfeld, *Trapping Distributions*, 14 INST. ON EST. PLAN. ¶¶ 1400–1407 (1980) (paragraph 1405 discusses need for equitable adjustments due to trapping distributions); see also Dobris I, *supra* note 1, at 105. For further reading, consult, for example, the Practising Law Institute's annual volume, *POST MORTEM ESTATE PLANNING*, edited by P. Asofsky, and the commentary cited in *supra* note 2.

<sup>12</sup> In 1979, Professor Joel C. Dobris made the following observation:

The cases dealing with equitable adjustments come from states where there is a tradition of creating trusts and paying close attention to the niceties of fiduciary administration. . . . [Their] impact . . . on fiduciary action and on the advice given by estates lawyers is unknown, but is likely to be widespread. The jurisdictions where the cases are decided, and the fact that virtually all are lower court decisions, are not as important as they might seem, because [equitable adjustment] cases are read as a single body of law by lawyers, judges, and commentators. [But w]hile certain equitable adjustments have gained acceptance, a clear rationale for making adjustments has yet to emerge.

Dobris I, *supra* note 1, at 105 (emphasis added).

Despite the lack of uniform practice, Dobris concluded that equitable adjustments are appropriate not only when exercise of a discretionary fiduciary power causes inequitable allocation of a tax burden, but also when such an allocation is caused by exercise of a nondiscretionary power. *Id.* at 148-49. In 1981, however, he reached a somewhat different conclusion:

[F]airness does not entitle beneficiaries to have a perfectly proportional relationship with the estate and each other. Therefore, fiduciaries need not adjust when it is too complicated, expensive, time consuming, or when the imposition is minimal or conjectural. The average transferor wants his . . . fiduciary to make reasonable efforts to obtain tax savings and to give reasonable consideration to all beneficial interests before exercising discretionary powers and allocating receipts and expenditures. *When feasible*, the average transferor also wants equitable apportionments to cure the *gross inequities* deriving from estate administration. . . .

Existing equitable adjustments are likely to be required in more jurisdictions. However, courts are unlikely to require additional adjustments unless changes in the tax law occur, and *gross inequities* arise from those changes. *The interest in simplicity is too strong.*

Dobris II, *supra* note 2, at 340-41 (emphasis added).

<sup>13</sup> See ACPC chart *infra* at Appendix.

responses to the problem, and (d) possible drafting responses, ranging from prohibiting adjustments to granting the fiduciary complete discretion to make adjustments and exculpating the fiduciary from liability for any resulting harm. The article discusses tax elections and nonelective procedures which primarily affect the fiduciary income tax return; for example, the fiduciary election to deduct administration expenses and casualty losses on the fiduciary return under section 642(g) or on the estate tax return under sections 2053 and 2054<sup>14</sup> and the nonelective deduction of principal expenses on the fiduciary income tax return that sometimes causes capital gains taxation of principal beneficiaries.<sup>15</sup> The article also discusses elections and procedures affecting the decedent's final income and gift tax returns and the federal estate tax return.<sup>16</sup> Finally, the article discusses extralegal methods of achieving beneficiary agreement on adjustment

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<sup>14</sup> See, e.g., *infra* text accompanying notes 19-91 (election to take administrative expense and casualty loss deductions either on fiduciary income tax return or on estate tax return). This article also discusses the following elections and nonelective tax procedures: (1) the election to make principal distributions that carry out distributable net income ("DNI" is defined *infra* note 92) and shift income tax burdens from income to principal beneficiaries, see *infra* text accompanying notes 122-47; (2) the election to deduct depreciation on the fiduciary income tax return, reducing income beneficiaries' and increasing principal beneficiaries' income tax burdens, see *infra* text accompanying notes 148-73; (3) the election to make disproportionate distributions of both income and principal to satisfy pecuniary or residuary gifts in kind, thus creating disproportionate income tax burdens for the beneficiaries, see *infra* text accompanying notes 174-214; (4) the selection of the estate or trust taxable year, see *infra* text accompanying notes 215-21; (5) the decision to sell assets, and the timing of such sales, see *infra* text accompanying notes 222-29; (6) the election to pay an estate's income tax in installments, see *infra* text accompanying notes 230-32; (7) the election to terminate subchapter S elections, see *infra* text accompanying notes 233-42; and (8) the selection of the year for either final distribution of an estate or termination of a trust, and the possible disproportionate sharing of advantages or disadvantages from distributing excess deductions, loss carryovers and capital gains, see *infra* text accompanying notes 243-46.

<sup>15</sup> See *infra* text accompanying notes 92-121.

<sup>16</sup> This article discusses the following elections and nonelective procedures that primarily affect the decedent's final income tax return: (1) the election to accrue series "E" and "EE" savings bond interest, see *infra* text accompanying notes 247-53; (2) the election to deduct medical expenses, see *infra* text accompanying notes 254-60; and (3) the election to file the decedent's final income tax return jointly with the surviving spouse, see *infra* text accompanying notes 261-71. The following federal estate tax elections and procedures affect inclusion in the gross estate: (1) decisions regarding inclusion of assets in the gross estate under sections 2033, 2036-2038, 2040(a), 2041 and 2042, see *infra* text accompanying notes 272-78; and (2) the election to include a distribution from a qualified employee benefit plan or individual retirement account under section 2039(c), (f) and (g), see *infra* text accompanying notes 279-88. The following federal estate tax elections and procedures affect valuation of assets: (1) the election to use the alternate valuation date under section 2032, see *infra* text accompanying notes 289-96; and (2) the election to value a farm or closely held business real property based on its actual use under section 2032A, see *infra* text accompanying notes 297-307. The following federal estate tax elections affect payment of estate tax: (1) to tender closely held corporate stock for redemption under section 303 and to use the proceeds to pay death taxes and other qualified expenses, see *infra* text accompanying notes 308-10; (2) to defer estate tax payment automatically under section 6166, see *infra* text accompanying notes 311-23; and (3) to defer estate tax payment on remainder interests under section 6163 or to request discretionary deferral of estate tax payments under section 6161, see *infra* text accompanying notes 324-27. This article also discusses the federal gift tax election to split gifts with the surviving spouse on the decedent's final gift tax returns under section 2513. See *infra* text accompanying notes 328-31. Finally, the article discusses the analogous equitable reimbursement sometimes made to settlors of short-term reversionary interest trusts for capital gains tax liability under section 677. See *infra* text accompanying notes 332-40.

problems, pointing out the variety of obstacles to reaching valid consensual beneficiary adjustment.<sup>17</sup> The article, however, deals only indirectly with tax election issues arising under The Economic Recovery Tax Act of 1981 and later legislation.<sup>18</sup>

## II. EXPLANATION AND ANALYSIS OF PARTICULAR EQUITABLE ADJUSTMENTS

### A. *Election to Take Administration Expense and Casualty Loss Deductions on the Fiduciary Income Tax Return or on the Estate Tax Return*

#### 1. *Tax Law Sources of the Election and Adjustment*

Under section 2053, an executor<sup>19</sup> may deduct from the decedent's gross estate funeral expenses, creditors' claims, administration expenses, and certain mortgage obligations (which are duly allowed and paid under local law).<sup>20</sup> Under section 2054 he may deduct any uninsured losses during administration from "fires, storms, shipwrecks, or other casualties, or from theft."<sup>21</sup> Alternatively, under section 642(g) an executor may elect to deduct administration expenses and casualty losses on the fiduciary income tax return for the taxable year in which the expenses are paid, or in which the losses are incurred, so long as they would be deductible for income tax purposes<sup>22</sup> (e.g., as section 212 expenses to produce investment income and as section 165 casualty losses) and the executor files a statement that such amounts have not been or will not be taken as deductions on the estate tax return.<sup>23</sup> The disallowance of double deductions under

<sup>17</sup> See *infra* text accompanying notes 341-47.

<sup>18</sup> After regulations are proposed, the authors intend to devote another article to such elections under, for example, the "qualified terminable interest" property provisions of sections 2056(b)(7) and 2523(f). See, e.g., The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403, 95 Stat. 172, 301 [hereinafter cited as ERTA]; Temp. Regs. § 22.2056-1, 47 Fed. Reg. 41736 (1982); see also Moore, *Conflicting Interests in Estate Planning after ERTA: Recognition and Resolution*, 17 INST. ON EST. PLAN. (preliminary outline, to be published Summer 1983); Strauss, *Qualified Terminable Interest Property Offers New Opportunities But Many Problems Are Unresolved*, 9 EST. PLAN. 74, 80 (1982).

<sup>19</sup> According to section 6018, the estate tax return must be filed by the "executor." Under Regulations section 20.6018-2, however, this term can refer to an administrator, to multiple executors or administrators, and to "every person in actual or constructive possession of any property of the decedent." Regs. § 20.6018-2. Thus, a trustee of a revocable trust (a will substitute) may make elections affecting the property to which he has legal title if there is no duly appointed executor serving at the time. See *id.* (if executor cannot make tax return on any property, then person holding legal or beneficial interest in that property must make return upon notice from District Director); see also I.R.C. § 2203; Regs. § 20.2203-1 ("person in actual or constructive possession of property of decedent" includes decedent's agents and representatives, safe-deposit companies, warehouse companies, other custodians of property in United States, brokers holding decedent's debtors in United States). Hereinafter all references to "executors" making elections should be understood to refer to any fiduciary designated under section 6018, unless otherwise specifically indicated.

<sup>20</sup> I.R.C. § 2053(a)(1), (2), (4); Regs. §§ 20.2053-1, -3, -8; Regs. § 20.2053-7.

<sup>21</sup> I.R.C. § 2054; Regs. § 20.2054-1.

<sup>22</sup> I.R.C. § 642(g); Regs. § 1.642(g)-1.

<sup>23</sup> According to Regulations section 1.642(g)-1, amounts allowable under sections 2053 or 2054 as a deduction in computing the taxable estate of a decedent may not be allowed as a deduction (or as an offset against the sale price of property in determining gain or loss) in computing the taxable

section 642(g) does not apply to deductions in respect of decedents (described in section 691(b)).<sup>24</sup> Furthermore, an executor may elect to take deductible expenses as income tax deductions in one year and not in another, and in any particular year may elect to deduct on the income tax return only a portion of such amounts paid that year, deducting the rest on the estate tax return.<sup>25</sup>

Unless the transferor expressly directs to the contrary, administration expenses and casualty losses are charged against principal of the trust or estate, even if deduction of these items on the fiduciary income tax return reduces the income beneficiaries' tax burden.<sup>26</sup> Estate tax, including any increase resulting from not deducting these expenses and losses on the estate tax return, ordinarily is paid from principal, while fiduciary income tax, other than capital gains tax, is paid from income.<sup>27</sup> The fiduciary trying to minimize total taxes compares marginal income and estate tax rates and, if the income tax rate is higher, deducts sufficient administration expenses and casualty losses on the income tax return to equalize, in so far as is possible, the two marginal rates.<sup>28</sup> Thus, this bracket equalization can shift the tax saving effect of the deductions from the principal beneficiaries,

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income of the estate or of any other person (e.g., a will substitute trust) unless there is "filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate . . . and that all rights to have such items allowed at any time as deductions . . . are waived." The statement must be filed "before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought." See generally I.R.C. § 6501 (regarding limitation periods). Thus, claiming an amount as a deduction on the estate tax return does not preclude also deducting the amount on the income tax return, "so long as the estate tax deduction is not finally allowed and the statement is filed [before the limitation period expires]." Regs. § 1.642(g)-1. Of course, if the statement and waiver have been filed, the amount cannot then be deducted on the estate tax return. *Id.* But see Prop. Regs. § 1.642(g)-1(a)(2), 48 Fed. Reg. 5762, 5763 (1983). Under this proposed regulation, the statement must waive the right to deduct such items if an estate tax return has not yet been filed. If an estate tax return deducting such items under sections 2053 and 2054 has been filed, the statement "should be filed no later than 180 days prior to the expiration of the statutory period of limitations upon assessment and collection of the estate tax"; otherwise the income tax deduction may not be taken until the estate tax deductions are "no longer claimed," or have been disallowed and "any resulting deficiency has been timely assessed." But cf. I.R.C. § 165(h)(2)(B) (regarding casualty losses: "No [casualty loss otherwise deductible on the fiduciary income tax return] shall be allowed if, at the time of filing the return, such loss has been claimed . . . in the estate tax return") (emphasis added). The Tax Equity and Fiscal Responsibility Act of 1982 § 203, Pub. L. No. 97-248, § 203, 96 Stat. 324, 422 [hereinafter cited as TEFRA]; see also I.R.C. § 641(b); Regs. § 1.641(b)-1 (1956) (stating general rule on deductions allowable to estates and trusts). See generally Probate and Trust Law Committee on Postmortem Estate and Tax Planning, Section of Real Property, American Bar Association, *Deduction of Administration Expenses Updated*, 17 REAL PROP. PROB. & TR. J. 382-97 (1982) [hereinafter cited as *Postmortem Estate and Tax Planning Committee*]; King, *Alternative Treatment of Administration Expenses*, in *POST MORTEM ESTATE PLANNING* 147-56 (P. Asofsky ed. 1981).

<sup>24</sup> The last sentence of I.R.C. section 642(g) states as follows: "This subsection shall not apply with respect to deductions allowed under Part II (relating to income in respect of decedents)." See also Regs. § 1.642(g)-2 (1956); *infra* note 88. See generally J. PRICE, *supra* note 2, § 12.12.

<sup>25</sup> Regs. § 1.642(g)-2.

<sup>26</sup> See REV. UNIF. PRINCIPAL & INCOME ACT, *supra* note 9, §§ 5(a), 13(a)(6).

<sup>27</sup> *Id.* §§ 5(a), 13(a)(6), (c)(4), (c)(5).

<sup>28</sup> Dobris I, *supra* note 1, at 121-22; see also Barton, *supra* note 11, ¶ 902.2; Conway & Hale, *supra* note 3, at A-14; Post Mortem Estate and Tax Planning Committee, *supra* note 23, at 392-93; J. PRICE, *supra* note 2, §§ 12.11-12.16.

who bear the burden of the expenses or losses, to the income beneficiaries, who in essence receive a windfall.

## 2. Legislative Responses

Although this election has an impact on any trust or estate paying both income and estate taxes, it appears that the principal and income allocation rules of only three states take it into account:

a. *New York Estates, Powers and Trusts Law, Section 11-1.2*. New York has codified the rule of *In re Estate of Warms*<sup>29</sup> to compensate principal beneficiaries for a portion of the economic harm caused by taking the deductions on the income tax return. The statutory formula reads as follows:

[E]ach person, including the estate or any trust, who has . . . the use of such income tax deductions shall reimburse to the principal chargeable with such increased estate taxes an amount determined by multiplying such increase in estate taxes by a fraction having a numerator equal to the income tax deduction made available to him as the result of the aforesaid election and a denominator equal to the total amount of the income tax deductions made available thereby.<sup>30</sup>

Thus, principal beneficiaries are compensated only for the increase in estate taxes and can receive substantially less than the deduction's value to income beneficiaries.<sup>31</sup> Finally, the statute states that a testator may expressly provide that no adjustment be made.<sup>32</sup>

b. *Connecticut General Statutes Annotated, Section 45-100e(35)(B)*. Connecticut takes a different approach to the problem. It permits incorporation by reference in wills and trusts of certain specified fiduciary powers,<sup>33</sup> one of which directs the fiduciary to claim "certain administration expenses, casualty losses . . . and other expenses" on the tax return which will "result in the lowest total taxes being paid by the estate and its beneficiaries, regardless of whether such expenses may be payable from the income or principal of such estate."<sup>34</sup> An adjustment is required only if "federal estate taxes paid from and chargeable to . . . principal are greater than if the contrary election had been made," in which case the difference in estate tax is reimbursed to principal from income (producing a result identical to New York's) or if the will or trust provides for a "preresiduary marital . . . deduction formula" gift followed by a residuary charitable gift.<sup>35</sup>

<sup>29</sup> 140 N.Y.S.2d 169 (Sur. Ct. N.Y. County 1955). See *infra* notes 38-39 and accompanying text (discussing *Warms*).

<sup>30</sup> N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(A)(McKinney Supp. 1982-83).

<sup>31</sup> Cf. *In re Estate of Warms*, 140 N.Y.S.2d at 170-71; see also Dobris I, *supra* note 1, at 123 (providing possible rationale for rule expressed in *Warms*). New York Estates, Powers & Trusts Law section 11-1.2(B)(1) provides that no adjustment be made for an increase in a marital deduction formula gift caused by an increase in the amount of the adjusted gross estate because of taking such expenses as estate tax deductions. N.Y. EST. POWERS & TRUSTS LAW § 11-1.2 (B)(1)(McKinney Supp. 1982-83); see *infra* note 77 and accompanying text.

<sup>32</sup> N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(A), (B)(1)(McKinney Supp. 1982-83). The statute makes no reference to equitable adjustment (nor does it have an express provision that no such adjustment shall be made) if the gift is made in revocable trust instead of by will.

<sup>33</sup> CONN. GEN. STAT. ANN. § 45-100d (West 1981).

<sup>34</sup> *Id.* § 45-100e(35)(B)(West 1981 & Supp. 1982).

<sup>35</sup> *Id.* A residuary charitable gift must be to an organization qualifying under I.R.C. section 501(c).



In no other situation is the fiduciary required to make an adjustment.<sup>36</sup> Connecticut's statutory power must be incorporated by reference for it to apply at all, whereas in New York the adjustment power exists unless a will specifies to the contrary.

c. *Maryland Estates and Trusts Code, Section 11-106.* The Maryland approach is more like that of New York, requiring adjustment, without incorporation by reference of a statutory power, in "an amount equal to the difference in estate taxes . . . to principal from the income of the trust or other assets," unless the transferor expressly directs to the contrary in the dispositive instrument.<sup>37</sup>

### 3. Judicial Responses

All of these legislative responses arose from the 1955 New York Surrogate's Court decision *In re Estate of Warm's*.<sup>38</sup> In that case, the principal beneficiary had claimed, alternatively: (1) the entire amount of administration expenses paid from principal, because they had been deducted on the fiduciary income tax return, or (2) the difference in estate tax liability, also paid from principal, caused by not taking those expenses on the estate tax return. Surrogate Frankenthaler granted only the latter relief:

Ordinary administration expenses . . . are generally payable from principal. . . . [T]he source of payment . . . does not change because of the fact that in the computation of taxes the expense was charged to income rather than to principal. The option granted by the Internal Revenue Code to the executors . . . cannot affect the propriety of the charge of administration expenses to principal. . . .

[T]he special guardian does not object to the income beneficiary retaining any amount in excess of the saving in estate tax . . . . The tax option which results in a benefit to the income beneficiary, especially where she is co-executrix, should not be exercised to the detriment of the remaindermen. The remainder interest is entitled to the benefits which would have resulted if the expense with which it is charged had been deducted on the estate tax return. The question which would have arisen if the executors had no option but would have had to deduct from income taxes an expense otherwise chargeable to principal need not here be decided.<sup>39</sup>

Thus, *Warm's* contains three important rulings: (a) principal beneficiaries cannot

Connecticut General Statutes Annotated section 45-100e(35)(B) also refers to a preresiduary orphans' deduction formula gift; this reference only applies to estates of decedents dying between 1976 and 1982, under wills and trusts that incorporated this power, because the I.R.C. section 2057 orphans' deduction was repealed by ERTA, *supra* note 18, § 427.

<sup>36</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(B)(West 1981 & Supp. 1982).

<sup>37</sup> MD. EST. & TRUSTS CODE ANN. § 11-106(a), (b)(1)(1974). The Maryland provision is similar to those of New York and Connecticut in not requiring an adjustment for an increase in the amount of a marital deduction formula gift because an election increases the amount of the "adjusted gross estate" subject to the formula gift. MD. EST. & TRUSTS CODE ANN. § 11-106(b)(1)(1974). See generally *infra* notes 70-74 and accompanying text. Thus, the three state legislatures which have addressed this adjustment problem have solved it in similar, though not entirely identical, ways. There appears to have been no effort to draft uniform legislation in this area.

<sup>38</sup> 140 N.Y.S.2d 169. See *supra* text accompanying note 29. *Accord In re Will of Backus*, 106 Misc. 2d 463, 434 N.Y.S.2d 106 (Sur. Ct. Nassau County 1980); *In re Will of Coe*, 80 Misc. 2d 374, 363 N.Y.S.2d 265 (Sur. Ct. Nassau County 1975); *In re Will of Dupuy*, 29 A.D.2d 965, 289 N.Y.S.2d 581 (App. Div. 1968). See also Dobris I, *supra* note 1, at 122-23.

<sup>39</sup> 140 N.Y.S.2d at 170-71.

have such administration expenses charged to income; (b) principal beneficiaries may be reimbursed for their economic harm (i.e., for the increase in estate tax resulting from the election); and (c) this is not the same issue as that arising from economic harm suffered by principal beneficiaries because of a nonelective tax procedure.

Although the *Warms* solution usually does not result in a pro rata sharing of the total tax benefit to the estate and its beneficiaries, but only in a reduction in the disproportionately large estate tax burden borne by principal beneficiaries, the *Warms* case did inspire the New York, Connecticut, and Maryland statutes and has been followed by courts in several other states:

a. *California*. In *Estate of Bixby*,<sup>40</sup> but for the *Warms* adjustment, the income beneficiary's \$100,000 income tax saving would have cost the principal beneficiary about \$60,000 in estate taxes.<sup>41</sup>

b. *Florida*. In *In re Kent's Estate*,<sup>42</sup> a routine *Warms* adjustment was approved.<sup>43</sup> In *In re Veith's Estate*,<sup>44</sup> the adjustment was made for the benefit of charitable residuary beneficiaries.<sup>45</sup>

c. *Pennsylvania*. In *re Bell's Estate*<sup>46</sup> involved a fairly straightforward application of the *Warms* approach.<sup>47</sup>

d. *Rhode Island*. In *Rhode Island Hospital Trust Company v. Sanders*,<sup>48</sup> adjustment was ordered under facts similar to those in the Florida case, *In re Veith's Estate*.<sup>49</sup>

#### 4. Drafting Solutions

Based on the ACPC chart, attorneys in six of the states discussed above<sup>50</sup> should be aware that in the absence of express provision to the contrary in the dispositive instrument, and barring peculiar circumstances, principal beneficiaries should be compensated for at least the increase in estate tax caused by deducting administration expenses and casualty losses on the fiduciary income tax return.<sup>51</sup> Connecticut fiduciaries are governed by no such statutory or judicial direction, but the incorporation by reference provision may be read as a strong hint to make a *Warms* adjustment. Nine of the other forty-four jurisdictions have local practices dealing with these adjustments.<sup>52</sup> Even in these jurisdictions there

<sup>40</sup> 140 Cal. App. 2d 326, 295 P.2d at 68 (1956).

<sup>41</sup> *Id.* at 336, 295 P.2d at 74-75.

<sup>42</sup> 23 Fla. Supp. 133 (Palm Beach County Ct. 1964).

<sup>43</sup> *Id.* at 136.

<sup>44</sup> 26 Fla. Supp. 145 (Dade County Ct. 1965).

<sup>45</sup> *Id.* at 148-50.

<sup>46</sup> 8 Ches. Co. 21 (Orphans' Ct. 1956), *aff'd*, 393 Pa. 623, 628 (1958).

<sup>47</sup> *Id.* at 32.

<sup>48</sup> 84 R.I. 347, 125 A.2d 100 (1956).

<sup>49</sup> *Id.* at 353-55, 125 A.2d at 103-05.

<sup>50</sup> California, Florida, Maryland, New York, Pennsylvania, and Rhode Island.

<sup>51</sup> See ACPC chart, *infra* at Appendix, question 1.a. Rhode Island and Pennsylvania appear to be members of this group. *But see* ACPC chart, *infra* at Appendix, nn.70a and 71.

<sup>52</sup> According to the ACPC chart, *infra* at Appendix, question 1.b., nine other states have local practices for making such adjustments, despite their lack of statutory or case law rules: Colorado;

is uncertainty as to whether the adjustments are necessary and, therefore, how they should be handled in drafting and postmortem planning.<sup>53</sup> Attorneys in those six states with statutory rules or judicial precedent must decide whether to provide a specific expression of contrary intent.

There are at least four reasonable ways to draft an instrument regarding this adjustment:

1. Include a formula or other mechanical procedure;
2. Require adjustment in the fiduciary's discretion;
3. Prohibit it; or
4. Say nothing about it, leaving it to the courts or legislature to guide the fiduciary.<sup>54</sup>

The first option alone involves at least three different types of reasonable formulae: (a) the fiduciary must reimburse principal in accordance with *Warms*: income beneficiaries, or the fiduciary on their behalf, would pay the principal account the lesser of the amount by which the estate tax is increased or the amount by which the income tax is reduced; (b) the fiduciary must reimburse principal for the entire income tax reduction; or (c) the fiduciary can use option (a) and reimburse the principal account for a portion of the additional economic benefit to the income beneficiaries, perhaps splitting that benefit equally between income and principal.<sup>55</sup>

Requiring the adjustment under a formula is probably appropriate only when the draftsman anticipates relatively simple fiduciary income tax returns.<sup>56</sup> Many unanswered questions concerning these adjustments remain, however, and perhaps no such return may reasonably be considered simple; for instance, it is far from settled whether an adjustment to the principal account constitutes income (for income tax purposes) to principal beneficiaries.<sup>57</sup>

If discretionary adjustments are directed, the transferor should exculpate the fiduciary broadly from liability for any loss caused by the adjustment and should make clear that no beneficiary has the right to a particular adjustment. The

Georgia, *but see infra* at Appendix, n.28; Illinois, *but see infra* at Appendix, n.29; Kentucky; Massachusetts; Nevada, *but see infra* at Appendix, n.48; North Carolina, *but see infra* at Appendix, n.58; Oregon, *but see infra* at Appendix, n.68; Wyoming, *but see infra* at Appendix, n.80.

<sup>53</sup> Cf. *Dobris II*, *supra* note 2, at 284-90 (remissions implied in fact). *But see Dobris I*, *supra* note 1, at 125 (*Warms* was obvious situation for equitable adjustment); *Weigel & Trost*, *supra* note 2, at 132.

<sup>54</sup> *Metzer*, *supra* note 2, at 493.

<sup>55</sup> *Id.* at 488-89. *See also Dobris I*, *supra* note 1, at 143-48. According to Professor Dobris, only option (c) comes close to splitting equitably the economic benefit from the tax election among all beneficiaries—his theory for such an adjustment is that all beneficiaries have a *de facto* "property right" in the economic benefit and that principal beneficiaries, to be compensated fully for the loss of that benefit, should receive a portion of the benefit equal to the proportion that the economic or present value of their interests bears to the economic or present value of all beneficiaries' interests.

<sup>56</sup> *Weigel & Trost*, *supra* note 2, at 135.

<sup>57</sup> Cf. *Britenstool v. Commissioner*, 46 T.C. 711 (1966), *acq.*, Rev. Rul. 78-445, 1978-2 C.B. 242. Compare the discussion of possible income characterization of reimbursements to principal on account of trapping distributions in *Conway & Hale*, *After-Death Tax Planning—Payments and Distributions*, 302 TAX MGMT. PORTFOLIO (BNA) at A-18 (1976, supplemented through 1981—portfolio withdrawn for revision, November 16, 1981) with *Moore*, *Conflicting Interests 1975*, *supra* note 2, ¶ 1918.

problem with such exculpation is that a court may read it narrowly<sup>58</sup> or, conceivably, may view it as negating the fiduciary's duty to make any adjustment. A New York case, *In re Estate of LeCompte*,<sup>59</sup> supports the basic enforceability of such a broad discretionary power, so long as the circumstances show that "there [are] sound reasons" to give the fiduciary power to make an adjustment "for an equitable allocation of . . . taxes."<sup>60</sup> In that case, however, the question of exactly how to exercise such a discretionary power was not addressed.<sup>61</sup>

Prohibiting adjustment may be the simplest course of all. In light of possible economic distortion of the various beneficiaries' interests, however, this simple solution may result in frustration of the transferor's original dispositive intent.<sup>62</sup>

If the fiduciary is also a beneficiary, the election necessarily involves a conflict of interest.<sup>63</sup> Three possible ways to draft an instrument in view of this problem are as follows:

- a. Do not permit any beneficiary to be a fiduciary authorized to make the election. Perhaps the instrument should even bar a beneficiary from serving as a successor to such a fiduciary.<sup>64</sup>
- b. Specifically recognize the existence of the conflict and either abrogate for that purpose the fiduciary's general duty not to self-deal or give reasonable guidelines for such elections,<sup>65</sup> using language compatible with a grant of discretion to make adjustments.<sup>66</sup>
- c. Set out a rigid formula for such adjustments, denying the fiduciary any

<sup>58</sup> See A. SCOTT, *supra* note 7, §§ 222, 222.2 (strict construction of exculpatory provisions in trust instruments). Grants of "absolute" discretion also tend to be read narrowly, *see, e.g.*, Estate of Collins, 72 Cal.App.3d 663, 672-74 (1977); *see also* Metzger, *supra* note 2, at 493; Weigel & Trost, *supra* note 2, at 135. *See generally* G. BOGERT & G. BOGERT, *supra* note 3, § 94 (discussing exculpatory or immunity clauses).

<sup>59</sup> 52 Misc. 2d 549, 276 N.Y.S.2d 208 (Sur. Ct. N.Y. County 1966).

<sup>60</sup> *Id.* at 552, 276 N.Y.S.2d at 211-12.

<sup>61</sup> *Id.* at 552, 276 N.Y.S.2d at 212. *In re Will of Backus*, 106 Misc. 2d 463, 434 N.Y.S.2d 106 (Sur. Ct. Nassau County 1980), however, indicates that as long as there is "no abuse of discretion by the . . . fiduciary as afforded under the decedent's will," a discretionary adjustment will be approved. *Id.* at 467, 434 N.Y.S.2d at 108.

<sup>62</sup> *See* Weigel & Trost, *supra* note 2, at 130-35; *see also* Taggart, *Adjustments Required When Tax Elections Alter Interests Among Beneficiaries*, in POST MORTEM ESTATE PLANNING 219, 224-27 (P. Asofsky ed. 1981).

<sup>63</sup> Moore states:

Certainly whenever beneficiaries are also acting as fiduciaries, the instrument should either state that equitable adjustments should not be made or that they should be made. Any beneficiary who is also a fiduciary may well have a conflict of interest in deciding whether or not to make an adjustment. By making the adjustment he might benefit himself, or by failing to make the adjustment, he might benefit himself, and if nothing is said in the instrument, he is placed squarely in this unfortunate position—he should either be told to make adjustments or not to make adjustments.

Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1920. *See also id.* ¶ 1916.

<sup>64</sup> *Id.* ¶ 1920.

<sup>65</sup> *See, e.g.*, *In re Estate of Colp*, 175 N.Y.L.J. 8 (Sur. Ct. N.Y. County Jan. 20, 1976). *Cf. In re Fiedler's Estate*, 55 N.J. Super. 500, 151 A.2d 201 (App. Div. 1959). *See generally* Taggart, *supra* note 2, at 254.

<sup>66</sup> *See* Metzger, *supra* note 2, at 493.

discretion, and structure the adjustment so as not to benefit the fiduciary as an individual, in effect penalizing the beneficiary for his fiduciary status.<sup>67</sup>

When counselling a fiduciary, an attorney should consider advising him to obtain court instructions before exercising any discretion with respect to an adjustment. There is authority, however, that judicial intervention is only appropriate after the fiduciary has complied with the transferor's intent and already has made an adjustment decision.<sup>68</sup> After such an adjustment has or has not been made, nothing should bar the anxious fiduciary from filing an account with the court specifically describing the adjustment (or failure to adjust), thereby obtaining judicial approval of his decision.<sup>69</sup> This technique is particularly important for a beneficiary who is also the fiduciary.

### 5. *Special Difficulties with the Administration Expense and Casualty Loss Deduction Election*

a. *Adjustments Between Marital and Nonmarital Beneficiaries Because of Marital Deduction Formula Gifts.* At this point one adjustment problem relating to the administration expense and casualty loss election deserves special mention. Since 1948, a married person has been able to transfer to his spouse a certain amount of property free of federal estate or gift tax.<sup>70</sup> Section 2056<sup>71</sup> has permitted deduction from the gross estate of the following amounts of qualifying property: from 1948 through 1976, up to one-half of the adjusted gross estate;<sup>72</sup> from 1977 through 1981, the greater of \$250,000 or one-half of the adjusted gross estate, with certain adjustments for lifetime gifts to the spouse; and after 1981, an unlimited amount.<sup>73</sup> Clearly, the election to deduct administration expenses and casualty losses on the fiduciary income tax return or the estate tax

<sup>67</sup> Moore approves of this approach. Moore, *Conflicting Interests* 1975, *supra* note 2, ¶ 1920.

<sup>68</sup> *In re Will of Raible*, 177 N.Y.L.J. 14 (Sur. Ct. Nassau County May 10, 1977); *In re Estate of Colp*, 176 N.Y.L.J. 8 (Sur. Ct. N.Y. County January 20, 1976). See Moore, *Conflicting Interests* 1978, *supra* note 2, ¶ 605.3.

<sup>69</sup> Such approval can be obtained by the fiduciary as a matter of right once any fiduciary power has been exercised. See generally G. BOGERT & G. BOGERT, *supra* note 3, § 143; E. SCOLES & E. HALBACH, *supra* note 2, at 620-29.

<sup>70</sup> I.R.C. §§ 2056, 2523. See I.R.C. §§ 812(e), 1004(a)(3)(1939); See also Berall, *Marital Deduction Planning*, 2 NOTRE DAME EST. PLAN. INST. 183, 184-85 (1978)(brief history of marital deduction); Dobris II, *supra* note 2, at 290-95 (summary of transfer taxation of interspousal gifts).

<sup>71</sup> The 1939 Code predecessor of section 2056 (1954) was section 812(e).

<sup>72</sup> For the deduction amount from 1948 to 1976, see section 2056(c), as originally enacted, and its predecessor, I.R.C. § 812(e)(1)(h)(1939), as enacted by the Revenue Act of 1948, Pub. L. No. 471, § 361(a), 62 Stat. 110. The adjusted gross estate was computed by subtracting from the gross estate amounts deductible under sections 2053 and 2054. See I.R.C. § 2056(c)(2), prior to 1982. This portion of section 2056 (and the parallel portion of section 2523) was repealed by ERTA section 403, because the concept is superfluous if no limit is placed on the deduction for qualifying property "passing" to the surviving (or donee) spouse. ERTA, *supra* note 18, § 403.

<sup>73</sup> For the deduction amount from 1977 to 1981, see section 2056(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(a), 90 Stat. 1520, 1854. See generally Kurtz, *The Impact of the Revenue Act of 1978 and the 1976 Tax Reform Act on Estate Tax Marital Deduction Formulas*, 64 IOWA L. REV. 739 (1976). For the current, unlimited deduction amount, see ERTA, *supra* note 18, § 403(a). For the definitive explanation of section 403 of the Economic Recovery Tax Act of 1981, see the JOINT COMMITTEE ON TAXATION'S GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, published December 29, 1981 [hereinafter cited as GENERAL EXPLANATION].

return affects both marital and nonmarital gift beneficiaries when the size of the marital gift depends on the maximum marital deduction or the size of the estate after such deduction.<sup>74</sup> Sometimes referred to as the "swing" between the marital and nonmarital gifts,<sup>75</sup> under the current unlimited marital deduction, this shift could equal the full value of the income tax deductions taken. When there is an unlimited marital deduction gift and administration expenses are deducted on the income tax return, this shift can result in estate tax liability when there might otherwise be none.<sup>76</sup>

Surprisingly, no statutory response has required an adjustment.<sup>77</sup> The cases found discussing this question have not required adjustment, except for a New York case, *In re Estate of Levy*,<sup>78</sup> which was overruled to some extent by New

<sup>74</sup> The critical requirement under section 2056 is that amounts deducted actually "pass" to the surviving or donee spouse. See I.R.C. § 2056(c). Nowhere in the list contained in that subsection is there any mention of disbursements for administration expenses and the like. For general information on such formula gifts, see R. COVEY, *THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS* (2d ed. 1978); D. WESTFALL, *ESTATE PLANNING LAW AND TAXATION* ¶ 12.05 (1981); Dobris II, *supra* note 2, at 291.

<sup>75</sup> According to Professor Dobris, this term was first used in Bronston, *Elections and Discretions Under the Code: The Executor's Dilemma*, 35 *TAXES* 986, 988 (1957). Dobris II, *supra* note 2, at 294 n.143.

<sup>76</sup> This discussion is not necessarily predicated on the transferor using a *maximum* marital deduction formula gift. See generally I.R.C. §§ 2010, 2505. Spouses owning combined property exceeding, but less than double, the unified credit amount might make optimal use of the unified credit as follows: the credit amount might be given to a trustee, with only income and limited principal powers to the surviving spouse, and the remainder of the decedent's property might be given to the surviving spouse in a manner qualifying for the marital deduction. Other transferors might use a *maximum* marital deduction formula gift, with the proviso that its amount be reduced to the minimum necessary to produce no estate tax liability for the decedent spouse's estate. With either type of plan, the election to deduct administration expenses and casualty losses on the fiduciary income tax return could alter the amount going to the surviving spouse.

<sup>77</sup> The New York statute provides:

Unless otherwise expressly provided by a will under which a disposition is made to or for the benefit of the surviving spouse of a decedent which qualifies for an estate tax marital deduction under any tax law of the state of New York or of the United States and the amount or size of such disposition is defined by the will in terms of the maximum marital deduction allowable under such tax law:

(1) No adjustment shall be required to be made between such disposition and the other interests in the decedent's estate by reason of (A) any increase in the amount or size of such disposition resulting from any election by the fiduciary, under such tax laws, to treat estate administration expenses as income tax deductions over the amount or size of such disposition had the contrary election been made . . . .

N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(B)(McKinney Supp. 1982-83). See CONN. GEN. STAT. ANN. § 45-100e(35)(B)(West 1981 & Supp. 1982); MD. EST. & TRUSTS CODE ANN. § 11-106(b)(1974). The Maryland statute explicitly applies to gifts under nontestamentary "controlling instrument[s]." If incorporated by reference into the instrument, see *supra* notes 33-36 and accompanying text, the Connecticut statute provides that "the fiduciary . . . is not required to make adjustments between income or principal or between the property interests passing to any beneficiaries which may be affected on account of such election," except when "one or more residuary legatees . . . is a charitable organization" under I.R.C. section 501(c) and the election results in greater estate tax being paid.

<sup>78</sup> 9 Misc. 2d 561, 563-64, 167 N.Y.S.2d 16, 18-19 (Sur. Ct. N.Y. County 1957). *But see In re Veith's Estate*, 26 Fla. Supp. 145, 150 (Dade County Ct. 1965)(discussed *infra* text accompanying 80-81).

York's statutory formula and has been distinguished in several subsequent New York cases.<sup>79</sup> In the leading Florida case, *In re Veith's Estate*,<sup>80</sup> the court refused to require an adjustment, finding that a testator using a maximum marital deduction formula clause partially remits the duty of impartiality: "If this is inequitable, it is an inequity created by the testator himself."<sup>81</sup>

Thus, there is a relatively clear rule that no adjustment is required. Even so, the dispositive instrument probably should negate the duty to make the adjustment, perhaps by granting the fiduciary the broadest possible discretion to make the election or even by directing the fiduciary not to make the adjustment or election. There are three reasons for prohibiting adjustment: (1) if the adjustment is from nonmarital beneficiaries to the surviving spouse, the adjustment amount could be deemed to not have "passed" from the decedent and hence may not qualify for the marital deduction;<sup>82</sup> (2) assuming an adjustment from the surviving spouse, this may frustrate the intention of the decedent to transfer as much as possible to the surviving spouse;<sup>83</sup> and (3) authorizing the fiduciary to make the adjustment may unreasonably increase the complexity and expense of administration.<sup>84</sup> Given the lack of any current statutory or case law rule favoring the adjustment, using a surviving spouse (or interested nonmarital beneficiary) as fiduciary should not raise a self-dealing problem. Notwithstanding this lack and the probability that the surviving spouse will be the preferred fiduciary in most estate plans, the conservative draftsman might consider having someone else serve.

b. *No Implicit Direction to Maximize the Value of a Maximum Marital Deduction Formula Gift.* A related issue is whether the transferor's expressed intention that the surviving spouse receive the maximum marital deduction amount directs the fiduciary to take these deductions on the fiduciary income tax return (to increase the portion of the estate available to fund the formula gift).<sup>85</sup> Connecticut's statutory powers, if incorporated by reference into an instrument, and the New York and Maryland statutes specifically negate any such duty to maximize the spouse's gift.<sup>86</sup> No cases were found directly on point. Therefore, as was true for the marital

<sup>79</sup> E.g., *In re McTarnahan's Estate*, 27 Misc. 2d 13, 14-15, 202 N.Y.S.2d 618, 619-20 (Sur. Ct. N.Y. County 1960); *In re Estate of Inman*, 22 Misc. 2d 573, 577, 196 N.Y.S.2d 369, 373 (Sur. Ct. N.Y. County 1959).

<sup>80</sup> 26 Fla. Supp. 145, 150 (Dade County Ct. 1965).

<sup>81</sup> *Id.* at 150. See Dobris II, *supra* note 2, at 300.

<sup>82</sup> Compare First Trust Co. of St. Paul v. United States, 402 F. Supp. 778 (D. Minn. 1975) with Empire Trust Co. v. United States, 226 F. Supp. 623, 627-29 (S.D.N.Y. 1963). See generally Taggart, *supra* note 62, at 228-30.

<sup>83</sup> See Dobris II, *supra* note 2, at 302; *id.* at 284-86 (equitable adjustment not required when will implies setting aside of impartiality duty); see also Moore, *Conflicting Interests 1975*, *supra* note 2, ¶¶ 1902, 1920.

<sup>84</sup> If the fiduciary is to have discretion as to whether to make the adjustment, the planner or draftsman theoretically must present the transferor with a whole range of administration expense and casualty loss figures, which might not be deducted on the fiduciary income tax return and thereby might reduce the amount of property available to fund the marital share. See generally Dobris II, *supra* note 2, at 302, 330-32.

<sup>85</sup> See generally Dobris II, *supra* note 2, at 301.

<sup>86</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(B)(West 1981 & Supp. 1982); MD. EST. & TRUSTS CODE ANN. § 11-106(c)(1974); N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(B)(2)(McKinney 1969 and Supp. 1982-83).

deduction formula gift problem discussed above, to maximize flexibility in post-mortem planning the dispositive instrument probably should explicitly remove any such implied duty.

c. *No Warms Adjustment for Administration Expenses Used to Offset Income in Respect of a Decedent* ("IRD"). A 1980 New York case, *In re Will of Backus*,<sup>87</sup> discussed whether a *Warms* adjustment is appropriate for administration expenses deducted on an income tax return to the extent that they offset IRD.<sup>88</sup> Because both estate tax and income tax on IRD are almost always paid out of principal, deduction of these expenses probably will not harm principal beneficiaries.<sup>89</sup> Also, the *Backus* court observed that "the amounts involved in IRD [usually] are relatively insignificant and in all likelihood [such] problems go unrecognized except by corporate fiduciaries and experienced estate practitioners."<sup>90</sup>

When large amounts of IRD are expected and the instrument or local law provides a formula or discretionary power to make a *Warms* adjustment, it probably is appropriate to follow *Backus* and to exclude IRD specifically when calculating the adjustment.<sup>91</sup> *Backus* indirectly supports any fiduciary who makes less than the maximum *Warms* adjustment when, depending on the particular circumstances involved, taking administration expenses or casualty losses on the fiduciary income tax return produces offsetting economic benefits for the principal beneficiaries.

## B. Deduction of Principal Expenses on the Fiduciary Income Tax Return, Resulting in Capital Gains Taxation of Principal Beneficiaries

### 1. Tax Law Sources of the Procedure and Adjustment

Section 643(a) defines distributable net income ("DNI") as including all "taxable income of the estate or trust, computed with [certain] modifications."<sup>92</sup>

<sup>87</sup> 106 Misc. 2d 463, 434 N.Y.S.2d 106 (Sur. Ct. Nassau County 1980).

<sup>88</sup> See Regs. § 1.691(a)-1(b)(definition of income in respect of a decedent); see also Regs. § 1.691(a)-2(a)(inclusion of income in respect of a decedent in gross income by recipients). Hereinafter, income in respect of a decedent will be referred to as "IRD."

<sup>89</sup> See REV. UNIF. PRINCIPAL & INCOME ACT, *supra* note 9, § 13(c)(4); see also Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1902.

<sup>90</sup> 106 Misc. 2d at 465-66, 434 N.Y.S.2d at 107.

<sup>91</sup> *Id.* at 467, 434 N.Y.S.2d at 108. See Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1902.

<sup>92</sup> Distributable net income as defined in I.R.C. section 643(a) will be referred to hereinafter as "DNI." See Regs. § 1.643(a)-0. Professor Boris I. Bittker characterized DNI best: "Because of [its] allocative function, DNI has been called 'the pie to be cut for tax purposes'—though no beneficiary will want a second helping." 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 81.3.1 (1981), quoting M. FERGUSON, J. FREELAND & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES ix (1970) [hereinafter cited as M. FERGUSON]. See also Regs. § 1.643(b)-1 (definition of "income" used with respect to DNI). I.R.C. § 643(d)(regarding interest and dividend withholding credits and DNI) was added by TEFRA, *supra* note 23, § 301(b), H.R. REP. NO. 4961, 97th Cong., 2d Sess., 128 CONG. REC. H6239 (daily ed. Aug. 17, 1982). Note that income excluded from gross income under section 103 is added back into DNI. Regs. § 1.643(a)-5. See generally Report of Committee on Income Taxation of Estates and Trusts, *Income Tax Opportunities and Pitfalls in Estate Distributions (Part I)*, 13 REAL PROP. PROB. & TR. J. 854, 855-56 (1978) [hereinafter cited as *Estates and Trusts Income Tax Committee*].



Among these modifications is an exclusion for capital gains allocated to principal and not actually distributed, required to be distributed or permanently set aside for charity.<sup>93</sup> Under section 641(b), this “taxable income . . . shall be computed [generally] in the same manner as for an individual.”<sup>94</sup> Thus, deductions of administration expenses payable from principal reduce DNI, even if paid from principal,<sup>95</sup> and even in tax years when there is no income allocable to principal.<sup>96</sup> When capital gains or other income allocable to principal are recognized, these deductions are still first used to reduce DNI (that is, income *not* allocable to principal), thereby reducing the tax burden of income beneficiaries and increasing that of principal beneficiaries.<sup>97</sup> Therefore, these deductions only reduce income allocable to principal when they exceed DNI.<sup>98</sup> This use of principal expenditures to reduce DNI does not involve a fiduciary election but instead involves an *automatic* diversion of economic benefit to the income beneficiaries. For this reason alone, some commentators have suggested that equitable adjustment to compensate principal beneficiaries is neither necessary nor appropriate.<sup>99</sup>

## 2. Statutory Responses

No statute tries to remedy this diversion of economic benefit to the income beneficiaries. Indeed, conventional principal and income allocation rules require it.<sup>100</sup>

## 3. Judicial Responses

Courts in Pennsylvania, New York, Florida, and Massachusetts have faced this problem, with conflicting results.

a. *Pennsylvania.* In an Orphans' Court case, *In re Rice's Estate*,<sup>101</sup> the court ordered an adjustment when the principal beneficiaries of a testamentary trust were forced to pay capital gains tax even though, in the relevant taxable year, the total of the capital gains deduction and deductible principal disbursements exceeded the amount of the gain<sup>102</sup> and the income beneficiaries had paid less

<sup>93</sup> Regs. § 1.643(a)-3.

<sup>94</sup> I.R.C. § 641(b). See also Regs. § 1.643(a)-1.

<sup>95</sup> See Regs. § 1.643(d)-2 (example of how administration expenses reduce DNI).

<sup>96</sup> See B. BITTKER, *supra* note 92, ¶ 81.3.2; M. FERGUSON, *supra* note 92, at 395-97, 403-04; Conway & Hale, *supra* note 57, at A-3 to A-4, A-6, A-15 to A-16; see also *In re Rice's Estate*, 8 Pa. D. & C.2d 379, 414-15 (Orphans' Ct. 1956).

<sup>97</sup> Dobris I, *supra* note 1, at 118-20; Dobris II, *supra* note 2, at 321-22.

<sup>98</sup> See Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1907.

<sup>99</sup> E.g., Weigel & Trost, *supra* note 2, at 133-34. See *In re Will of Backus*, 106 Misc. 2d 463, 434 N.Y.S.2d 106, 108 (Sur. Ct. Nassau County 1980).

<sup>100</sup> E.g., REV. UNIF. INCOME & PRINCIPAL ACT, *supra* note 9, §§ 5, 13 (1962). These sections, however, might be ignored pursuant to section 2(a)(3) of the Act. *But see infra* notes 105-08 and accompanying text; *infra* note 117.

<sup>101</sup> 8 Pa. D. & C.2d 379 (1956).

<sup>102</sup> *Id.* at 416. In *Rice*, a testamentary trust realized \$402,000 in capital gains; during the relevant fiscal year, \$202,000 in deductible attorneys' fees were charged to principal. *Id.* at 412. The then current capital gains deduction was 50%. *Id.* Thus, if the remaining \$201,000 in income could have been offset by the deductible principal charges of \$202,000, the principal account would have borne no income tax burden in that year. *Id.*

tax because DNI had been reduced by the amount of those principal expenditures.<sup>103</sup>

To support the adjustment, the Orphans' Court cited *Warm's* as "precedent, at least by close analogy."<sup>104</sup> The *Rice* court found that the operation of the tax laws had been inequitable and ordered an adjustment, disregarding the absence of any fiduciary choice as to whether principal expenditures would reduce DNI.

b. *New York*. The Surrogate's Court in *In re Estate of Dick*<sup>105</sup> refused to order an adjustment when a New York testamentary trustee, presumably trying to follow *Warm's* by analogy, charged the income account in the manner approved in *Rice*.<sup>106</sup> The New York Surrogate's Court agreed with the Pennsylvania Orphans' Court that the "inequities created by the tax statute, as between income and principal interests in a trust, are apparent" and agreed with the fiduciary that *Rice* supported his position.<sup>107</sup> Surrogate Cox did not agree that *Warm's* justified the adjustment:

[The *Warm's* decision] involved the exercise by an estate fiduciary of a statutory option . . . . In the case at bar the trustee was not granted an option by the . . . . statute. That statute permitted only one method of computing the tax and this court [does not have] the authority to alter the impact of the tax statute.<sup>108</sup>

c. *Florida*. The court in *In re Kent's Estate*,<sup>109</sup> citing *Dick* as authority, refused to order an adjustment because the fiduciary had no choice.<sup>110</sup>

d. *Massachusetts*. In *New England Merchants National Bank v. Converse*,<sup>111</sup> the Massachusetts Supreme Judicial Court refused an adjustment under similar facts, but for somewhat different reasons from those given by the New York and Florida courts. The court held that the adjustment was not "practical."<sup>112</sup> It cited the absence of significant uniform practice among Massachusetts fi-

<sup>103</sup> Judge Taxis held as follows:

Whether by accident or design, the result is that, even when there are capital gains, the trust [principal] loses the benefit of the deduction for expenses charged to principal and the benefit of that deduction is given to income by statutory fiat. . . .

The basic design seems to have been to prevent expenses charged to principal from going to waste. This portion of the change would have made sense, but why a principal expense should be given to income as an income tax deduction, when the trust [principal] could have used it, seems at least odd if not plainly inequitable.

*Id.* at 412-13.

<sup>104</sup> *Id.* at 414. Indeed, Judge Taxis used a *Warm's* formula: "In such a situation, I take the view that income should reimburse principal for the amount of tax which the trust [principal] was obliged to pay . . . ." *Id.* at 413.

<sup>105</sup> 29 Misc. 2d at 648, 218 N.Y.S.2d 182 (Sur. Ct. N.Y. County 1961).

<sup>106</sup> *Id.* at 650, 218 N.Y.S.2d at 184.

<sup>107</sup> *Id.* at 649, 218 N.Y.S.2d at 184.

<sup>108</sup> *Id.* at 650, 218 N.Y.S.2d at 184-85 (emphasis added). Surrogate Cox discussed at length the analogous situation posed by estate tax apportionment statutes and reviewed New York precedent barring its judges from varying from those statutory requirements. *Id.* at 650, 218 N.Y.S.2d at 185.

<sup>109</sup> 23 Fla. Supp. 133, 136 (Palm Beach County Ct. 1964).

<sup>110</sup> *Id.*

<sup>111</sup> 373 Mass. 639, 369 N.E.2d 982 (1977).

<sup>112</sup> *Id.* at 640-41, 369 N.E.2d at 983.

duciaries to make the adjustment.<sup>113</sup> The court looked to the potentially numerous trusts and estates for which no adjustments had yet been made and for which accounts might have to be reopened and “catch up” adjustments made, reducing current income distributions.<sup>114</sup> It wondered whether such adjustments would be reasonable for small estates and trusts.<sup>115</sup> Finally, the court supposed that when “large sums” were governed by dispositive instruments “drawn after 1954,” there “no doubt commonly” had been included “provision for the problem here presented.”<sup>116</sup>

Thus, *Rice* supports adjustment, regardless of whether any *election* is involved, because the federal tax law is sometimes unfair to principal beneficiaries; *Dick* and *Kent* oppose adjustment because no election is involved and the fiduciary’s duties to be impartial and not to self-deal are irrelevant;<sup>117</sup> and *Converse* opposes the adjustment because, this long after 1954, it simply is not practical.

#### 4. Drafting Solutions

Because substantial changes to the DNI system are unlikely,<sup>118</sup> draftsmen should consider providing for reimbursement to principal from income. The difficult question is what system to use.<sup>119</sup> One reasonable method would be to

<sup>113</sup> *Id.* at 643, 369 N.E.2d at 984.

<sup>114</sup> *Id.* The court also was concerned that, if its holdings were not applied retroactively, the diversity of principal and income allocation rules would complicate settlement of accounts. *Id.* at 643-44, 369 N.E.2d at 984.

<sup>115</sup> *Id.* at 644, 369 N.E.2d at 985.

<sup>116</sup> *Id.*

<sup>117</sup> Professor Dobris has concluded:

The *Dick* opinion is wrong; principal should be reimbursed for the lost use of the deduction. Requiring an adjustment [also] is the proper course of action . . . when the allocation of benefits and burdens of mandatory action is unjust under standard allocation rules. . . .

[One] approach might be to regard *Dick* as a case that confirms the general proposition that no adjustment will be decreed when the fiduciary has no discretion, because it is the presence of discretion that requires impartiality and leads to the adjustment. This . . . assumes that a discretionary power is a prerequisite to an adjustment. [This assumption] may be invalid. . . . If discretion is not required, as seems to be the case, *Dick* is simply wrong.

Dobris I, *supra* note 1, at 141-42. See also Dobris II, *supra* note 2, at 321-23. It seems a misuse of a court’s equity powers to adjust for fiduciary actions when no other economic outcome is possible given the federal tax laws and the authorizing dispositive instrument. For example, Weigel & Trost state:

To require compensating adjustment in the context of non-elective tax provisions must be considered an administrative Pandora’s Box, however appealing as a matter of equity. . . . While some courts have recognized the implications of such requirements, not all have shown an awareness that the theory of fiduciary fairness which underlies the decisions in *Warms* and *Bixby* is inapplicable in most instances of non-elective tax provisions.

Weigel & Trost, *supra* note 2, at 134.

<sup>118</sup> *But see* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER J (Tent. Draft No. 9 1982).

<sup>119</sup> National practice provides no answers. See ACPC chart, *infra* at Appendix, questions 2.a. and 2.b. According to the chart, no jurisdiction’s law directly requires the adjustment, and only in Nevada is it common practice to make it. *But see* Louisiana practice, *infra* at Appendix n.37 (such principal charges should not be made against income without approval of the income beneficiary).

reimburse principal in an amount equal to income tax charged to principal times a fraction, the denominator of which is the total taxable income for that year and the numerator of which is net income attributable to principal (i.e., capital gains, IRD, and other such income minus deductions taken on the fiduciary income tax return that were paid from principal). Given the problems with exculpating fiduciaries,<sup>120</sup> a discretionary power to adjust probably should not be used. But except when large amounts of capital gain and substantial inequities are involved, this adjustment probably should be prohibited expressly in the instrument. Such a prohibition may not be necessary in New York and Florida, in light of their case law.<sup>121</sup> Because no fiduciary discretion is involved, there should be no problem in designating a beneficiary as fiduciary.

### C. *Trapping Distributions Resulting in Principal Beneficiaries Bearing Income Tax Burdens*

#### 1. *Tax Law Sources of the Election and Adjustment*

Another apparently unfair allocation of income tax liability arises in connection with so-called "trapping distributions."<sup>122</sup> These are distributions from the principal of an estate or distributor trust to a distributee trust, made to split taxable income between the two entities.<sup>123</sup> This can only occur when a distribution carries out DNI to the distributee trust (e.g., when an executor funds a residuary trust in two or more taxable years) and the distributee trust does not distribute all of its DNI to its beneficiaries during its taxable year.<sup>124</sup> Complete or partial distribution of a specific bequest under section 663(a)(1) does not carry out DNI and therefore cannot be used to make a trapping distribution.<sup>125</sup> Under conven-

<sup>120</sup> See *supra* notes 58-61 and accompanying text.

<sup>121</sup> See *supra* notes 105-10 and accompanying text.

<sup>122</sup> See generally Cohan & Frimmer, *Trapping Distributions: The Trap That Pays*, 112 TR. & EST. 766 (1973); Cornfeld, *supra* note 11, ¶¶ 1401, 1401.1 and 1401.2; *Estates and Trusts Income Tax Committee, supra* note 92, at 868-71; J. PRICE, *supra* note 2, § 12.34.

<sup>123</sup> "These distributions are called 'trapping distributions' because the estate's DNI carried out by its distribution is 'trapped' as principal in the trust. With proper timing the use of trapping distributions . . . permits considerable deferral of tax." *Estates and Trusts Income Tax Committee, supra* note 92, at 868.

<sup>124</sup> The basic procedure involved here is the inclusion of distributed amounts in distributees' gross income. Regarding such inclusion for beneficiaries of "simple" trusts, which are required to distribute current income and only distribute current income in the relevant taxable year, see section 652 and Regulations section 1.652(a)-1. For inclusion of distributions to beneficiaries of estates and of complex trusts, which may or may not accumulate income, but which do distribute principal in the relevant taxable year, see section 662 and Regulations sections 1.662(a)-1, 1.662(a)-2, and 1.662(a)-3.

<sup>125</sup> Section 663(a)(1) provides:

Any amount which . . . is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments [shall not be included as an amount falling within the scope of section 661(a) or 662(a)].

The second sentence of section 663(a)(1) states that a distribution of a specific amount of income from a "simple" trust (i.e., one to which section 651(a) applies) *can* carry out DNI and be used to make a trapping distribution. Regulations section 1.663(a)-1(b)(1) provides:

tional principal and income allocation rules, if the estate or distributor trust distributes principal, it remains principal in the distributee trust.<sup>126</sup> The estate or distributor trust, however, still receives a distribution deduction under section 651 or section 661 equal to the amount of DNI carried out to the distributee trust.<sup>127</sup> Assuming that the distributee trust does not make distributions during its taxable year from other sources in excess of its DNI, it must pay income tax on a portion of the estate's or distributor trust's DNI, presumably from its newly augmented principal account.<sup>128</sup> Thus, (a) two entities share the income tax liability on the estate's or distributor trust's DNI, (b) the personal representative or distributing trustee can fund the distributee trust with a smaller economic value than if the estate or distributor trust had been required to bear the income tax liability on all of its own DNI, and (c) the principal of the distributee trust may be substantially less after the tax payment than the principal beneficiaries may otherwise have expected.<sup>129</sup>

The fiduciary minimizing income taxation of an estate or distributor trust often funds distributee trusts with a series of principal distributions, in several taxable years, to equalize the highest marginal tax rates paid by the estate or distributor trust and the distributee trust or trusts each year. In addition, if trust accounting income also is distributed to the distributee trust, its trustee can make income distributions carrying out DNI to its beneficiaries and thereby equalize highest marginal tax rates among the estate or distributor trust, the distributee trust and

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In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. . . . [A] bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property.

<sup>126</sup> E.g., REV. UNIF. PRINCIPAL & INCOME ACT, *supra* note 9, §§ 5(a), 13(c).

<sup>127</sup> See sections 651, 661, and the regulations thereunder.

<sup>128</sup> Note, however, that if beneficiaries receive distributions of such principal in subsequent taxable years, they might be liable to an additional amount of income tax under the "throwback" rules. See generally Cornfeld, *supra* note 11, ¶ 1400.6; I.R.C. §§ 665-668 and the regulations thereunder. The amount of such additional taxation approximates the difference between the amount that would have been paid by the beneficiary had he received the accumulation distribution in the year in which it was originally received by the trust, minus any income tax already paid by the trust attributable to the accumulation distribution. See generally Regs. § 1.665(a)-OA. This approximation involves a complex averaging system. See I.R.C. § 667(b); J. PRICE, *supra* note 2, § 10.2. This "throwback" tax only is imposed on accumulation distributions as defined in Regulations section 1.665(b)-1A. Such distributions do not include those of "income accumulated before the birth of [a] beneficiary or before [a] beneficiary attains the age of 21." I.R.C. § 665(b). Distributions to simple trusts from an estate or another trust that may be characterized as "outside income" (within the meaning of Regulations section § 1.665(e)-1A(b)) result in throwback taxation; "outside income" includes IRD, unrealized accounts receivable assigned to the simple trust and "distributions from another trust that include distributable net income or undistributed net income of such other trust" but *excludes* all other distributions if they are *from an estate*. Regs. § 1.665(e)-1A(b)(3).

<sup>129</sup> Professor Dobris gives a good example of how such a distribution not only traps estate or distributor trust income in the distributee trust, but also traps the principal beneficiaries of the latter trust into paying additional income tax. See Dobris 1, *supra* note 1, at 128.

the distributee trust beneficiaries.<sup>130</sup> Such marginal tax rate equalization is the same basic strategy involved in planning where to take administration expense and casualty loss deductions. The unfairness to distributee trust principal beneficiaries also is similar, for another group of beneficiaries pays less income tax while they pay more. Even though income tax payment by the distributee trust is often deferred, because its taxable year ends before that of the estate or distributor trust and distribution is made after the distributee trust's year ends, its principal beneficiaries eventually may bear a disproportionately large share of the income tax burden.

## 2. Statutory Responses

No statutes discussing the election were found.

## 3. Judicial Responses

Although only one significant case has been decided in this area, it probably has caused adjustments for principal beneficiaries in many situations. In *In re Holloway's Estate*,<sup>131</sup> the New York Surrogate's Court recognized that trapping distributions long have been an important tax minimization technique of the "sophisticated fiduciary," but concluded that they nonetheless cause unfair allocation of income tax liability.<sup>132</sup> Surrogate Bennett held that the *Dick* decision was inapposite because it had involved no true fiduciary election,<sup>133</sup> but held that the decision partially to fund the trust with principal could be an *election* breaching the fiduciary duties to be impartial and not to self-deal:

[A] realistic view of this problem requires the determination based upon the purely equitable principle that the burden of income taxes should be charged to the account into which the tax item goes. . . . Here the distribution resulting in taxes for which an adjustment is sought was in fact corpus or principal. Such distribution was only 'deemed' income by the taxing authorities. The tax in fact is attributable to receipt by the estate of income for accounting purposes. While the Code provisions may fly in the face of reality, there is no reason for a court concerned with the proper administration of estates to follow suit.<sup>134</sup>

Thus, Surrogate Bennett took an approach similar to that taken by the Pennsylvania court in *Rice*.<sup>135</sup> The language of *Holloway* and *Rice* supports the broader proposition that, even when nonelective tax procedures alter beneficial interests, a state court can override statutory principal and income allocation rules and order an adjustment.

<sup>130</sup> See Cornfeld, *supra* note 11, ¶¶ 1400.4, 1401.1, 1401.2; *Estates and Trusts Income Tax Committee*, *supra* note 92, at 865-68.

<sup>131</sup> 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. Nassau County 1965).

<sup>132</sup> *Id.* at 362, 327 N.Y.S.2d at 866. In this regard, the court noted that the Code can be "a serious tax trap for the unwary." *Id.*

<sup>133</sup> *Id.* at 364, 327 N.Y.S.2d at 867. See *supra* notes 105-08 and accompanying text.

<sup>134</sup> *Id.* at 365, 327 N.Y.S.2d at 869.

<sup>135</sup> See *supra* notes 101-04 and accompanying text.

#### 4. Drafting Solutions

The *Holloway* adjustment has been referred to as so obviously equitable that "it is a common practice" for trustees to make it.<sup>136</sup> The ACPC study, however, shows no such "common practice."<sup>137</sup> Although some commentators advocate routinely drafting to require the adjustment,<sup>138</sup> a more moderate approach is indicated:

a. *Formula Direction*. It usually is difficult, if not impossible, to reconstruct the income tax situation of the estate or distributor trust to the extent necessary to calculate the exact amount of tax eventually borne by the principal beneficiaries of the distributee trust (particularly with residuary distributions). Often untaxed DNI is added to the estate or distributor trust's principal account and later distributed to the distributee trust, compensating the latter trust's principal beneficiaries at least in part for earlier principal reductions. Further, as noted above, their income tax might not become due and payable for many months (if the distributee trust has a different taxable year).<sup>139</sup>

Thus, when the draftsman wishes to permit the fiduciary to adjust accounts, he should provide a particular formula for the fiduciary, so that not all of these factors need be considered. Additionally, there are at least two reasonable methods of reimbursement: (1) the income account of the estate or distributor trust could immediately reimburse the distributee trust principal account, or (2) the distributee trust income account could reimburse the distributee trust principal account over a period of several years.<sup>140</sup> Either method will involve additional inequities if the current income beneficiaries of the estate or distributor trust are different from those of the distributee trust.<sup>141</sup> Such reimbursements may constitute income to the principal beneficiaries or to the trustee, and such liability probably should be taken into account when drafting the formula.

b. *Discretionary Direction*. Given the formula's lack of flexibility, a simple

<sup>136</sup> E.g., Cornfeld, *supra* note 11, ¶ 1405; see also Conway & Hale, *supra* note 57, at A-19.

<sup>137</sup> See ACPC chart, *infra* at Appendix, questions 3.a and 3.b. Only in New York is the adjustment required. In six other states (Colorado, Connecticut, Maryland, Nevada, Oregon and Rhode Island) it is common practice to make the adjustment.

<sup>138</sup> E.g., Conway & Hale, *supra* note 57, at A-19; see also Cornfeld, *supra* note 11, ¶ 1405.

<sup>139</sup> See *infra* notes 215-21 and accompanying text (discussion of fiduciary selection of a taxable year); I.R.C. §§ 441(b), 443(a)(2); *Estates and Trusts Income Tax Committee*, *supra* note 92, at 856-58. The committee states: "With proper timing the use of trapping distributions permits . . . considerable deferral of tax." *Id.* at 868.

<sup>140</sup> See Conway & Hale, *supra* note 57, at A-19; see also Cohan & Frimmer, *supra* note 122, at 768-69; Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1920.

<sup>141</sup> Cornfeld states:

[I]n many, if not most, cases where the tax is shifted in order to achieve overall tax savings, the income and remainder beneficiaries will be friendly and have common interests. . . . [I]n [such] cases . . . an equitable adjustment [can] have favorable estate planning consequences. The adjustment will serve to deplete the assets of the income beneficiary who in most cases will be in a generation older than the remainderman. Thus, the remainderman will ultimately receive the amount of the adjustment without imposition of another estate tax.

Cornfeld, *supra* note 11, ¶ 1405.

discretionary power to make adjustments sometimes is more sensible.<sup>142</sup> New York case law supports the basic power of the fiduciary to "apportion between capital and income [such] money paid for . . . taxes."<sup>143</sup> There is no precedent from New York or elsewhere, however, considering a challenge to any "actual method of apportionment or the mathematics of the apportionment."<sup>144</sup> Thus, the fiduciary still may have to argue in support of the reasonableness of a particular adjustment, making broad exculpation a necessity.<sup>145</sup> Finally, whenever a beneficiary affected by such a discretionary adjustment serves as fiduciary, the issue of self-dealing arises, possibly forcing the fiduciary to elect automatically against his own best interests.<sup>146</sup>

c. *Prohibition of Adjustment.* Due to the complexity of such planning,<sup>147</sup> the transferor reasonably may decide to bar all such adjustments, notwithstanding the resulting inequity. Transferors who want to favor beneficiaries other than the principal beneficiaries of the distributee trust should explicitly authorize the fiduciary to sacrifice their interests to minimize income taxes and thereby benefit other beneficiaries. Other transferors will bar adjustment because administration of a complicated formula is costly for all beneficiaries, particularly principal beneficiaries ordinarily bearing such administration expenses.

<sup>142</sup> See Barton, *supra* note 11, ¶ 902.1 (general approaches to drafting such clauses).

<sup>143</sup> See *supra* notes 59-61 and accompanying text (discussion of New York case *In re Estate of LeCompte*).

<sup>144</sup> *In re Estate of LeCompte*, 52 Misc. 2d 549, 552, 276 N.Y.S.2d 208, 212 (Sur. Ct. N.Y. County 1966).

<sup>145</sup> See *supra* note 58 and accompanying text (grants of absolute discretion tend to be read narrowly).

<sup>146</sup> See *supra* notes 63-67 and accompanying text (conflict of interest for beneficiary who is also fiduciary).

<sup>147</sup> On planning complexity, Cornfeld states:

The making of equitable adjustments may have further tax consequences by creating a further trapping of income. Unfortunately (or fortunately depending on one's point of view), the tax consequences of such a trapping resulting from an equitable adjustment are not entirely clear. For example, assume a residuary trust otherwise qualifying as a simple trust, receives a trapping distribution in 1980, resulting in an income tax of \$5,000 payable April 15, 1981. If the trustee withholds \$5,000 of 1981 income adding same to corpus as an equitable adjustment, the following possible arguments could be made: First, it could be argued that the withholding constituted a constructive distribution to the income beneficiary as a payment of a liability of such income beneficiary to the corpus of the trust. Second, it could be argued that the amount of the adjustment constituted income which was not "required to be distributed currently" under the terms of the governing instrument and local law for purposes of I.R.C. section 651 or section 652 . . . . Under this theory, the trust would become a complex trust for the year 1981 (and each subsequent year in which an equitable adjustment would be required). Finally, it could be argued that the requirement of the equitable adjustment affects the determination of what constitutes "income" under local law and the governing instrument. Under this theory, the trust would remain a simple trust with permanent tax saving with respect to the income trapped by the adjustment.

Cornfeld, *supra* note 11, ¶ 1405. Each approach produces a dramatically different postmortem income tax planning result. The least expensive way to deal with such complexity might be to prevent it from arising in the first place. See also *supra* note 57.



D. *Election to Deduct Depreciation on the Fiduciary Income Tax Return, Reducing Income Beneficiaries' and Increasing Principal Beneficiaries' Income Tax Burdens*

1. *Tax Law Sources of the Election and Adjustment*

As noted above, in the absence of an explicit direction to the contrary in the dispositive instrument, income beneficiaries of an estate or trust are liable for any income tax on DNI received by them.<sup>148</sup> The total amount of DNI available for distribution in any tax year is in turn determined under sections 641(b) and 643(a), taking into account deductions of the estate or trust.<sup>149</sup> In general, an estate or trust may deduct otherwise allowable depreciation as long as beneficiaries do not deduct it.<sup>150</sup> Under section 167(h), the personal representative or trustee and the beneficiaries must allocate the depreciation deduction "on the basis of the income . . . allocable to each," but this allocation may be varied for trustees and trust beneficiaries "in accordance with the pertinent provisions of the instrument creating the trust."<sup>151</sup> Thus, assuming that the income beneficiaries receive all income and that conventional principal and income allocation rules apply, section 167(h) could result in depreciation reducing only the income beneficiaries' income tax liability, leaving the principal beneficiaries to pay income tax on later transactions involving depreciated property in which gain is recognized or depreciation is recaptured.<sup>152</sup> This problem can be referred to as a "nonelective procedure" because the section 167(h) allocation is as automatic as, for example, DNI reduction by deductible principal expenses.<sup>153</sup> To the extent that the method of depreciation can be selected and the fiduciary can depart from customary principal and income allocation rules, however, this "procedure" is more similar to the sort of "election" discussed in the immediately preceding section.<sup>154</sup>

2. *Statutory Responses*

No statutes directly address this potentially unfair allocation of economic benefit to income beneficiaries. Note, however, the discussion below of discretionary reallocation of principal and income when "reasonable and equitable"

<sup>148</sup> See generally *supra* note 124.

<sup>149</sup> See *supra* note 92 and accompanying text (definition of DNI).

<sup>150</sup> I.R.C. § 642(e); see also Regs. § 1.642(e)-1.

<sup>151</sup> I.R.C. § 167(h). Regulations section 1.167(h)-1(b) provides:

**Trusts.** . . . [T]he allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, *unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount.* In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve . . . .

(Emphasis added.)

<sup>152</sup> *Id.*; I.R.C. §§ 1245, 1250; Conway and Hale, *supra* note 57, at A-12.

<sup>153</sup> See *supra* notes 97-99 and accompanying text.

<sup>154</sup> See *supra* text accompanying notes 130-35.

under, for instance, section 2 of the Revised Uniform Principal and Income Act.<sup>155</sup>

### 3. *Judicial Responses*

Research has disclosed only one court that has addressed this issue directly, the New York Surrogate's Court, in *In re Will of Pross*.<sup>156</sup> In that case, a testamentary trustee had taken large depreciation deductions for a "tax shelter" limited partnership interest during a five-year period, causing the income beneficiary to have no income tax liability for those years.<sup>157</sup> When the limited partnership defaulted on certain debts and its secured creditors foreclosed, the trustee recognized over \$21,000 of capital gain (because the partnership interest's basis had been reduced by this amount in the prior five years).<sup>158</sup> Conventional principal and income allocation rules required the principal to pay the capital gains tax, even though it had received no benefit from the depreciation.<sup>159</sup> Surrogate Brewster, citing *In re Holloway's Estate*,<sup>160</sup> refused to allow this result:

If the trustees set aside the amount deducted for depreciation to preserve principal in fulfillment of their duty, the reserve would be wholly applicable to principal and the source of the capital gain. However, in this case, there was no reserve. The capital gain is nothing more than a paper entry which has come about by reason of the depreciation deduction having reduced the base [sic] of the property below the amount realized upon the foreclosure. There was no addition to, appreciation of or replacement for the trust principal. . . . To the extent that the income beneficiary received the benefits of the deduction for depreciation without any concomitant benefit to trust principal, equity requires that the charge for the capital gains tax be placed on the person receiving the capital gain.<sup>161</sup>

Surrogate Brewster concluded that, under section 2(a)(3) of New York's version of the Revised Uniform Principal and Income Act, the fiduciary had been free to do whatever would have been "reasonable and equitable . . . in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs."<sup>162</sup> While *Pross* has been referred to as authority for equitable adjustment even when the fiduciary has no discretion,<sup>163</sup> it did involve an election not to establish a depreciation reserve and probably should therefore be considered distinct from the *Rice-Dick-Converse* line of cases.<sup>164</sup>

<sup>155</sup> REV. UNIF. PRINCIPAL & INCOME ACT, *supra* note 9, § 2.

<sup>156</sup> 90 Misc. 2d 895, 396 N.Y.S.2d 309 (Westchester County Sur. Ct. 1977).

<sup>157</sup> *Id.* at 896-98, 396 N.Y.S.2d at 309-10.

<sup>158</sup> *Id.* at 897, 396 N.Y.S.2d at 310. This amount of capital gain was recognized because the partnership interest's basis had been reduced by distributions in the prior five years. The recognition effect could as readily have been produced by sale of such a depreciated asset by the trustee.

<sup>159</sup> *Id.* at 897-98, 396 N.Y.S.2d at 310-11.

<sup>160</sup> 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. Nassau County 1965); *see supra* text accompanying notes 131-35.

<sup>161</sup> 90 Misc. 2d at 898, 396 N.Y.S.2d at 311.

<sup>162</sup> *Id.* at 897-98 (quoting N.Y. EST. POWERS & TRUSTS LAW § 11-2.1(a)(1)(McKinney 1965)).

<sup>163</sup> Dobris I, *supra* note 1, at 142 n.224.

<sup>164</sup> *See supra* notes 101-08, 111-16 (no deduction required due to statute or prevailing practice).

#### 4. Drafting Solutions

Estate planners and draftsmen have substantially more flexibility in dealing with this problem than do advisors of fiduciaries. Moreover, they have substantially more flexibility in drafting trust provisions than in drafting estate administration provisions.<sup>165</sup> Section 167(h) allows "pertinent provisions of the instrument creating [that] trust" to apportion "the allowable deduction . . . between the income beneficiaries and the trustee."<sup>166</sup> These provisions in turn can direct the trustee to create a depreciation reserve, and the deduction is allocated to the trustee to the extent that income is either set aside for the reserve or allocated to the trustee (i.e., accumulated).<sup>167</sup> The depreciation deduction is similarly allocated if the trustee is merely permitted by the instrument to establish such a reserve.<sup>168</sup> If the trustee may establish a reserve under local law and does so, the deduction is again allocated.<sup>169</sup> Strangely enough, executors and administrators may not allocate the deduction even if the will or local law authorizes them to establish reserves; to the contrary, section 167(h) requires that the deduction allocation be based solely on the income allocation.<sup>170</sup>

Guidelines for planners or draftsmen who anticipate substantial amounts of depreciation and resulting income tax liability for principal beneficiaries are the following:

- a. Arrange for depreciable property to be held in trust (or if devised, to be used to fund a testamentary trust as soon as possible after the decedent's death);
- b. Direct or permit the trustee to establish a reserve; if discretion is given, exculpate the trustee.

When the focus of drafting is on an *estate* holding depreciable assets, the draftsman cannot merely direct or permit establishment of a reserve.<sup>171</sup> Reallocation of the economic benefit of the depreciation deduction for estate beneficiaries

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<sup>165</sup> The inflexible DNI system is the root cause of the *Pross* inequities, and the only complete solution would be a reform of that system directly linking the depreciation deduction to income allocable to principal for income tax purposes. Because such a reform is unlikely, a more limited solution must be sought. *But see* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER J (Tent. Draft No. 9 1982). For a general discussion of the DNI system, see *supra* note 92.

<sup>166</sup> I.R.C. § 167(h). Although I.R.C. section 167(h) refers to apportionment of the depreciation deduction between income beneficiaries and the trustee, this effectively means apportionment between those beneficiaries and the *principal* beneficiaries. Under customary principal and income allocation rules, principal beneficiaries would pay capital gains taxes involving principal assets, and the trustee presumably would make those tax payments on their behalf. *See generally* REV. UNIF. PRINCIPAL & INCOME ACT, *supra* note 9, § 13(c)(4).

<sup>167</sup> *See supra* note 151. Regulations section 1.167(h)-1(b)(2) states:

If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation, . . . the deduction is allowed to the trustee. . . . The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

<sup>168</sup> Regs. § 1.167(h)-1(b)(2).

<sup>169</sup> *Id.*

<sup>170</sup> I.R.C. § 167(h); Regs. § 167(h)-1(c).

<sup>171</sup> *Id.*

requires an adjustment similar to that suggested for the *Rice–Dick–Converse* situation.<sup>172</sup> Here the draftsman should use a formula whenever possible, perhaps simply transferring from income to principal whatever capital gains tax is borne by principal beneficiaries, as required in *Rice*.<sup>173</sup> Establishment of depreciation reserves probably should be barred, because section 167(h) allows no deduction allocation on that basis.

When substantial principal beneficiary income tax burdens are not expected, establishment of depreciation reserves by trustees may be unwise, particularly when income beneficiaries have high marginal income tax brackets and need substantial amounts of income. Even when substantial economic harm to principal beneficiaries results, some transferors will prefer to prohibit this adjustment to favor income beneficiaries. In either case, the draftsman should state the transferor's intent, should prohibit the adjustment expressly and in many instances should also prohibit establishment of depreciation reserves, particularly when local law requires or permits them.

#### E. *Disproportionate Distributions of Income and Principal to Satisfy Pecuniary or Residuary Gifts in Kind, Causing Disproportionate Sharing of Income Tax Burdens by Beneficiaries*

##### 1. *Tax Law Sources of the Election and Adjustment*

Inequities generated by non-pro rata distributions of income and principal arise in several ways:

a. When particular distributions of income are not required, disproportionate distributions of income or of principal to satisfy pecuniary or residuary gifts (but not distributions under specific dispositions) can carry out DNI and cause inequitable sharing of income tax liability by beneficiaries.<sup>174</sup>

b. The accumulation of income by a trust and its distribution in later taxable years can cause beneficiaries to be taxed under the so-called "throwback" rules (generally based on what their individual income tax liabilities would have been had they received the distribution in the year of accumulation, minus any tax already paid by the trust).<sup>175</sup>

c. Finally, if assets are distributed by a fiduciary in kind to satisfy a pecuniary disposition (whether or not under a formula), the income tax bases of the assets are adjusted to fair market value at the time of distribution.<sup>176</sup> If such assets are

<sup>172</sup> See *supra* text accompanying notes 119-31.

<sup>173</sup> 8 Pa. D. & C.2d 379 (1956); see *supra* text accompanying notes 101-04.

<sup>174</sup> See *supra* notes 92-98, 124-28 and accompanying text (background discussion of the DNI system); see also Asofsky, *Funding Bequests*, POST MORTEM ESTATE PLANNING 255-65 (P. Asofsky ed. 1981); Dobris II, *supra* note 2, at 325-39. See generally J. PRICE, *supra* note 2, §§ 12.30-12.33.

<sup>175</sup> See *supra* note 128. Again, these rules generally do not apply to accumulation of income by estates or to distributions to beneficiaries who were less than 21 years of age when the trust earned the income. I.R.C. § 665(b); Regs. § 1.665(e)-1A(b). See generally B. BITTKER, *supra* note 92, ¶ 81.5; H. DUBROFF & D. KAHN, FEDERAL TAXATION OF ESTATES, GIFTS AND TRUSTS, ¶¶ 37.1 (3d ed. 1980), 37.5 (advantages of accumulation distributions).

<sup>176</sup> E.g., *Kenan v. Commissioner*, 114 F.2d 217, 220 (2d Cir. 1940); Rev. Rul. 60-87, 1960-1 C.B. 286.

distributed under a specific disposition or from the residue, however, their income tax bases in the hands of distributees equal their values in the federal estate tax return.<sup>177</sup> If that value is below the date of distribution value, the distributee of a residuary distribution thus may receive not only an amount of DNI based on the distribution value but also a relatively low income tax basis; if the residuary distribution is from a trust rather than from an estate, the distributee may also have to pay additional throwback income tax.<sup>178</sup>

The interaction of these income tax effects raises the following possibilities of economic harm to distributees:

a. *Income Accumulation.* Ideally, a trust will accumulate income only for beneficiaries who later will have no throwback tax problem (such as those under the age of twenty-one years when income is accumulated) or for those wishing to defer payment of the throwback tax until the later taxable year when the accumulated income is finally distributed.<sup>179</sup> Beneficiaries who currently have relatively little other income or who will not be able to bear easily the throwback tax in a later year might be harmed by such accumulations and later distributions.<sup>180</sup> Generally, any beneficiary whose marginal income tax bracket in the current tax year is lower than that of the trust (or of the estate, in some cases), and to whom trust income subsequently is distributed (even without throwback taxation), can be harmed by accumulation and later distribution.

b. *Non-Pro Rata Income Distribution Problems.* A fiduciary who has the discretion to sprinkle income among several beneficiaries whose marginal income tax brackets change from year to year can penalize beneficiaries having relatively high marginal income tax brackets by making distributions during such tax years. Further, such a fiduciary can penalize beneficiaries having relatively low brackets by not making distributions.<sup>181</sup>

c. *Non-Pro Rata Principal Distribution Problems: Satisfying Pecuniary and Residuary Gifts in Kind.* These problems are similar to those concerning trapping distributions<sup>182</sup> because disproportionate distributions of principal to satisfy residuary or formula pecuniary gifts can carry out unequal amounts of DNI and effectively reduce the economic value of the distributions.<sup>183</sup> If the amount of a formula pecuniary gift can be objectively ascertained as of the moment of death or as of the effective date of a trust, the beneficiary does not receive a share of DNI and the distribution value is unaffected.<sup>184</sup> If a fiduciary makes such specific distributions in the same taxable year in which he makes nonspecific

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<sup>177</sup> I.R.C. § 1014; Regs. §§ 1.1014-1, -3. See also H. DUBROFF & D. KAHN, *supra* note 175, ¶ 35.4; Barton, *supra* note 11, ¶ 903.1. See generally Regs. §§ 1.1014-2 to -9.

<sup>178</sup> See *supra* notes 128 and 175.

<sup>179</sup> See generally Cornfeld, *supra* note 11, ¶ 1400.6 (throwback rules not applicable to distributions by estates or to accumulations of income before the 21st birthday of the distributee).

<sup>180</sup> See *Estates and Trusts Income Tax Committee*, *supra* note 92, at 865-68, 876-77.

<sup>181</sup> See Dobris II, *supra* note 2, at 335-39.

<sup>182</sup> See generally *supra* notes 122-30 and accompanying text.

<sup>183</sup> See Asofsky, *supra* note 174, at 259-64; see also *Estates and Trusts Income Tax Committee*, *supra* note 92, at 876-77; J. PRICE, *supra* note 2, § 12.32.

<sup>184</sup> Regs. § 1.663(a)-1(a), -1(b). See generally *supra* note 125.

distributions (which do carry out DNI), the distribution of economic value can be even further skewed.<sup>185</sup> Finally, if date of distribution values are used to make in kind distributions, an estate or trust may recognize gain or loss on distribution, perhaps imposing a capital gains tax on the principal beneficiaries and giving them an equitable adjustment claim.<sup>186</sup> All of these problems again raise the basic question of whether a fiduciary should consider individual beneficiary marginal income tax rates before deciding to make distributions.

d. *Suitability of Income Tax Basis for Distributees*. If distributed assets receive a new, higher income tax basis equal to fair market value on the date of distribution, this benefits high bracket income tax beneficiaries intending to sell or otherwise exchange the asset in the near future, but perhaps not other beneficiaries.<sup>187</sup> If assets are distributed to satisfy a pecuniary formula gift at their estate tax value, the assets retain that value as their income tax basis in the hands of the distributee.<sup>188</sup> If such an asset has appreciated since its estate tax valuation, its distribution would be relatively less desirable for a high bracket income tax distributee, and more desirable for a low bracket income tax distributee, planning to sell the asset in the relatively near future.<sup>189</sup>

Thus, equitable adjustment claims can arise from non-pro rata distributions of income or principal, depending on different marginal income tax rates among beneficiaries, the fiduciary's knowledge of how such rates will change over several taxable years and the possibility that appreciated assets will be sold by beneficiaries in the current or a future taxable year.

## 2. Statutory Responses

No statute directly addresses these issues. Many states have departed from the common law rule that personal representatives of an estate must satisfy pecuniary or residuary gifts in cash unless the beneficiaries consent to another mode of distribution.<sup>190</sup> New York and several other states now specifically permit in kind satisfaction of legacies and other gifts without court order; usually, beneficiaries may still object to noncash, non-pro rata distributions.<sup>191</sup> Section

<sup>185</sup> For instance, assume that there are nine specific amount legatees (which amount exceeds \$10,000) and one residuary legatee and that the value of all legacies is equal. Assume further that the estate earns only \$10,000 DNI during its fiscal year and that the personal representative distributes to each legatee in kind an asset then worth \$10,000. The first nine legatees would pay no income tax at all and the last would pay income tax on a full \$10,000. See also I.R.C. § 663(b) (allowing fiduciary of a complex trust to elect to treat amounts distributed within 65 days of the end of its taxable year as having been distributed in the prior year); Regs. §§ 1.663(b)-1, -2.

<sup>186</sup> See, e.g., Rev. Rul. 64-314, 1964-2 C.B. 167; Rev. Rul. 69-486, 1969-2 C.B. 159; see also Asofsky, *supra* note 174, at 263-64.

<sup>187</sup> See generally *Estates and Trusts Income Tax Committee*, *supra* note 92, at 861; Moore, *Conflicting Interests 1978*, *supra* note 2, ¶¶ 603.2-603.3.

<sup>188</sup> Regs. § 1.1014-1.

<sup>189</sup> See Moore, *Conflicting Interests 1978*, *supra* note 2, ¶¶ 603.2-603.3.

<sup>190</sup> See *Villard v. Villard*, 219 N.Y. 482, 500, 114 N.E. 789, 793 (1916); see also Asofsky, *supra* note 174, at 271.

<sup>191</sup> N.Y. EST. POWERS & TRUSTS LAW § 11-1.1(b) (McKinney Supp. 1982-83):

In the absence of . . . provisions in the . . . order . . . appointing a fiduciary, . . . or in

3-906 of the Uniform Probate Code,<sup>192</sup> enacted in some form by over a dozen states, further states that a "residuary estate shall be distributed in kind [only] if . . . it is practicable to distribute undivided interests."<sup>193</sup> A few states have specifically eliminated any fiduciary responsibility to consider the income tax basis of assets distributed.<sup>194</sup> All of these statutory provisions require, implicitly or explicitly, that such property be distributed in kind only at its fair market value at the time of distribution.<sup>195</sup> None, however, address the question of whether the beneficiaries' income tax status must be taken into account in making such distributions.

### 3. Judicial Responses

Several cases have discussed related issues. For instance, in a 1965 Pennsylvania case, *In re Salesky's Estate*,<sup>196</sup> the Orphans' Court held that a widow who had taken against the will was entitled to an equitable adjustment because her distribution had been the only one made during the estate's fiscal year and had carried out almost all of the estate's DNI.<sup>197</sup> The estate's income tax saving totalled almost \$15,000 and the widow, because of individual deductions, actually paid almost \$10,000 in taxes.<sup>198</sup> According to Judge Taxis, "equitable principles demand that an adjustment should be made measured by the tax saving to the estate or the tax detriment to the distributee, whichever is less."<sup>199</sup> A similar result occurred in a 1966 Florida case, *In re Estate of Cooper*,<sup>200</sup> in which the executor had explicitly agreed to compensate the widow "because of

the . . . instrument, every fiduciary is authorized:

(20) To distribute in kind any property at its fair market value at the date of distribution.

See also COLO. REV. STAT. § 15-1-804(2)(u)(Supp. 1982); Asofsky, *supra* note 174, at 272-73.

<sup>192</sup> UNIF. PROB. CODE, 8 U.L.A. 281 (1975).

<sup>193</sup> UNIF. PROB. CODE § 3-906(a)(4), 8 U.L.A. 281, 471 (1975). According to the "Comment" to this section:

[I]t directs a personal representative to make distribution in kind whenever feasible and to convert assets to cash only where there is a special reason for doing so. . . . It is implicit . . . that each residuary beneficiary's basic right is to his proportionate share of each asset constituting the residue.

<sup>194</sup> See Asofsky, *supra* note 174 at 273-74, citing N.C. GEN. STAT. § 28A-22-8 (1977). The North Carolina statute provides as follows:

Unless otherwise restricted by the terms of the will or trust, an executor or trustee shall have absolute discretion to make distributions in cash or in specific property, real or personal, or an undivided interest therein or partly in cash or partly in such property, and to do so without regard to the income tax basis for federal tax purposes of specific property allocated to any beneficiary.

<sup>195</sup> E.g., N.Y. EST. POWERS & TRUSTS LAW § 11-1.1(b)(20)(McKinney Supp. 1982-83); *Uniform Short Form Clauses for Wills and Trusts Act* § 3-101(m), 15 REAL PROP. PROB. & TR. J. 837, 850-51 (1980)(proposed fiduciary power allows satisfaction of any payment, distribution or division with any property at current fair market value as determined by the fiduciary without court approval).

<sup>196</sup> 15 Pa. Fiduc. 213, 215 (Orphans' Ct. 1965).

<sup>197</sup> *Id.* at 215-16.

<sup>198</sup> *Id.* at 216.

<sup>199</sup> *Id.*

<sup>200</sup> 186 So. 2d 844, 845-46 (Fla. Dist. Ct. App. 1966).

the fact that she [was] required to pay Federal income taxes on'' distributions in satisfaction of her dower rights.<sup>201</sup> Strangely, *Cooper* did not cite *Salesky*, and *Cooper* has been cited more often than *Salesky* as authority for adjustment because of inequities caused by disproportionate DNI distributions.<sup>202</sup> In light of the *Cooper* executor's explicit agreement, however, *Salesky* seems to be the only case that squarely supports such an adjustment.

There appear to be no cases discussing whether a fiduciary must consider a distributee's current or future income tax status and the income tax basis of assets when planning distributions. Two courts, however, have addressed the related issue of whether fiduciaries must consider beneficiary income tax planning when making certain other trust income distributions. In a Massachusetts Supreme Judicial Court case, *Third National Bank & Trust Co. v. Campbell*,<sup>203</sup> the income tax basis of real estate investment trust interests held as trust assets had been reduced over several years by nontaxable capital distributions (because the real estate trusts had no taxable income during those years).<sup>204</sup> When the trustee sold those interests at a value in excess of their income tax bases, a capital gain resulted.<sup>205</sup> Under the instrument, the nontaxable capital distributions had augmented trust accounting income but the principal beneficiaries had borne the capital gains tax burden.<sup>206</sup> Nevertheless, the court refused to order an adjustment because to do so would have been the equivalent of ordering creation of a reserve to protect the principal beneficiaries, which would have been "manifestly impractical."<sup>207</sup> *Campbell* in turn was quoted at length by the New York Surrogate's Court in *In re Estate of Simmons* to support denial of an adjustment in a similar situation involving stock dividends payable to income beneficiaries.<sup>208</sup>

#### 4. Drafting Solutions

Thus, planners, draftsmen or fiduciary advisors have little precedent or local practice to guide decisions about such adjustments.<sup>209</sup> Generally speaking, such

<sup>201</sup> *Id.* at 845.

<sup>202</sup> See, e.g., Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1908; Dobris I, *supra* note 1, at 135-36.

<sup>203</sup> 336 Mass. 352, 145 N.E.2d 703 (1957).

<sup>204</sup> *Id.* at 353-54, 145 N.E.2d at 704.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* at 356-57, 145 N.E.2d at 706. Cf. Moore, *Conflicting Interests 1978*, *supra* note 2, ¶ 606.5.

<sup>208</sup> 30 Misc. 2d 1022, 1023-24, 220 N.Y.S.2d 515, 517 (Sur. Ct. N.Y. County 1961). See *Pastan v. Pastan*, 378 Mass. 148, 154-55, 390 N.E.2d 253, 256-57 (1979). Cf. *Commercial Trust Co. v. Barnard*, 27 N.J. 332, 340, 142 A.2d 865, 869 (1958).

<sup>209</sup> See ACPC chart, *infra* at Appendix, questions 4.a., 4.b., 6.a. and 6.b. When principal distributions carrying out DNI subject the distributee to income taxation (question 4), only one state, Pennsylvania, requires adjustment and in only five (Colorado, Oklahoma, Oregon, Nevada, and Rhode Island) is it common practice to adjust accounts. When disproportionate distributions send high basis assets to one beneficiary and low basis assets to another (question 6), no jurisdiction requires adjustment (*but see* the Arkansas and Missouri responses to question 6.b. and nn.7, 46, ACPC chart, *infra* at Appendix) and in only one state, Nevada, is it a common practice to adjust. In seven states, however, non-pro rata distributions do not appear to be made without authorization



adjustments probably are not a cost effective way of protecting beneficiaries' interests; i.e., they quickly become impossibly complex and unacceptably expensive.<sup>210</sup> The accumulation issue probably can best be resolved by the grant of broad discretion to accumulate or distribute income with absolutely no duty (or authority, even) to make adjustments among beneficiaries. If the fiduciary is prohibited from making such accumulation adjustments, exculpation should be unnecessary.

Regarding disproportionate distributions of income in any single taxable year, Professor Dobris has suggested that whenever a distribution is made to the income tax advantage of one beneficiary and disadvantage of another beneficiary, an adjustment in the amount of the disadvantage should be made if it does not exceed the advantage to the first beneficiary.<sup>211</sup> This is nothing more or less than a *Warms* (or *Salesky*) adjustment, of course, and should involve all of the difficulties of adjustments in the accumulation area. The draftsman should specifically remove any duty to make such adjustments because they would be too complex and expensive. This is best done either by granting broad discretion to make pro rata or non-pro rata income distributions without consideration of distributees' income tax status, or by limiting such discretion with ascertainable standards, such as support or medical care.

As seen in the *Salesky* and *Cooper* cases, dramatic inequities can arise from distributions in kind to satisfy pecuniary and residuary gifts and elective share rights. Accordingly, the fiduciary should be granted broad discretion to make such distributions, without regard to beneficiary income tax planning, but perhaps at the same time should be granted authority to make adjustments in his reasonable discretion, with broad exculpation.<sup>212</sup>

With respect to the income tax basis of distributed assets, fiduciaries should be given broad discretion to make distributions in kind, without regard to income tax basis and with exculpation for any claim resulting from such distributions.<sup>213</sup>

Finally, recall the self-dealing problems raised by having a beneficiary serve as the fiduciary who makes any of these distributions or adjustments.<sup>214</sup>

## F. Selection of Taxable Year for the Estate or Trust and Shifting of Income Tax Burdens Among Beneficiaries

### 1. Tax Law Sources of the Election and Adjustment

Under section 441, personal representatives and trustees are permitted to choose a taxable period other than the calendar year and thereby can elect to have the

in the instrument or beneficiary agreement (ACPC chart *infra* at Appendix: Colorado, n.15; Delaware, n.22; Louisiana, nn. 36, 37a; Massachusetts, n.41; New York, n.54; North Carolina, n.61; Ohio, n.67).

<sup>210</sup> See Dobris II, *supra* note 2, at 328, 330-32.

<sup>211</sup> Dobris II, *supra* note 2, at 335-38; see also Asofsky, *supra* note 174, at 261.

<sup>212</sup> Cf. *supra* notes 58-61 and accompanying text (methods of drafting for *Warms* adjustment).

<sup>213</sup> Although income tax basis considerations can complicate considerably such distribution planning, some draftsmen include a formula or broad discretion to allow the fiduciary to make adjustments. Some of these formulae, for instance, guarantee each distributee an amount of income tax basis that bears the same relationship to total basis as the date of distribution value of the distributee's assets bears to date of distribution value of all estate or trust assets.

<sup>214</sup> See *supra* notes 63-67 and accompanying text.

estate's or trust's first taxable year contain less than twelve months (an estate's year would begin on the day after the date of the decedent's death and end on the last day of the month selected).<sup>215</sup> Most individual distributees will be calendar year taxpayers, and trust distributees may have taxable years different from that of the estate or distributor trust.<sup>216</sup> The selection of a taxable year can produce inequities similar to those produced by disproportionate distributions of income and principal: when one beneficiary's income tax planning would be harmed by a distribution at a particular time but another beneficiary (having a different taxable year) would be helped, the fiduciary can in fact choose which to help and which to harm.<sup>217</sup> Assume, for instance, that an estate with a September 1 to August 31 fiscal year has two distributees, one an individual reporting on a calendar year basis and the other a trust with an August 1 to July 31 fiscal year. If the estate makes an August distribution to both, the trust will be able to defer taxation on its DNI until the end of its next taxable year (therefore, until the next calendar year), but the individual will have to report his DNI as income for that calendar year since it is the individual's taxable year in which the estate's fiscal year ends.<sup>218</sup> If an equitable adjustment were made, it presumably would involve some sharing of the economic value of the greater deferral received by the trust.

## 2. Statutory Responses

No statutes deal with this problem.

## 3. Judicial Responses

No cases were found dealing with this problem.

## 4. Drafting Solutions

Again, this problem is similar to that of disproportionate DNI distributions.<sup>219</sup> The approach taken for DNI distributions, though, would be impractical for

<sup>215</sup> Sections 441(b) and (e) state in pertinent part:

(b) **Taxable Year.**—For purposes of this subtitle, the term “taxable year” means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year . . .

(3) the period for which the return is made; if a return is made for a period less than 12 months. . . .

(e) **Fiscal Year.**—For purposes of this subtitle, the term “fiscal year” means a period of 12 months ending on the last day of any month other than December.

I.R.C. § 441(b), (e); see also Regs. §§ 1.441-1, 1.443-1(a)(3). See generally J. PRICE, *supra* note 2, § 12.9; Conway & Hale, *supra* note 57, at A-33.

<sup>216</sup> Conway & Hale, *supra* note 57, at A-33.

<sup>217</sup> I.R.C. §§ 652(c), 662(c). See Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1906.

<sup>218</sup> Maximum deferral is produced if a trust with a January 31 fiscal year is the distributee of an estate with a February 28 fiscal year. Then, if the estate distributes DNI (earned in 1982) to the trust in February 1983 and the trust distributes it through to a calendar year beneficiary, he would include the DNI (originally from 1982) in his 1984 tax return, due April 15, 1985, even though he received that DNI in February 1983. See J. PRICE, *supra* note 2, § 12.09 (illustrating rule of section 662(c)).

<sup>219</sup> See *supra* notes 181-86 and accompanying text.

selection of a taxable year and would involve an unacceptable administrative expense. Malcolm Moore was correct in concluding that “[n]o equitable adjustment should be called for in this situation; what is required is merely the realization that interests of beneficiaries may pull in different directions.”<sup>220</sup> The fiduciary advisor has no legal basis for telling the fiduciary to make any such adjustment, and practical reasons for telling him not to do so. The planner or draftsman should specifically authorize the fiduciary to elect whatever taxable year he deems to be in the best interests of all beneficiaries and should relieve him of any duty to make adjustments. Finally, recall the points above regarding exculpation and having a beneficiary as fiduciary.<sup>221</sup>

### G. *Decisions to Sell or Exchange Estate or Trust Assets and Timing of Those Sales*

#### 1. *Tax Law Sources of the Election and Adjustment*

Fiduciaries having discretion to decide whether and when to sell assets can shift economic interests among beneficiaries. For instance, sales causing recognition of capital gains taxable to principal beneficiaries during taxable years when other income is received can trigger the *Rice–Dick–Converse* problem discussed above.<sup>222</sup> More generally, when a fiduciary is considering whether to sell an asset or whether to distribute it in kind with a section 1014 stepped-up basis or with an increase in basis to its fair market value at the date of distribution, he must choose between penalizing principal beneficiaries of the distributor trust or estate (who usually bear the burden of the capital gains tax) or penalizing distributee beneficiaries (who, because of individual income tax planning and unrecognized appreciation, could be deterred from then selling the asset).<sup>223</sup> It is again the combination of the DNI system with income tax basis adjustments at death and at distribution that produces disparate economic effects for beneficiaries.<sup>224</sup>

#### 2. *Statutory Responses*

Under the common law, sales by personal representatives are valid only if approved by court order, in the absence of specific statutory or testamentary authorization.<sup>225</sup> Trustees are in a somewhat similar position, but usually have been held to have the power to sell in the absence of a direction to retain an asset.<sup>226</sup> There appears to be no common law or statutory rule, however, on adjustment for beneficiaries who suffer disproportionate income tax burdens because of sales.

<sup>220</sup> Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1906.

<sup>221</sup> See *supra* notes 58-61, 63-67 and accompanying text.

<sup>222</sup> See *supra* notes 92-99 and accompanying text; see also Dobris I, *supra* note 1, at 136-37 (fiduciary often has discretion to decide which assets are to be sold).

<sup>223</sup> See *supra* notes 176-78, 187-89 and accompanying text.

<sup>224</sup> See Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1914.

<sup>225</sup> E.g., W. BOWE & D. PARKER, 5 PAGE ON THE LAW OF WILLS § 45.5 (1962); J. RITCHIE, N. ALFORD and R. EFFLAND, *DECEDENTS' ESTATES AND TRUSTS* 1261-64 (6th ed. 1982).

<sup>226</sup> E.g., G. BOGERT & G. BOGERT, *supra* note 3, § 133; A. SCOTT, *supra* note 7, § 190.

### 3. *Judicial Responses*

Although analogies exist in cases on adjustments for depreciation and disproportionate distributions of income and principal,<sup>227</sup> they do not directly support claims arising only because of the making or timing of sales or other taxable exchanges.

### 4. *Drafting Solutions*

Planners and draftsmen probably should take the same basic approach suggested for disproportionate distributions of income and principal: adjustment should not be required, and broad discretion should be granted to the fiduciary to make sales without regard to capital gains taxation to the trust or estate and without regard to beneficiaries' income tax considerations. Malcolm Moore has suggested that it may be appropriate to require an adjustment "to the extent of capital gains taxes paid" and not "for losses incurred,"<sup>228</sup> but such inequities are just another consequence of multiple beneficiaries having different income tax goals.<sup>229</sup> If the transferor is concerned about particular assets the sale of which will produce extremely large capital gains for principal beneficiaries, he should either prohibit the sale of such assets (usually unwise) or reallocate specifically the capital gains tax liability from their sale.

### H. *Election to Pay Estate Income Taxes in Installments*

The personal representative of an estate may elect to pay its income tax in four equal installments, with the first payable on the due date of the return and the remaining three due quarterly thereafter.<sup>230</sup> Trustees may not make this election. No interest need be paid on the installments,<sup>231</sup> thereby reducing the economic cost of estate income taxation. Hence, failure to elect to pay in installments has the effect of depriving the estate's income beneficiaries of the income that could have been earned on the deferred tax. There appear to be no statutes or judicial decisions discussing this problem as an equitable adjustment issue, presumably because it involves a different aspect of fiduciary duty than is discussed above. Election to pay the estate's income tax in installments affects only one group of beneficiaries—i.e., those who bear the economic burden of the timing of such income tax payments. Failure to make the election probably benefits no one. Therefore, no significant issue arises under the duty of impartiality, nor should any arise regarding the self-dealing prohibition. This election appears to involve only the personal representative's duty to maximize the value of

<sup>227</sup> See *supra* notes 101-16, 156-64 and accompanying text.

<sup>228</sup> Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1914.

<sup>229</sup> Cf. Moore, *Conflicting Interests 1975*, *supra* note 2, ¶¶ 1906, 1914.

<sup>230</sup> Section 6152(b) provides in reference to dates prescribed for payment of four installments:

[T]he first installment shall be paid on the date prescribed for the payment of the tax, the second installment shall be paid on or before 3 months, the third installment on or before 6 months, and the fourth installment on or before 9 months, after such date.

I.R.C. § 6152(b). See generally J. PRICE, *supra* note 2, § 12.3.

<sup>231</sup> Regs. § 1.6152-1.

the estate by minimizing the economic cost of income taxation.<sup>232</sup> There probably is no need to plan or draft explicitly for such an election or to relieve the fiduciary from the duty to make the election because, in virtually all cases, beneficiaries cannot be harmed by it.

## I. Election to Terminate Subchapter S Qualification

### 1. Tax Law Sources of the Election and Adjustment

Personal representatives and trustees under wills of subchapter S corporation shareholders dying before January 1, 1983 (or dying after that date but during a subchapter S corporation fiscal year beginning before that date) may elect not to consent to the corporation's original subchapter S election and thereby terminate its qualification.<sup>233</sup> Under the Economic Recovery Tax Act of 1981, the life income beneficiary of a so-called "qualified subchapter S trust" holding subchapter S shares has a similar election right (that is, not to qualify the trust and, thereby, to terminate the corporation's qualification for having an unqualified shareholder).<sup>234</sup> Under the Subchapter S Revision Act of 1982,<sup>235</sup> however, only personal representatives or trustees who own more than half of the shares of the corporation and beneficiaries of "qualified subchapter S trusts" have this election right.<sup>236</sup> An in-depth discussion of the many factors affecting this election is beyond the scope of this article, but, simply stated, the passing through of corporate deductions could benefit current income beneficiaries of an estate or trust or "qualified subchapter S trust," while increases in corporate value and changes in corporate operations after termination of the subchapter S election may benefit future income or principal beneficiaries.<sup>237</sup> Presumably, however, *beneficiaries* of "qualified subchapter S trusts" may elect based solely on whether these factors favor their individual interests, regardless of harm caused to future interest holders.

### 2. Statutory Responses

No statutes discuss adjustment for beneficiaries economically harmed by the election.<sup>238</sup>

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<sup>232</sup> See *supra* note 3 and accompanying text. Cf. I.R.C. § 121(a), (d)(2); Rev. Rul. 82-1, 1982-1 C.B. 26; Prop. Regs. §§ 35.3452(c)-1, 35.3453(e)-1, 47 Fed. Reg. 51,376-78, 51,381 (1982) (allowing middleman "payor" fiduciaries to file exemption certificates to prevent multiple withholding).

<sup>233</sup> I.R.C. § 1362(d). Section 1362 was enacted by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669. See also Subchapter S Revision Act of 1982 § 6 (effective dates of Act).

<sup>234</sup> I.R.C. § 1361(d)(2). For decedents dying prior to the effective date of the Subchapter S Revision Act of 1982, see I.R.C. § 1371(e), (g). See generally GENERAL EXPLANATION, *supra* note 73, at 148; Conway & Hale, *supra* note 3, at A-22 to A-23; Stephenson, *Effect of Subchapter S in Lifetime and Post Mortem Planning in Light of Recent Changes*, 5 EST. PLAN. 82, 86-88 (1978).

<sup>235</sup> See *supra* note 233.

<sup>236</sup> I.R.C. § 1362(d)(1)(B); see also REPORT OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE ON H.R. 6055, 97th Cong., 2d Sess. 9-12 (1982).

<sup>237</sup> See REPORT OF THE COMMITTEE ON FINANCE OF THE UNITED STATES ON H.R. 6055, 97th Cong., 2d Sess. 5-6 (1982); GENERAL EXPLANATION, *supra* note 73, at 147. See generally J. PRICE, *supra* note 2, § 12.7.

<sup>238</sup> *But cf.* CONN. GEN. STAT. ANN. § 45-100f(24) (West 1981 & Supp. 1982). The statutes grant fiduciaries the power to "file appropriate consent to the continuation of any subchapter S election

### 3. *Judicial Responses*

No cases discussing this problem were found.

### 4. *Drafting Solutions*

The problems of fiduciaries having this right to elect are again similar to those of fiduciaries having the power to make disproportionate distributions of income and principal. The fiduciary must consider so many factors in consenting to continuation of the subchapter S election (not the least of which are possible fiduciary duties owed to other subchapter S corporation shareholders) that it would be unreasonably complex and expensive to require adjustments for economic harm suffered by beneficiaries because of the election.<sup>239</sup> Planners or draftsmen should give such fiduciaries broad discretion to make all subchapter S corporate share decisions that are reasonably foreseeable, including discretion to make this particular election, without regard to economic harm suffered by any individual beneficiary, and should exculpate fiduciaries from any liability arising from such decisions.<sup>240</sup> To avoid self-dealing problems, the fiduciary should not also be a beneficiary.<sup>241</sup> Finally, for draftsmen anticipating that not more than half of the shares will be transferred to the fiduciary but still desiring the flexibility of having some individual able to terminate qualification after the death of the shareholder, the "qualified subchapter S trust" may be a perfect solution.<sup>242</sup> Such draftsmen should recall, however, that the life income beneficiary of the trust has neither the duty to consider other beneficiaries before making the election nor any apparent duty to make equitable adjustments.

## J. *Closing the Estate or Terminating the Trust and Disproportionate Sharing of Benefits or Burdens from Distribution of Loss Carryovers, Excess Deductions and Capital Gains*

### 1. *Tax Law Sources of the Election and Adjustment*

The election to close an estate or terminate a trust involves two unique fiduciary income tax effects: (a) beneficiaries receive a proportionate share of capital loss carryovers, which may be used in beneficiaries' future tax years, and of excess deductions (i.e., deductions in excess of adjusted gross income), which must be used in the fiscal year in which the termination distribution is received; and (b) capital gains are added to DNI during that year and consequently are distributed to all beneficiaries who receive termination distributions that otherwise carry out

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in existence at the time of the testator's death," but only if the testator specifically refers to this power "in such will or other instrument." This implies that a revocable trust's trustee might be granted the same power through incorporation by reference. CONN. GEN. STAT. ANN. § 45-100f(24)(West 1981 & Supp. 1982).

<sup>239</sup> Cf. Dobris II, *supra* note 2, at 326-32 (factors in determining whether adjustment is an unreasonable administrative burden).

<sup>240</sup> See CONN. GEN. STAT. ANN. §§ 45-100f(24), 45-100e(32)(West 1981 & Supp. 1982)(examples of other powers that may be given to fiduciaries who are expected to manage a small business interest).

<sup>241</sup> See *supra* notes 63-67 and accompanying text.

<sup>242</sup> See *supra* note 236 and accompanying text.

DNI.<sup>243</sup> If in an estate's final taxable year the only distribution made is of all remaining estate property to a residuary testamentary or inter vivos trust, any excess deductions first will benefit the trust's income beneficiaries because the excess deductions will reduce trust DNI distributable to them.<sup>244</sup> Thus, closing an estate or terminating a trust raises the same set of general issues as disproportionate distributions of income and principal during administration, as well as the *Rice-Dick-Converse* issue discussed above.<sup>245</sup> For example, an individual beneficiary who has recognized a significant long term capital loss may welcome a distribution carrying out long term capital gains in his taxable year during which closing or termination occurs, while a beneficiary not having significant individual taxable income may resist the passing out of excess deductions which must be used in his taxable year during which closing or termination occurs.

## 2. Statutory Responses

No statutes that discuss this problem were found.

## 3. Judicial Responses

No cases discussing this problem were found.

## 4. Drafting Solutions

All adjustments probably should be specifically prohibited in this area, and the fiduciary should be given broad discretion with respect to the timing of closing the estate or terminating the trust, for the following reasons: (a) few fiduciaries appear to time closing or termination to favor one group of beneficiaries over another—instead, the election probably is a result of many separate factors, causing harm to beneficiaries to occur in relatively few cases; and (b) if there is no intent to favor one group of beneficiaries over another, the adjustment would unreasonably increase the complexity and cost of the closing or termination. Moreover, once this decision to close or terminate has been reached, no real election is involved that would warrant adjustment.<sup>246</sup> Therefore, the instrument simply should prohibit such adjustments, making it unnecessary to bar a beneficiary from serving as fiduciary.

## K. Election to Report Series "E" and "EE" Savings Bond Interest on the Decedent's Final Income Tax Return

### 1. Tax Law Sources of the Election and Adjustment

United States Series E and EE savings bonds are purchased at a discount and ordinarily held until maturity without the holder's recognizing any of the annual

<sup>243</sup> Regs. §§ 1.642(h)-1, -2; 1.643(a)-3(d). See also Conway & Hale, *supra* note 57, at A-34 to A-35.

<sup>244</sup> I.R.C. § 642(h). See generally *Estates and Trusts Income Tax Committee*, *supra* note 92, at 867-68; Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1911.

<sup>245</sup> See *supra* notes 101-08, 111-16, 181-86 and accompanying text.

<sup>246</sup> See Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1911.

interest income until the time of redemption.<sup>247</sup> A decedent's executor, or the trustee of a revocable trust, if required to file the decedent's final income tax return, is authorized under section 454(a) to report any such unrecognized income on that return.<sup>248</sup> If the income instead is distributed with the bonds either to a specific donee or to residuary beneficiaries, there is no recognition on distribution and the distributee receives the income as IRD<sup>249</sup> with the bonds.<sup>250</sup> Reporting the interest as accrued (recognizing it) on the final return can produce the following effects. Because the income tax due is a debt of the estate, it can reduce estate tax liability; it also can alter the amount of any will or trust formula gift based on estate value after deductions. Further, it can increase income tax liability of a surviving spouse who files jointly with the executor or trustee.<sup>251</sup>

## 2. Statutory Responses

No statutes directly discussing this problem were found.

## 3. Judicial Responses

No cases directly discussing this problem were found.

## 4. Drafting Solutions

Planners or draftsmen first should consider whether resulting income tax liability at the estate or trust level may adversely and significantly affect formula gifts. In most cases, however, adjustment should be specifically prohibited. Most inequities will be relatively minor, because the beneficiary who bears the increased income tax liability will receive a reduction in estate tax due to deductibility of that liability on the estate tax return. Even if significant change is produced in the value of formula gifts, the adjustment will be unreasonably complex and expensive.<sup>252</sup> When the fiduciary distributes such bonds on a non-pro rata basis and thereby allocates IRD disproportionately, the probability of significant inequities appears to be so small that no such adjustment should be allowed. But recall the self-dealing problems that could arise from naming a beneficiary as the fiduciary who makes the election.<sup>253</sup>

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<sup>247</sup> Section 454(a) states in pertinent part:

If, in the case of a taxpayer owning any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, . . . the increase in the redemption price . . . occurring in the taxable year does not . . . constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year, treat such increases as income received in such taxable year.

See generally J. PRICE, *supra* note 2, § 12.6; Conway & Hale, *supra* note 3, at A-5; Dobris II, *supra* note 2, at 301-13; Fink, *U.S. Series E Bonds: When to Report the Interest After the Owner's Death*, 6 EST. PLAN. 168-73 (1978); Green & Reisman, *Handling the Decedent's Final Income Tax Return for the Best Overall Tax Benefits*, 9 EST. PLAN. 348, 351 (1982); Taggart, *supra* note 3, at 30-31.

<sup>248</sup> Regs. § 1.454-1(a). See *supra* note 19.

<sup>249</sup> See *supra* note 88 and accompanying text.

<sup>250</sup> See Regs. § 1.691(a)-2(b).

<sup>251</sup> See *infra* text accompanying notes 261-65; see also Dobris II, *supra* note 2, at 311.

<sup>252</sup> See generally Dobris II, *supra* note 2, at 311.

<sup>253</sup> See *supra* notes 63-67 and accompanying text.



## L. Election to Deduct Medical Expenses on the Decedent's Final Income Tax Return or on the Estate Tax Return

### 1. Tax Law Sources of the Election and Adjustment

Under section 213, an executor may deduct medical expenses incurred but not paid prior to death on either the federal estate tax return or the decedent's final income tax return, if the expenses are paid within one year of death.<sup>254</sup> This election raises an issue similar to the section 642(g) election to take administration expenses and casualty losses on either the fiduciary income tax return or the estate tax return. For this to be a significant problem, different beneficiaries must bear the burden of income tax liability on the final return and the estate tax, or they must receive formula gifts based on estate value after deductions.<sup>255</sup> In either event, either a *Warms* or marital-nonmarital formula gift adjustment in the amount of any economic harm suffered could reasonably be requested by disadvantaged beneficiaries.<sup>256</sup>

### 2. Statutory Responses

Under the Connecticut Fiduciary Powers Act, if an instrument incorporates its "administration and other expenses" provision by reference, the fiduciary may take the same approach to the medical expense deduction adjustment as he takes to the *Warms* adjustment: it need be made only if a charitable organization under section 501(c) is a residuary legatee under a will containing a "preresiduary marital . . . deduction formula" gift, or if the fiduciary has deducted the medical expenses on the income tax return and estate taxes "paid from and chargeable to" principal are increased.<sup>257</sup> No other statute directly discusses this problem.

<sup>254</sup> Section § 213(c) states in pertinent part:

(1) **Treatment of Expenses Paid After Death.**—For purposes of subsection (a) [of § 213], expenses for the medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred.

(2) **Limitation.**—Paragraph (1) shall not apply if the amount paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent, but this paragraph shall not apply if (within the time and in the manner and form prescribed by the Secretary) there is filed—

(A) a statement that such amount has not been allowed as a deduction under section 2053, and

(B) a waiver of the right to have such amount allowed at any time as a deduction under section 2053.

Section 213 reflects significant amendments by TEFRA, *supra* note 23, § 202. See TEFRA § 202(b)(3)(B) regarding the redesignation of prior section 213(d) as the current section 213(c). See generally J. PRICE, *supra* note 2, § 12.5; Conway & Hale, *supra* note 3, at A-4 to A-5; Dobris II, *supra* note 2, at 307; Green & Reisman, *supra* note 247, at 351; Taggart, *supra* note 3, at 27.

<sup>255</sup> For a discussion of the marital-nonmarital share adjustment see *supra* notes 70-73 and accompanying text.

<sup>256</sup> See Dobris II, *supra* note 2, at 307-08.

<sup>257</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(B)(West Supp. 1982).

### 3. *Judicial Responses*

No cases were found directly discussing this problem.

### 4. *Drafting Solutions*

Recall the discussion above regarding the *Warms* adjustment.<sup>258</sup> In light of the lack of statutory or case law on the medical expense deduction election, the fiduciary advisor probably should refrain from recommending a *Warms*-type adjustment in this situation. Nonetheless, the planner or draftsman should specifically state the transferor's intent about this adjustment and probably should prohibit it. This is because few decedents' final income tax returns will be sufficiently simple to permit use of an adjustment formula and in most estates the gain in equity from the adjustment will be more than counterbalanced by the increase in complexity and administrative expense.<sup>259</sup> Thus, the instrument should specifically authorize the election and prohibit the adjustment; if for some reason discretionary adjustment is permitted, exculpation should be provided. The self-dealing problems with a beneficiary serving as fiduciary should be considered.<sup>260</sup>

## M. *Election to File the Decedent's Final Income Tax Return Jointly with the Surviving Spouse*

### 1. *Tax Law Sources of the Election and Adjustment*

Under section 6013(a), the executor can elect to file the decedent's final income tax return jointly with the surviving spouse.<sup>261</sup> This return will include income received by the decedent individually through the date of his death and the surviving spouse's income for the entire year.<sup>262</sup> Because the fiduciary thereby subjects himself to joint and several liability for the entire income tax, the election to file jointly may not benefit the estate or trust as a whole, depending on, among other things, whether the surviving spouse agrees to pay her pro rata share of the tax.<sup>263</sup>

If a joint return is filed, the surviving spouse shares the benefit of the decedent spouse's deductions, capital loss carryovers and the like; the fiduciary gets the possibility of lower rates, deductions attributable to the surviving spouse and more advantageous maximum tax treatment.<sup>264</sup> If the surviving spouse is not an estate or trust beneficiary, an election benefitting the surviving spouse may be

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<sup>258</sup> See *supra* notes 19-69 and accompanying text.

<sup>259</sup> Calculating the economic benefit or harm from this election is difficult because, while deducting medical expenses on the income tax return might appear to increase the taxable estate (by decreasing the debt deduction for income taxes due on the final income tax return), their deduction on the estate tax return directly reduces the taxable estate even more. Green & Reisman, *supra* note 247, at 351.

<sup>260</sup> See *supra* notes 63-67 and accompanying text.

<sup>261</sup> I.R.C. § 6013(a)(3) provides in part: "[I]n the case of death of one spouse or both spouses the joint return with respect to the decedent may be made only by his executor or administrator . . . ." See also Taggart, *supra* note 3, at 17-18, 22-27. See generally J. PRICE, *supra* note 2, § 12.4; Green & Reisman, *supra* note 247, at 351-53.

<sup>262</sup> Regs. § 1.6013-1(d).

<sup>263</sup> Conway & Hale, *supra* note 3, at A-3 to A-4.

<sup>264</sup> See Taggart, *supra* note 3, at 22; Green & Reisman, *supra* note 247, at 352.

an obvious violation of fiduciary duty. If the surviving spouse is a beneficiary, however, then that spouse may merely be disproportionately benefitted from the election (presumably, to the disadvantage of residuary or other beneficiaries who bear the decedent's debts, including income tax liability under his final return).<sup>265</sup>

## 2. Statutory Responses

Connecticut's statutory power, if incorporated by reference into the instrument, authorizes the executor<sup>266</sup> to file jointly with the surviving spouse and to "pay the entire amount of such" income tax without thereby incurring "personal liability."<sup>267</sup> Although the power does not directly address the issue of equitable adjustments,<sup>268</sup> it should protect a fiduciary refusing to adjust after electing to file jointly or after paying a portion of the surviving spouse's share of the income tax.

## 3. Judicial Responses

No cases were found directly discussing this problem.

## 4. Drafting Solutions

Most decedents will want the fiduciary to file jointly with the surviving spouse, without having to make any adjustment. If so, to clarify the decedent's intent the adjustment probably should be prohibited in the instrument.<sup>269</sup> Further, calculation of such an adjustment would be complex and expensive and should be prohibited for that reason alone. If the decedent does not want the fiduciary to benefit the surviving spouse through the election, he should direct the fiduciary to bargain with the surviving spouse for a reasonable contractual apportionment of the income tax liability.<sup>270</sup> If such a direction is given, however, the fiduciary should be exculpated from any claim arising from the apportionment agreement. Again, recall the obvious self-dealing problems with having the surviving spouse (or another interested beneficiary) as the fiduciary authorized to elect.<sup>271</sup>

<sup>265</sup> See *supra* notes 254-56 and accompanying text (discussing inequities resulting from the medical expense deduction election).

<sup>266</sup> Another fiduciary having the duty to file the final income tax return also should be covered. See *supra* note 19 (meaning of "executor").

<sup>267</sup> See CONN. GEN. STAT. ANN. § 45-100(e)(35)(C) (West 1981 & Supp. 1982). The statute provides:

The fiduciary is specifically authorized but not required to execute and file a joint income tax return with the surviving spouse or his executor or administrator for the year of the decedent's death and for any prior years. . . . The fiduciary shall incur no personal liability for any action taken by it in good faith in accordance with . . . the foregoing [authorization].

<sup>268</sup> Compare CONN. GEN. STAT. ANN. § 45-100(e)(35)(A), (B) with CONN. GEN. STAT. ANN. § 45-100(e)(35)(C) (West 1981 & Supp. 1982).

<sup>269</sup> Professor Dobris characterizes this as a remission of fiduciary duty argument. Dobris II, *supra* note 2, at 284-89.

<sup>270</sup> Cf. *supra* notes 258-60 and accompanying text.

<sup>271</sup> See *supra* notes 63-67 and accompanying text.

N. *Decisions Not to Exclude or Not to Resist Inclusion of Property in the Decedent's Estate Tax Gross Estate*

Several commentators have referred to the practical ability of a fiduciary to decide not to resist inclusion of inter vivos trust property in the gross estate under section 2036 (dealing with a retained life estate in the trust property or powers to alter beneficial enjoyment), section 2037 (involving certain contingent reversions) or section 2038 (involving retained powers to alter, amend or revoke) as an "election" potentially giving rise to adjustment claims.<sup>272</sup> Such inclusion in the gross estate can reallocate economic benefits to beneficiaries bearing the estate tax burden for farm or closely held business assets,<sup>273</sup> to beneficiaries seeking an increase in income tax basis of included assets under section 1014 (to minimize later capital gains taxation on their sale or other taxable exchange)<sup>274</sup> or away from beneficiaries who bear the burden of increased estate taxes.

A similar issue arises relating to whether a fiduciary filing the estate tax return excludes joint ownership property (other than that held by a married couple) under section 2040(a) because it is attributable to contributions by a person other than the decedent.<sup>275</sup> If the other joint owner or owners are not obligated to pay the estate tax on such excludible joint ownership property,<sup>276</sup> they can benefit from its inclusion in the gross estate because of the possible increase in income tax basis under section 1014(b)(9).

Nevertheless, the fiduciary does not have an "election" in the equitable adjustment sense for either type of exclusion. First, the fiduciary filing the estate tax return must give a "true, correct, and complete" statement of all

<sup>272</sup> I.R.C. §§ 2036, 2037, 2038. See generally Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1905. Dobris states:

Usually an executor fights to exclude an item from the gross estate to save death taxes. Therefore the Government will readily allow an executor to include property. Occasionally, an executor might wish to include property to increase its income tax basis, or to meet Internal Revenue Code percentage requirements for relief provisions. Thus, when a particular asset raises close questions of law or fact as to its includibility in the gross estate, the executor in effect possesses a discretionary power to include it.

Dobris II, *supra* note 2, at 314-15. Cf. I.R.C. §§ 2033 (property in which the decedent had an interest), 2041 (general powers of appointment), 2042 (proceeds of life insurance), 2043 (transfers for insufficient consideration).

<sup>273</sup> See generally *infra* notes 297-323.

<sup>274</sup> See generally I.R.C. § 1014; Regs. §§ 1.1014-1 to -9.

<sup>275</sup> Regarding spousal joint ownership, ERTA, *supra* note 18, § 403, created an entirely different rule for "joint interests of husband and wife" under section § 2040(b)(1). The Act provides:

Notwithstanding subsection (a), in the case of any [interests in property held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants], the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified joint interest.

ERTA, *supra* note 18, § 403. Thus, this section has no application whatsoever to § 2040(b) spousal joint ownership. Regarding § 2040(a), see H. DUBROFF & D. KAHN, *supra* note 175, ¶ 7.1; see also Regs. § 20.2040-1(a)(general discussion of joint interests).

<sup>276</sup> See REV. UNIF. ESTATE TAX APPORTIONMENT ACT § 2, 8 U.L.A. 159, 160 (1964).

assets.<sup>277</sup> Strictly speaking, then, no fiduciary choice exists. Second, even if the fiduciary has a choice about inclusion of assets, few state court judges will try to decide adjustment claims by speculating about final includibility, valuation of assets and eventual tax effects on all beneficiaries. Third, if an adjustment is sought because of inclusion, to grant relief the state court judge would have to contradict the outcome of the federal estate tax proceeding. If adjustment is sought because of exclusion, the court would have to find that the fiduciary violated the federal tax laws. State court judges probably would, and should, avoid such "no win" situations. Regarding, in particular, exclusion of joint ownership value because of contribution by someone other than the decedent, not only does section 2040(a) appear to contemplate that the executor will inform the Service about all such excludible amounts, but also the tax laws do not explicitly recognize any other possible use of this exclusion. Nothing in the capital gains provisions evidences a congressional intent that the fiduciary be able to choose the income tax basis for such a potentially excludible property interest.<sup>278</sup>

O. *Election to Include Lump Sum Distributions from a Qualified Benefit Plan or Individual Retirement Account ("IRA") or to Exclude \$100,000 of Installment Distributions from the Decedent's Gross Estate*

1. *Tax Law Sources of the Election and Adjustment*

Here a trustee has a true tax election to make. A trustee who has been designated as the beneficiary (distributee) of a decedent's account in a qualified benefit plan or IRA can, if the plan permits, elect either of the following methods of distribution: (a) distribution of the proceeds of the account in installments, thereby causing ordinary income taxation of any employer contribution portion of each installment as it is received and making up to \$100,000 of the proceeds eligible for exclusion from the decedent's gross estate under section 2039(c), or

<sup>277</sup> See Internal Revenue Service Form 706 (Rev. June 1982), notation on page 1 above the signature line. See generally IRM 4350, EXAMINATION TECHNIQUE HANDBOOK FOR ESTATE TAX EXAMINERS ¶¶ 352, (11)30–(11)40 (1980).

<sup>278</sup> Section 6659 may impose a penalty tax on any distributee selling an asset subject to such a "valuation overstatement." ERTA, *supra* note 18, § 722; see also GENERAL EXPLANATION, *supra* note 73, at 332-35.

There may be many areas of fiduciary administration in which the fiduciary has the practical freedom to disobey the law. To extend the remedy of equitable adjustment into such areas, however, would be to pervert its essentially equitable nature by presupposing court findings of economic entitlement based upon essentially unlawful or inequitable conduct by fiduciaries.

Commentators have suggested that the discretion of the fiduciary filing the federal estate tax return to determine asset value under section 2031 when no clear fair market value exists is another such fiduciary "election." See, e.g. Barton, *supra* note 11, ¶ 902.2; Dobris II, *supra* note 2, at 313-14; Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1912. This is another false "election," however, for the reasons noted above. It also seems unlikely that any state court would order an adjustment unless it were prepared further to determine the precise fair market value of the asset. Thus, such adjustments would be impractical—if there is sufficient uncertainty about valuation to allow a de facto election, how can a court or fiduciary be expected to determine a precise amount by which to reduce one beneficiary's interest or increase another's interest?

(b) distribution of the proceeds in a lump sum (within one calendar year), thereby requiring their complete inclusion in the gross estate and qualifying plan proceeds (but not IRA proceeds) for income taxation under special ten-year averaging.<sup>279</sup> Even if lump sum distribution is elected, the fiduciary distributee of a qualified plan (but not an IRA) can forego special ten-year averaging for the distribution and still make it eligible for exclusion from the gross estate.<sup>280</sup> Because of the new unlimited marital deduction, elections by a surviving spouse of a decedent dying after January 1, 1982, to receive a lump sum distribution individually and to take advantage of special ten-year averaging will generate no additional estate tax liability and should give rise to no adjustment problem, even if the spouse is also a fiduciary.<sup>281</sup>

## 2. Statutory Responses

Connecticut's statutory power, if incorporated by reference into the instrument, specifically authorizes the fiduciary to make this election without personal liability.<sup>282</sup> Neither the Connecticut power nor any statute directly discusses adjustment to beneficiaries' accounts to remedy inequities caused by the election.

## 3. Judicial Responses

A few courts have placed estate tax liability for such distributions on the

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<sup>279</sup> See J. PRICE, *supra* note 2, § 12.21; Rich, *The Decedent's Pension Plan: Estate Tax Exclusion or Income Tax Averaging?*, POST MORTEM ESTATE PLANNING 95-102 (P. Asofsky ed. 1981); Moore, *Conflicting Interests 1978*, *supra* note 1, ¶ 607.1-607.4; see also I.R.C. §§ 72, 402, 403, 408 and 2039(c), (f), (g), and the regulations thereunder. Section 245 of TEFRA (I.R.C. § 2039(g)) placed a \$100,000 limit on the section 2039(c) exclusion for decedents dying after December 31, 1982. *But cf.* I.R.C. § 2517(b)(unchanged by TEFRA). See Sollee, *TEFRA's Impact on Qualified Plans*, 5 NAT'L L.J. 15, 17-18 (1982).

At the time of writing, all that is clear about section 2039(g) is that it will complicate tax planning substantially. Until the Service discloses, among other things, how it intends to collect estate taxes due on undistributed installment or annuity payments, it is impossible to say how much complication will result.

If an executor or administrator is the designated beneficiary, this designation results in automatic inclusion of the proceeds in the gross estate under section 2039(c); if a beneficiary, such as a surviving spouse, is individually designated as beneficiary and also is appointed personal representative, however, exclusion of the proceeds from the gross estate is still possible. See Moore, *Conflicting Interests 1978*, *supra* note 2, ¶ 607.3.

<sup>280</sup> See I.R.C. §§ 402(a), 403(a), § 2039(f); Regs. § 20.2039-4(c)(1981). Income tax free rollover of a lump sum distribution into an IRA appears to be possible for an individual surviving spouse distributee, but not for a spouse serving as a fiduciary. See I.R.C. § 402(a)(5), (7); see also I.R.C. §§ 408(d)(3), 408(a)(7), regarding required IRA distributions after death.

<sup>281</sup> See generally ERTA, *supra* note 18, § 403 (marital deduction amendments).

<sup>282</sup> The Connecticut statute provides the fiduciary with the following power:

To elect, either revocably or irrevocably, to receive death benefits and any other sums payable with respect to any pension and profit-sharing plans in a lump sum, in instalments [sic] or as an annuity; to waive the benefit of any income averaging provisions available for distributions from pension and profit-sharing plans; to elect a different mode of distribution with respect to each applicable pension and profit-sharing plan. . . . A decedent's spouse, if acting as a fiduciary, shall take no part in the exercise of any election under any pension or profit-sharing plan.

CONN. GEN. STAT. ANN. § 45-100e(35)(G)(West Supp. 1982). See also CONN. GEN. STAT. ANN. § 45-100e(35)(H)(West Supp. 1982)(fiduciary not personally liable for action taken to implement election); REV. UNIF. ESTATE TAX APPORTIONMENT ACT § 2, 8 U.L.A. 159-60 (1964).

designated beneficiary and have removed it from other estate or trust beneficiaries.<sup>283</sup> No case, however, has ordered an adjustment as such.

#### 4. *Drafting Solutions*

The problems arising from this election should not be resolved by requiring adjustment of beneficiary accounts.<sup>284</sup> The draftsman should attack this problem directly through the instrument's death tax allocation clause. For instance, if a qualified plan participant wishes to prevent inequity, he would be better advised simply to exclude any plan distribution from the coverage of the general estate tax apportionment clause of his will or trust (or both), perhaps supplementing this with a statement of intent in the beneficiary designation that the designated beneficiary is to bear all estate tax liability attributable to the distribution.<sup>285</sup> If the conflict is not so removed, the participant can be presumed to have favored the designated beneficiary over other beneficiaries potentially bearing the estate tax burden, and therefore no equitable adjustment should be ordered.<sup>286</sup> Finally, it is preferable for a fiduciary designated as beneficiary not to have an individual beneficial interest in the proceeds because of self-dealing problems.<sup>287</sup> Often, however, the plan participant will want to create such a conflict of interest, for example, by having a surviving spouse trustee. If so, this intention should be explicitly set forth in the instrument (and perhaps the beneficiary designation), and the fiduciary should be expressly absolved of any duty to make equitable adjustments.<sup>288</sup>

### P. *Election to Use the Alternate Valuation Date for Estate Tax Valuation*

#### 1. *Tax Law Sources of the Election and Adjustment*

Under section 2032, the fiduciary may elect to value the gross estate on the federal estate tax return as of the date of death or the alternate valuation date. For each gross estate asset, the latter date is the earlier of six months after the date of death and the date of the asset's distribution, sale, exchange or other

<sup>283</sup> See *First Nat'l Bank of Shelby v. Dixon*, 38 N.C. App. 430, 435-36, 248 S.E.2d 416, 419-20 (1978). Cf. *Roe v. Farrell*, 69 Ill. 2d 525, 529-30, 372 N.E.2d 662, 664, (1978) (in absence of federal law, states are free equitably to apportion federal estate tax liability and costs of administration between probate and nonprobate assets).

<sup>284</sup> See generally ACPC chart, *infra* at Appendix, questions 7.a. and 7.b. No jurisdiction appears to require adjustment and none appears to have a practice of making it. *But see* ACPC chart, *infra* at Appendix, n.16 (Colorado practice); n.48 (Nevada practice).

<sup>285</sup> See, e.g., D. WESTFALL, *supra* note 74, ¶ 6.02; Barton, *supra* note 11, ¶ 903.2; Suter, *Careful Drafting of Apportionment Clauses Can Ensure Tax Burden Will Fall Where Client Intends*, 9 EST. PLAN 156, 157 (1982); Suter, *Techniques to Apportion Estate Taxes Will Have to be Reviewed Due to the New Tax Law*, 9 EST. PLAN. 96, 99 (1982).

<sup>286</sup> This, of course, is Professor Dobris' remission of fiduciary duty approach. See Dobris II, *supra* note 2, at 283-90 (judicial toleration of disproportionate allocation when a dispositive instrument contains an express or implied setting aside of the duty of impartiality).

<sup>287</sup> See *supra* notes 63-67 and accompanying text.

<sup>288</sup> Query: if all fiduciary duty is removed, would this "election" in fact be a general power of appointment? See generally I.R.C. §§ 2041, 2514, and the regulations thereunder. Cf. *Brittenstool v. Commissioner*, 46 T.C. 711 (1966), *acq.*, Rev. Rul. 78-445, 1978-2 C.B. 242.

disposition.<sup>289</sup> If the beneficiaries bearing the estate tax burden are not identical to those receiving the asset (and therefore bearing the burden of potential capital gains taxation on sale or other exchange of the property), higher overall values will benefit those having a relatively small estate tax burden and paying income tax at relatively high rates, while lower overall values will benefit those beneficiaries having a relatively large estate tax burden and paying income tax at relatively low rates.<sup>290</sup> Perhaps more importantly, election of higher overall values may significantly increase the size of formula gifts, or affect qualification under the Code's actual use valuation provisions for farm and other family business real property or under its closely held business estate tax deferral provisions.<sup>291</sup> Any equitable adjustment for such inequities can involve either reallocation on a pro rata basis of the total economic value of all tax benefits resulting from the election, or instead only compensation for any beneficiary who suffers significant economic harm from the election.

## 2. Statutory Responses

Three state statutes limit the availability of an adjustment. The Connecticut statutory power, if incorporated into the instrument, takes the most direct approach, relieving the fiduciary of the duty to make adjustments in all alternate valuation date situations.<sup>292</sup> The Maryland and New York statutes are compulsory, but only cover an instrument giving the surviving spouse an amount determined under a formula based on the amount of the federal estate tax marital deduction: both negate any duty to adjust and explicitly remove any further duty to elect the valuation date that will cause the greater marital deduction gift.<sup>293</sup> None of these statutes directly deals with harm suffered by beneficiaries because of disqualification under the farm and family business relief provisions referred to above.

## 3. Judicial Responses

While at least two New York cases have referred to this election, neither

<sup>289</sup> I.R.C. § 2032(a)(1), (2); *see also* Regs. § 20.2032-1(c).

<sup>290</sup> *See generally* J. PRICE, *supra* note 2, § 12.17; Conway & Hale, *supra* note 3, at A-8 to A-10; Dobris II, *supra* note 2, at 302-06; Moore, *Conflicting Interests 1978*, *supra* note 2, ¶¶ 602.6, 604; Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1903; Weigel & Trost, *supra* note 2, at 133.

<sup>291</sup> *See infra* text accompanying notes 297-323 (discussions of the farm and closely-held business relief provisions).

<sup>292</sup> The Connecticut statute provides:

The fiduciary may elect to value the estate [as of] the date of the decedent's death or [as of the alternate] valuation date, . . . whether or not such election increases or decreases the federal estate tax. No adjustments shall be required to be made between income and principal or between the property interests passing to any beneficiaries . . . as a result of such an election.

CONN. GEN. STAT. ANN. § 45-100e(35)(A)(West 1981 & Supp. 1982).

<sup>293</sup> *See* N.Y. EST. POWERS & TRUSTS § 11-1.2(B)(McKinney Supp. 1982-83); MD. EST. & TRUST CODE § 11-106 (1974); *see also* Dobris II, *supra* note 2, at 306 n.226 ('[A] New York court exercising its equitable powers would also reject any equitable adjustment for the death tax increase').



required that such an adjustment be made.<sup>294</sup> It appears that no other courts have directly discussed this problem.

#### 4. *Drafting Solutions*

In light of current practices,<sup>295</sup> the following guidelines are suggested:

a. *Simple Estate and Income Tax Returns.* When the planner or draftsman expects the fiduciary to face relatively simple estate and income tax results from the election, he could reasonably include an adjustment formula based upon a pro rata sharing of any economic harm flowing from the election and readily quantifiable by the claiming beneficiary. This approach probably would not work if qualification for farm and family business relief provisions were at issue.

b. *Complicated Estate and Income Tax Returns.* In some cases, a discretionary grant of authority to make adjustments, framed in broad terms and buttressed with broad exculpation, may be appropriate. Such discretion would be the only reasonable manner of allowing the fiduciary to adjust for essentially speculative economic harm. For example, a surviving spouse's marital deduction formula gift may be reduced when other elections have been made to increase the gift's value and disqualification under the actual use valuation has resulted. Unless there is a substantial likelihood that such economic harm will be suffered, however, this adjustment is essentially speculative and should be prohibited.

Thus, in most situations, this adjustment would be unreasonably complex and expensive and in most instruments should be prohibited. Although the risks of self-dealing and lack of impartiality will be present when a beneficiary (particularly, the surviving spouse) serves as fiduciary,<sup>296</sup> many transferors will have good reasons for assuming these risks.

#### Q. *Election to Value Farm or Other Closely Held Business Real Property Based on Its Actual Use, Not on Fair Market Value*

Section 2032A permits an executor to elect to value qualifying farm or other closely held business real property based on its actual use, reducing the land's value for estate tax purposes by up to \$750,000 for decedents dying in 1983 and thereafter.<sup>297</sup> Qualification depends on satisfaction of complicated conditions

<sup>294</sup> See *In re McTarnahan's Estate*, 27 Misc. 2d 13, 14, 202 N.Y.S.2d 618, 619 (Sur. Ct. N.Y. County 1960)(no equitable adjustment ordered when fiduciary's election under section 642(g) to apply administration expenses as a credit against estate income taxes resulted in an increase in size of gift to surviving spouse); *In re Estate of Yalden*, 175 N.Y.L.J. 13 (Sur. Ct. Queens County June 24, 1976)(fiduciary failed to elect alternate date and was surcharged; no equitable adjustment made among beneficiaries' interests).

<sup>295</sup> See ACPC chart *infra* at Appendix, questions 5.a., 5.b. In only one state, California, might adjustment be required (*but see* ACPC chart at Appendix n.12); and in only two states, Oklahoma and Nevada, is adjustment a common practice (*but see* ACPC chart at Appendix n.48, Nevada fiduciary has absolute discretion). For information on negative responses regarding practices, see *infra* ACPC chart at Appendix nn.24 (District of Columbia, exception for unusual circumstances), 69 (Oregon, adversely affected beneficiary must consent to any adjustment).

<sup>296</sup> See *supra* notes 65-69 and accompanying text; *see also* Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1915.

<sup>297</sup> See ERTA, *supra* note 18, § 421 (I.R.C. §§ 1040, 2032A amendments). For the most authoritative, and possibly the best, explanation of current section 2032A, see GENERAL EXPLA-

regarding use and disposition of the real property and the conduct of family members, both before and after death.<sup>298</sup> Qualification permits valuation under a net rent capitalization method or a vague multiple factor method; experience has shown that the former often produces remarkably low values.<sup>299</sup> Retaining qualification after death is also subject to complicated requirements on continuation of the business use, continued ownership and continued family business participation for ten years.<sup>300</sup> If the postmortem requirements are not met, a recapture tax is imposed in the amount of the estate tax reduction attributable to the reduced value of the property.<sup>301</sup> Finally, the income tax basis of such property is adjusted to the actual use value, not the fair market value, but may be increased to the fair market value if the recapture tax is paid, provided that the qualified family devisee also pays interest on the recapture tax amount from the date on which the estate tax was originally due.<sup>302</sup>

Clearly, this provision may be advantageous to devisees bearing the estate tax burden for the real property, but may penalize devisees wishing to sell the property or otherwise end its farm or business use.<sup>303</sup> Although one group of beneficiaries may receive the benefit of the election and another may receive its cost, an equitable adjustment should never be necessary. First, the better drafting practice is to allocate all estate tax liability attributable to such specially valued property directly to the family members receiving it.<sup>304</sup> Second, and more importantly, to make a qualifying election the fiduciary must provide the Service with an agreement signed by all persons having an interest in the property, in which they consent to personal liability for and collection of any recapture tax eventually payable on account of the qualified property.<sup>305</sup> Such "interested parties" include every person with a conceivable right to challenge payment of

NATION, *supra* note 73, at 244-54; *see also* J. PRICE, *supra* note 2, § 12.18; Committee on Tax Legislation and Regulations, Real Property, Probate and Trust Law Section, American Bar Association, *Special Rules for Valuation and Deferral of Payment of Taxes, Recommendations for Regulations and Legislative Changes Regarding I.R.C. § 2032A*, 17 REAL PROP. PROB. & TR. J. 321 (1982) [hereinafter cited as *Recommendations for I.R.C. § 2032A*].

<sup>298</sup> *See also* GENERAL EXPLANATION, *supra* note 73, at 244-48, 249-51 (effect of ERTA, *supra* note 18, on section 2032A predeath qualification requirements, election requirements, valuation requirements and postdeath recapture rules). *See generally* I.R.C. § 2032A(a) to (c). Regarding pre-mortem qualification, *see* Regs. §§ 20.2032A-3, 20.2032A-4.

<sup>299</sup> I.R.C. § 2032A(e)(7)(net rent capitalization method), (e)(8)(multiple factor method). The former subsection utilizes the reciprocal of a five-year average for Federal Land Bank interest rates. *See also* Hartley, *Final Regulations under 2032A: Who, What and How to Qualify for Special Use Valuation*, 53 J. TAX'N 306 (1980). *See generally* *Recommendations for I.R.C. § 2032A*, *supra* note 297, at 329-31, 334-38 (discussion of valuation under section 2032A(e)(7) and (e)(8)).

<sup>300</sup> *See generally* I.R.C. § 2032A(c).

<sup>301</sup> I.R.C. § 2032A(c). *See also* I.R.C. § 6324B and the regulations thereunder; § 6325; *Recommendations for I.R.C. § 2032A*, *supra* note 297, at 326 (subordination of recapture tax lien imposed by section 6324B).

<sup>302</sup> *See* I.R.C. § 1016(c); GENERAL EXPLANATION, *supra* note 73, at 250-51.

<sup>303</sup> The most thoughtful discussion of this equitable adjustment topic appears in Barton, *supra* note 11, ¶¶ 902.2, 902.3. *See also* Weigel & Trost, *supra* note 2, at 135.

<sup>304</sup> *See* Barton, *supra* note 11, ¶¶ 902.2, 902.3.

<sup>305</sup> Regs. § 20.2032A-8(c)(1)(1981). *See also* I.R.C. §§ 6324B(d), 6325. The family members can avoid such personal liability, however, if they post bond in compliance with section 2032A(c)(11). I.R.C. § 2032A(c)(5).

that tax, with the exception of potential will contestants and creditors of the decedent.<sup>306</sup> Thus, although beneficiaries may disagree as to the overall benefit of the election, all must consent for it to be valid. If any beneficiary were later to claim economic harm because of the election, he presumably would be estopped from seeking an equitable adjustment.<sup>307</sup> Finally, any such adjustment would inevitably be complex and costly, and for this reason alone should be prohibited.

#### R. *Tender of Closely Held Corporate Stock For Redemption and Use of Proceeds to Pay Death Taxes and Other Qualified Expenses*

Under section 303, any beneficiary or other distributee who receives certain closely held corporate stock included in a decedent's gross estate, the value of which exceeds thirty-five percent of the gross estate's value (minus amounts deductible under sections 2053 and 2054), and who is liable for death taxes, funeral costs and administration expenses, may tender the stock for redemption and treat gain on the redemption as long term capital gain.<sup>308</sup> Although equitable adjustment may be possible in connection with section 303 redemptions, the only beneficiaries potentially harmed by such a redemption are those tendering the stock. The redemption clearly cannot qualify under section 303 unless the beneficiaries receiving the stock are directly liable for those taxes and expenses.<sup>309</sup> Further, Professor Babette Barton has warned that an equitable ad-

<sup>306</sup> Regs. § 20.2032A-8(c)(2). This subsection restricts a qualifying "interest in property" to one which "as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate." *Id.* (emphasis added). Thus, the interest can be future or contingent. *Id.* See generally *infra* note 341 and accompanying text (consensual adjustment may require appointment of guardian ad litem for minor, unborn, contingent or unascertainable beneficiaries). By sufficiently limiting all future and contingent interests in the real property, the decedent may eliminate the need to have guardians ad litem appointed to sign the consent agreement on behalf of the beneficiaries of those interests. Such beneficiaries, however, probably could not claim an equitable adjustment based on the special use valuation election. See generally *Recommendations for I.R.C. § 2032A*, *supra* note 297, at 326.

<sup>307</sup> But see CONN GEN. STAT. ANN. § 45-100e(35)(F), (H)(West Supp. 1982)(fiduciary authorized to make all elections respecting valuations authorized by section 2032A, without incurring personal liability for action taken or omitted in good faith). Connecticut's provision implies that at least some legislators fear that equitable adjustment claims may arise from the election.

<sup>308</sup> I.R.C. § 303. See GENERAL EXPLANATION, *supra* note 73, at 255-58 (explaining prior law and 1981 amendments to section 303). See also J. PRICE, *supra* note 2, §§ 11.14-11.21; Kahn, *Closely-Held Stocks—Deferral and Financing of Estate Tax Costs Through Sections 303 and 6166*, 35 TAX LAWYER 639, 640-46, 658, 664-76 (1982).

<sup>309</sup> I.R.C. § 303(b)(3). Cf. Moore, *Conflicting Interests 1978*, *supra* note 2, ¶ 608 (whether expenses taken as income or estate tax deductions makes no difference in meeting qualifying percentage tests of section 303(b)(2)(A)). A problem appears to be raised under section 6166, which allows deferral of estate tax payments for that portion of the tax attributable to closely held business interests if the value of those interests exceeds 35% of the adjusted gross estate. I.R.C. § 6166(a)(1). A section 303 redemption generally is not a disposition of the family business interest that can result in acceleration of the deferred estate tax liability under section 6166(g). See I.R.C. § 6166(g)(1)(A), (B). If the section 303 redemption does not qualify under the explicit terms of section 6166(g)(1)(B)(which requires the proceeds to be used to make qualifying payments within one year), however, acceleration can occur. This conflict is more apparent than real, however, because section 303 specifically requires that the owner of such stock be personally liable for death tax payments and therefore it is unlikely that payments other than for federal estate tax will cause the 50% threshold of section 6166(g)(1)(A)

justment after a section 303 redemption could be disastrous: “[A] compensating adjustment, in the form of a reduction in taxes apportioned to such shareholders, would pro tanto sacrifice a right to relief under I.R.C. Section 303.”<sup>310</sup>

### S. *Election to Defer Automatically Payment of Estate Tax Attributable to Closely Held Businesses*

#### 1. *Tax Law Sources of the Election and Adjustment*

Pursuant to section 6166, an executor holding a qualifying closely held business interest may elect to defer payment of the estate tax attributable to that interest for five years and to pay it in up to ten annual installments.<sup>311</sup> During the deferral period, the fiduciary must pay interest on unpaid tax.<sup>312</sup> The provision imposes interest charges as follows: on \$345,800 reduced by the amount of the credit allowable under section 2010(a), at four percent per year; and on the tax attributable to the rest of the business interest, at the then effective general rate for unpaid taxes.<sup>313</sup> If an interest or estate tax installment payment is missed,<sup>314</sup> if the fiduciary accumulates undistributed income in the estate<sup>315</sup> or if more than fifty percent of the original value is withdrawn (through sale of the interest or other withdrawal of value from the business),<sup>316</sup> the obligation to pay is accelerated and the right to deferral is terminated.<sup>317</sup> Thus, the election to terminate deferral is an additional election available to a fiduciary receiving such a business interest.

Conflicts among beneficiaries arise when different groups bear the burdens or reap the benefits of the election or termination. For instance, one group of beneficiaries may bear the burden of the interest payable on deferred tax, while another group receives reduced income because section 6166 effectively bars reinvestment in a different business.<sup>318</sup> Still another group of beneficiaries may bear an additional risk of loss due to retention of the business interest.<sup>319</sup> Hence,

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to be exceeded. *See generally infra* notes 311-21 and accompanying text (discussion of section 6166).

<sup>310</sup> Barton, *supra* note 11, ¶ 902.2, at 9-52 n.73.

<sup>311</sup> I.R.C. § 6166(a)(1). The heading of section 6166(a) is misleading because only a nine-year “installment payment” period is involved. *See also* ERTA, *supra* note 18, § 422 (amendments to section 6166); GENERAL EXPLANATION, *supra* note 73, at 255-58; J. PRICE, *supra* note 2, §§ 11.26-11.31; Kahn, *supra* note 308, at 646-49, 651-55, 664-81. *See generally* Regs. §§ 20.6166-1, 20.6166A-1, 20.6166A-2.

<sup>312</sup> I.R.C. § 6166(f)(1).

<sup>313</sup> *See* Kahn, *supra* note 308, at 650. *See also* I.R.C. §§ 6601(j), 6621(b). *Compare* I.R.C. § 6601(j)(2)(establishing interest rate of four percent on deferral amount of up to \$345,800 minus “credit allowable under section 2010(a)”) with I.R.C. § 2001(c)(tax of \$345,800 imposed on estate of \$1,000,000).

<sup>314</sup> I.R.C. § 6166(g)(3).

<sup>315</sup> I.R.C. § 6166(g)(2).

<sup>316</sup> I.R.C. § 6166(g)(1).

<sup>317</sup> I.R.C. § 6166(g). *See also* I.R.C. §§ 6324A, 6325; Regs. §§ 20.6324A-1, 20.6325-1, 301.6324A-1. *See generally* Kahn, *supra* note 308, at 655-64.

<sup>318</sup> I.R.C. § 6166(g)(1).

<sup>319</sup> *See* Professor Barton’s explanation of how inequities can arise under this election:

an equitable adjustment decision would be complicated by the varying needs and expectations of such beneficiaries regarding business performance during the deferral period. If the election requires the decedent's estate to remain open during the deferral period, perhaps with a personal representative retaining legal title to the business interest, any beneficiary whose right to income does not commence until final distribution will be penalized.<sup>320</sup> Further, administration expenses that can be deducted either on the fiduciary income tax or the estate tax return may be significantly increased, perhaps thereby necessitating further *Warms* adjustments.<sup>321</sup>

## 2. Statutory Responses

Connecticut's statutory power, if incorporated by reference into the instrument, deals indirectly with the adjustment issue: "The fiduciary is authorized in its discretion to elect to pay . . . any part of the federal estate tax . . . [under section] 6166."<sup>322</sup> Any fiduciary taking "action . . . in good faith under said authorization" is specifically relieved of "personal liability" for making the election.<sup>323</sup> No other statute directly discusses this election problem.

## 3. Judicial Responses

No cases were found directly discussing this problem.

## 4. Drafting Solutions

If one group of beneficiaries bears the burden of estate taxes on the business interest, another group bears the burden of interest charges on deferred tax, a third group is harmed by lower earnings from the business and a fourth bears the risk that the business interest will decline in value, at least four separate

[T]he one complication, as with all elections, is that the benefits and brunt may not be distributed ratably among beneficiaries. In fact, precisely the same conflicts adverted to earlier, in connection with . . . [the *Warms* election, *supra* notes 29-69 and accompanying text] will arise here, since the interest assessed for the privilege of deferral is now settled to be deductible either as an administrative expense on the estate tax return or as a deduction on the estate's income tax return. . . .

Either way, equitable assignments and adjustments among beneficiaries necessitate precise ascertainment both of the potential economic gains and costs of deferral and of the respective participants in each. [T]he potential net economic gain . . . consists of the difference between after-tax investment income from the deferred tax dollars . . . over after-tax costs of deferral. . . . In other words, the overall net economic gain from deferral is a function of four factors, [gross investment income, income taxes, actual interest charges for deferral and income or estate tax savings from their deduction], the amount . . . of which turns on actions by the fiduciary . . . . However, the incidence of these four factors, or fiduciary actions to maximize the gain, is borne differently by individual beneficiaries.

Barton, *supra* note 11, ¶ 902.2 [footnotes omitted].

<sup>320</sup> See IND. CODE § 29-1-17-7 (1976)(unless decedent's will otherwise provides, all income received by personal representative during administration of estate constitutes asset of estate and, if not expended during administration, augments residue).

<sup>321</sup> See *supra* notes 19-69 and accompanying text.

<sup>322</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(D)(West 1981 & Supp. 1982).

<sup>323</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(H)(West Supp. 1982).

drafting goals must be reconciled: minimizing estate taxes, minimizing interest charges, maximizing current business income and facilitating reinvestment of trust or estate assets. To the extent possible, draftsmen should place all of these risks and burdens on the same group of beneficiaries. If the transferor disapproves of this direct approach, he probably should give the fiduciary broad discretion to make the election (and, perhaps, to terminate deferral) and grant equally broad exculpation to the fiduciary from any resulting claim. Such exculpation should not be so broad as to exonerate the fiduciary, for example, for negligent failure to pay interest or negligent withdrawals from the business causing acceleration and loss of the deferral benefits. Consider, however, the fiduciary's dilemma regarding reinvestment: how can a fiduciary safely elect to defer estate tax payment when the acceleration provisions of section 6166 imply a virtual refusal to reinvest when otherwise reasonable?

T. *Election to Defer Estate Tax Payments on Remainder Interests and to Request Discretionary Deferral of Estate Tax Payments*

Sections 6163 and 6161 appear to present similar issues. Section 6163 allows deferral of any estate tax attributable to a remainder interest until six months after the termination of the preceding interest,<sup>324</sup> provided interest is paid at the general rate for unpaid taxes during the deferral period.<sup>325</sup> Section 6161, however, grants the Commissioner discretion to extend the time for payment of tax on any estate up to ten years for "reasonable cause."<sup>326</sup> Thus, the discretionary aspect of a section 6161 deferral supersedes any conceivable fiduciary "election" and eliminates the need for equitable adjustment. The Connecticut statutory power, if incorporated by reference into the instrument, authorizes the fiduciary to defer estate tax payment under both sections and immunizes the fiduciary from any resulting personal liability.<sup>327</sup> Again, the planner or draftsman should eliminate these issues by, when possible, placing all deferral burdens and benefits on the same group of beneficiaries. Equitable adjustment would be unreasonably complex and expensive, and the draftsman foreseeing serious inequities and not wishing to place all burden and benefits on one group of beneficiaries instead should give the fiduciary broad discretion to make such elections and grant equally broad exculpation from resulting claims.

<sup>324</sup> I.R.C. § 6163(a).

<sup>325</sup> I.R.C. § 6601(a).

<sup>326</sup> I.R.C. § 6161(a)(2). Section 6163(a) states that estate tax on a "reversionary or remainder interest" may be paid up to six months "after the termination of the precedent interest." Section 6163(b) states that "the Secretary may extend the time for payment for [an additional] reasonable period or periods not in excess of 3 years from the expiration of the period of postponement provided in subsection (a)." See also I.R.C. § 6165; Regs. § 20.6165-1 (1962). See generally J. PRICE, *supra* note 2, §§ 12.37-12.38; H. DUBROFF & D. KAHN, *supra* note 175, ¶ 18.3, at 290-91 (discussing application of "reasonable cause" standard for extension under section 6161); King, *Extensions of Time to Pay Estate Tax Pursuant to Sections 6161 and 6163*, in POST MORTEM ESTATE PLANNING 285-91 (P. Asofsky ed. 1981).

<sup>327</sup> CONN. GEN. STAT. ANN. §§ 45-100e(35)(E), (H)(West Supp. 1982).

## U. *Election to Split Gifts with a Surviving Spouse on the Decedent's Final Gift Tax Return*

### 1. *Tax Law Sources of the Election and Adjustment*

Under section 6019, the fiduciary required to file the estate tax return (under section 6018) and the decedent's final income tax return (under section 6012 or 6013) also must file any federal gift tax return that the decedent would have had to file had he not died.<sup>328</sup> Under the section 2513 regulations, the fiduciary can consent to split gifts made by the decedent or by the surviving spouse and treat them as having been made one-half by each.<sup>329</sup> Under the unified federal estate and gift tax system, if the decedent has made premortem taxable gifts and a fiduciary wishes to reduce gift taxes, he can do so by obtaining the surviving spouse's consent to split gifts. Similarly, if the surviving spouse has made gifts prior to the decedent's death, the fiduciary can increase the decedent's gift or estate tax liability by electing to have the surviving spouse's gifts split, thereby causing one-half of them to be included in the decedent's final gift tax return. These effects can be heightened by the nondeductibility on the estate tax return of such gift taxes actually paid by the estate.<sup>330</sup> This problem is somewhat analogous to that of deducting medical expenses on the decedent's final income tax return: when the beneficiary bearing the burden of the decedent's debts is not identical to the beneficiary bearing the burden of estate or gift taxes, the gift splitting election can cause significant inequities. If the surviving spouse is not a beneficiary of the estate or trust, assuming some portion of the surviving spouse's gift tax or increasing the decedent's estate or gift tax by electing to split gifts can violate the fiduciary's basic duty to minimize overall taxation— if the surviving spouse is a beneficiary, the election also may violate the duty to treat beneficiaries impartially.

### 2. *Statutory Responses*

Again, only Connecticut's statutory power, if incorporated by reference into the instrument, specifically deals with this issue:

The fiduciary is also authorized but not required to execute and file a gift tax return with the decedent's spouse . . . [and] to consent to treat any gifts made by the decedent's spouse as being made one-half by the decedent. The fiduciary may pay such . . . gift taxes as are chargeable to the decedent and, in its discretion, may pay the entire amount of such taxes. The fiduciary shall incur no personal liability for any [such] action taken by it in good faith.<sup>331</sup>

<sup>328</sup> J. PRICE, *supra* note 2, § 12.4; Conway & Hale, *supra* note 3, at A-6; Wintriss, *Gift-splitting Can Increase Tax Effectiveness of Gift Program That Is Part of an Estate Plan*, 9 EST. PLAN. 340, 342, 344-45 (1982).

<sup>329</sup> Regs. § 25.2513-2(c). If the decedent spouse leaves no estate to be administered (e.g., having transferred all assets to a revocable trust), the surviving spouse instead can elect, perhaps with no fiduciary duties. Rev. Rul. 67-55, 1967-1 C.B. 278.

<sup>330</sup> Regs. § 20.2053-6(d); Rev. Rul. 70-600, 1970-2 C.B. 194. See generally Wintriss, *supra* note 328, at 344-45 (gift tax paid by estate of consenting spouse nondeductible because decedent not liable for tax at date of death).

<sup>331</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(C)(West 1981 & Supp. 1982).

Because under section 2513(d) the fiduciary subjects himself to joint and several liability for the surviving spouse's gift tax, this authorization to "pay the entire amount of *such* taxes" apparently authorizes the fiduciary to pay the surviving spouse's pro rata share of the tax as well, regardless of whether she is a beneficiary. No other statutes directly discuss this problem.

### 3. *Judicial Responses*

No cases were found directly discussing this problem.

### 4. *Drafting Solutions*

There are at least three possible approaches to planning or drafting for this election: (a) place the burden of any premortem gift taxes on those beneficiaries who bear the estate tax burden (optimally, on the surviving spouse), (b) prohibit the election entirely, or (c) specifically permit the election in a manner similar to that used by the Connecticut provision (i.e., also permit the fiduciary to pay the surviving spouse's share of the gift tax liability). If the third alternative is chosen, the draftsman should exculpate the fiduciary and, in light of the potentially donative quality of this election, should clearly indicate approval of the fiduciary's transferring an additional economic benefit to the surviving spouse. Fiduciaries administering estates or trusts under instruments not discussing the election probably can safely refrain from adjustment, due to the absence of any statutory or case law requiring it. The fiduciary also can refrain from compensating the surviving spouse who suffers economic harm by electing to split gifts, because the voluntary quality of the election would almost certainly estop her from later claiming an adjustment.

## V. *Reimbursement of Settlor's of Short Term Reversionary Interest Trusts for Capital Gains Tax Payable Because of Sales of Trust Assets*

A superficially similar adjustment question arises regarding fiduciary reimbursement of capital gains tax paid by the settlor of a short term reversionary interest trust because of sale or other taxable exchange of principal assets. Section 673 allows income from a reversionary trust terminating at least ten years after its creation (or upon the earlier death of the income beneficiary) to be taxed to the income beneficiary, not to the settlor.<sup>332</sup> Section 677(a)(2), however, provides that income accumulated for the settlor or gain recognized by the principal account and eventually reverting to the settlor (e.g., capital gains) is taxed to him in the year in which it is recognized by the trust.<sup>333</sup> Because the settlor conceivably may not have the wherewithal to pay the tax (the trust principal is beyond his direct reach, of course), New York and Pennsylvania courts have approved equitable reimbursement of at least a portion of the settlor's income

<sup>332</sup> Regs. § 1.673(a)-1 (note subsection (d) regarding contingent reversions).

<sup>333</sup> Regs. § 1.677(a)-1(b)(2); see also Regs. § 1.677(a)-1(c). See generally Berall, *How to Deal with the Capital Gains Problem of the Settlor of a Short-Term Trust*, 7 EST. PLAN. 86 (1980).



tax liability.<sup>334</sup> Furthermore, New York statutorily authorizes such reimbursements.<sup>335</sup> The ACPC survey, however, shows that only Nevada has a practice of reimbursement; in the other four jurisdictions in which relevant law or practice exists (New York, Pennsylvania, Rhode Island and the District of Columbia), reimbursement is neither generally required nor frequently made.<sup>336</sup> Nonetheless, an equitable reimbursement right would resemble a section 676 reversionary interest effective during the trust term, because under section 677 the settlor himself (not the trustee) would bear the tax liability and principal would be distributed out to pay his liability.<sup>337</sup> Hence, section 673 qualification could be lost for any portion of principal that could be reimbursed because of such settlor tax liability.<sup>338</sup> Therefore, it is recommended that the instrument not only bar reimbursement but also bar direct payment of the liability from trust principal.<sup>339</sup> New York draftsmen should specifically negate its statutory power. Courts facing this issue usually should presume, because reimbursement threatens section 673 disqualification, that the settlor intended not to create such an equitable reversionary right. Consensual reimbursement appears to be useless here—a contractual side payment by the trust beneficiary likely would raise the same problems as reimbursement.<sup>340</sup>

### III. CONSENSUAL ADJUSTMENTS

Neither statute nor judicial precedent nor draftsmanship offers a complete solution to the equitable adjustment questions raised above. One further way to dispose of adjustment claims may be to have the fiduciary and beneficiaries negotiate an out of court settlement (perhaps taking the form of a consensual approval of the fiduciary's account). Consensual adjustment often will be un-

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<sup>334</sup> New York: *In re Cowen*, 151 N.Y.L.J. 16 (Sup. Ct. N.Y. County February 13, 1964); *In re Goldman*, 151 N.Y.L.J. 13 (Sup. Ct. N.Y. County April 7, 1964). Pennsylvania: *In re French's Estate*, 61 Pa. D. & C.2d 654, 658-59 (Orphans' Ct. 1963). The *French* court used its equitable powers to reimburse only that amount which the trustee would have paid had he been liable for the tax.

<sup>335</sup> N.Y. EST. POWERS & TRUSTS LAW § 7-1.11(a)(McKinney 1979).

<sup>336</sup> See ACPC chart, *infra* at Appendix, questions 8.a. and 8.b. See also *id.* nn.24, 48, 55, 74.

<sup>337</sup> See Rev. Rul. 66-161, 1966-1 C.B. 164; see also Levin & Natsui, *Permitting Trust to Make Distributions to Pay Tax on Trust Gains May Be Inadvisable*, 55 J. TAX'N 372, 374-75 (1981). Levin & Natsui state:

[W]here a nonadverse trustee has the power to sell appreciated trust assets, thereby giving rise to capital gains, it is arguable that the [settlor] is to be treated as the owner of a portion of the trust from its inception.

*Id.*

<sup>338</sup> See Levin & Natsui, *supra* note 337, at 374.

<sup>339</sup> See Berall, *supra* note 333, at 87 (discussing how two methods of tax payment produce same economic result and may produce same disqualification under section 673); see also *Diedrich v. Commissioner*, 102 S. Ct. 2414 (1982)(similar reasoning regarding section 2502 gift tax liability); Levin & Natsui, *supra* note 337, at 375 (reimbursement or direct payment may result in grantor being taxed on income of part of trust).

<sup>340</sup> The only sure solution to this problem is amendment of the Code to permit such reimbursements without sections 673 and 676 dangers.

workable or still will involve legal proceedings, however, because (a) to be valid, the settlement must be agreed to by beneficiaries who are ascertainable and sui juris (a guardian ad litem may have to be appointed for minor, incapacitated, contingent or unborn beneficiaries); (b) agreement without independent legal representation of beneficiaries may be invalid and the fiduciary's legal representative may have serious ethical concerns; (c) negotiations may be time consuming and costly; and (d) a trust beneficiary may be barred by a spendthrift provision from so alienating any of his interest.<sup>341</sup> Even if these difficulties are overcome, the fiduciary or anxious beneficiary still may want to obtain court approval of the adjustment.<sup>342</sup>

Consensual adjustments can be particularly useful when neither the planner nor the transferor has anticipated the significant inequities that result from the tax election (e.g., when unexpected large sales of appreciated assets and substantial principal expenditures have caused serious economic harm to principal beneficiaries, and *Rice-Dick-Converse* adjustments have been specifically prohibited).<sup>343</sup> When no readily apparent legal or equitable right to such adjustment exists under the instrument (or under state law), additional problems arise: adjustment reasonably can be viewed as income to the originally favored or disfavored beneficiary, reducing the economic value of the adjustment and perhaps necessitating further adjustments,<sup>344</sup> and if adjustments are not income, they likely are gifts by the originally favored beneficiaries to those disfavored, potentially subject to federal and state gift taxes.<sup>345</sup>

Planners and draftsmen should note that particular adjustment issues are more or less amenable to resolution through consensual adjustment. For instance, trapping distribution adjustments usually will benefit future principal beneficiaries of a distributee trust, and these beneficiaries will often be contingent, incapacitated (perhaps on account of minority) or unascertainable, thereby requiring appointment of a guardian and substantial court intervention.<sup>346</sup> Beneficiary agreement on non-pro rata distributions, on the other hand, is frequently encountered in estate distribution, and many states have cases or statutes specifically authorizing a personal representative to distribute in accordance with the wishes of the beneficiaries.<sup>347</sup>

<sup>341</sup> See J. RITCHIE, N. ALFORD & R. EFFLAND, *supra* note 225, at 661-63, for analogous problems encountered in beneficiary terminations of trusts; see also E. SCOLES & E. HALBACH, *supra* note 2, at 370; Westfall, *Nonjudicial Settlement of Trustees' Accounts*, 71 HARV. L. REV. 40, 61 (1957).

<sup>342</sup> But see *supra* note 68 and accompanying text.

<sup>343</sup> See *supra* text accompanying notes 101-20.

<sup>344</sup> See *supra* note 57 and accompanying text; Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1915 (discussion of whether adjustment is income or gift).

<sup>345</sup> Moore, *Conflicting Interests 1975*, *supra* note 2, ¶ 1915. See generally I.R.C. § 2501; see also Regs. § 25.2511-1(c).

<sup>346</sup> See generally *supra* note 124. See also Regs. §§ 1.652(a)-1 (general discussions of this effect), 1.662(a)-1, 1.662(c)-4 (similar discussion of sections 661 and 662).

<sup>347</sup> E.g., UNIF. PROB. CODE § 3-912, 8 U.L.A. 281, 474 (1975)(directs executor to "abide by the terms of" any agreement among the beneficiaries "to alter the . . . amounts to which they were entitled under the will . . . or under the laws of intestacy, in any way that they provide . . .").

## IV. CONCLUSION

Equitable adjustments are as complex and varied as the fiduciary tax elections and nonelective procedures that give rise to them. Their intricacies and dilemmas stem from contradictions inherent in fiduciary duty: how can a fiduciary not only conserve property but also minimize tax burdens, treat all beneficiaries fairly and be totally selfless in doing so? The essence of some commentary and judicial decisions regarding these adjustments seems to be philosophical inquiry rather than legal analysis.<sup>348</sup> The purpose of this article has not been to further the philosophical debate over such adjustments, however, but to inform professionals in this area as to current precedents and practice and thereby to encourage evolution of uniform practices. As the ACPC survey shows, in some states beneficiaries have no practical rights and in other states fiduciaries have little protection.<sup>349</sup> Few of the major texts and treatises in the decedents' estates and trusts area even discuss the topic. Clearly, a greater effort at analysis and policy making must be made before uniform practices can evolve.

The development of equitable adjustment practices largely has represented a balancing of the goals of protecting beneficiary rights and reducing administration expense. How particular problems should be approached, however, depends upon one's role in the fiduciary administration system:

A. *Draftsmen and Planners*

Draftsmen and planners should begin by considering whether, notwithstanding possible inequities under a tax election, the cost and complexity of making an adjustment will outweigh its value to disadvantaged beneficiaries. Most equitable adjustments probably should be expressly prohibited. When the draftsman confronts relatively simple inequities and can draft a simple solution (presumably involving a formula and relatively infrequent adjustments), adjustments should be required. If the fiduciary is willing to risk litigation, beneficiary strife and, consequently, increased administrative costs, broad discretion to make such adjustments may be given, but always with broad exculpation. The draftsman always should consider going to the root of the inequity and directly removing it: in some situations mentioned in this article, reserves for principal charges, depreciation and the like could be established, and the draftsman could allocate tax and expense burdens to remove inequities. Finally, the draftsman should inform the client that naming a beneficiary as the fiduciary to make such elections or adjustments creates risks of self-dealing claims. While these risks will be acceptable to some clients, they should only be consented to after a complete discussion with the draftsman or planner.

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<sup>348</sup> Dobris concluded his first article on equitable adjustments as follows: "Equity requires equality. That is, *equity requires harmony, classical forms, proportion*. Equitable adjustments provide order in the baroque world of postmortem planning." Dobris 1, *supra* note 1, at 149 (emphasis added). See also *In re Bixby's Estate*, 140 Cal. App. 2d 326, 339, 295 P.2d 68, 75 (1956) ("such a rule commends itself to the *conscience of the court* as one under which no one is injured by an *unjust encroachment* on his inheritance") (emphasis added).

<sup>349</sup> See generally ACPC chart, *infra* at Appendix.

### B. *Advisors of Fiduciaries*

The threshold problem for the average advisor will be insuring that the fiduciary consults with him about current and future equitable adjustment questions. Assuming such consultation occurs, the advisor will find few helpful precedents on equitable adjustments, not only because few courts and legislatures have examined the problem, but because those courts that have discussed equitable adjustments have not always taken a well-reasoned approach. In some states, statutes or cases require adjustments, while in a few states adjustments are explicitly prohibited. Sometimes the instrument will direct or prohibit adjustment. In any event, if the fiduciary can reasonably infer transferor intent not to adjust, that intent should be followed. In the absence of any such guidance, fiduciaries should approach claims for adjustment conservatively and do nothing unless precedent or statute requires it. They should be aware of what other local fiduciaries are doing and have done in the past about such elections. The fiduciary should communicate with as many of the beneficiaries as possible and whenever possible obtain their consent to the adjustment decision. The fiduciary should not discourage beneficiaries from seeking independent advice; he should welcome it. He also should welcome advice from the court, by filing accounts after the decision has been made and possibly by obtaining court orders in advance, when beneficiary agreement cannot be reached. Finally and most importantly, the prudent fiduciary must make a suitable record of considerations leading to the adjustment decision: this record should include analyses of relevant tax statutes and estate or trust law involved, calculations of probable economic effects on beneficiaries and copies of letters to beneficiaries describing the approach chosen.

### C. *Judges*

Judges also should enter this area with caution. They should review in detail the *Converse* case: its pragmatic analysis of the many consequences of such adjustments takes into account not only possible beneficiary harm but also possible fiduciary harm.<sup>350</sup> As a general rule, courts should not intervene in estate and trust accounting to reallocate beneficiaries' interests if no real choice existed for the fiduciary. The focus of their analysis should not be on whether some conceivable economic inequity resulted from the operation of the tax laws, but on whether the fiduciary had any choice about how the economic effects of a transaction would be passed on to beneficiaries. The *Dick* approach should be followed to the extent that it prohibits equitable adjustments when, as a practical matter, no election was available to the fiduciary.<sup>351</sup> Judges should also bear in mind that draftsmen, planners and fiduciary advisors often will have discussed such issues at length with transferors and, even if such discussions do not appear on the face of a dispositive instrument, every attempt should be made to respect

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<sup>350</sup> *New England Merchants Nat'l Bank v. Converse*, 373 Mass. 639, 643-44, 369 N.E.2d 982, 984 (1977).

<sup>351</sup> *In re Estate of Dick*, 29 Misc. 2d 648, 218 N.Y.S.2d 182 (Sur. Ct. N.Y. County 1961). See *supra* notes 105-08 and accompanying text.

an explicit or reasonably implicit intent not to make adjustments. Finally, in deciding such questions, courts should clearly state their approach, whenever possible in terms of their own or sister state precedents, and follow it in each subsequent case; in this way harm to clients for whom dispositive instruments have already been drafted will be minimized.

#### *D. Legislatures*

It is the role of the legislatures to balance the interests of fiduciaries and beneficiaries on a long term basis. State legislatures clearly cannot lessen the complexity of fiduciary tax elections. Similarly, it is beyond the resources of most to reconsider systematically the basic rules of fiduciary accounting set down in, for instance, the Revised Uniform Principal and Income Act.<sup>352</sup> Such uniform state legislation should be revised to solve the most serious of the equitable adjustment problems discussed in this article. In the absence of new uniform legislation, however, other state legislatures should carefully review the Connecticut tax election and equitable adjustment statute and discuss with fiduciaries, bar associations, other professional groups and consumer groups the possibility of enacting some or all of its provisions.<sup>353</sup>

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<sup>352</sup> See *supra* note 9.

<sup>353</sup> CONN. GEN. STAT. ANN. § 45-100e(35)(West 1981 & Supp. 1982).

# **APPENDIX**

## **EQUITABLE ADJUSTMENTS**

### **THE AMERICAN COLLEGE OF PROBATE COUNSEL**

Compiled by  
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Hartford, Connecticut

#### **INTRODUCTORY STATEMENT**

This chart and its footnotes set forth each state's law and local practice (where, as in most jurisdictions, there is no case or statutory law). Instruments may either authorize equitable adjustments, forbid them or say nothing, in which case local law or practice will apply.

The chart was compiled in a joint project between the American College of Probate Counsel and the Committee on Income of Estates and Trusts, Section of Taxation, American Bar Association. The chart entries for each state are based on an opinion received from a reporter for that state. With rare exceptions, reporters have been Fellows of the College from that state. Footnotes to the chart are, for the most part, verbatim comments of each reporter. Neither the College nor the individual reporters assume any responsibility for the accuracy of the information contained in the Appendix.

**Equitable Adjustments**

	A L A B A M A	A L A S K A	A R I Z O N A	A R K A N S A S S	C A L I F O R N I A	C O L O R A D O	C O N N E C T I C U T	D E L A W A R E	
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:									
a. required?	no		no <sup>2</sup>	no	yes <sup>9</sup>	no	no	no	
b. made as a matter of practice?	no		no	no <sup>6</sup>	yes <sup>9</sup>	yes <sup>14</sup>	no <sup>19</sup>	no	
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:									
a. required?	no		no <sup>3</sup>	no	no	no	no	no	
b. made as a matter of practice?	no		no	no <sup>6</sup>	no <sup>10</sup>	no	no	no	
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:									
a. required?	no		no	no	no	no	no	no	
b. made as a matter of practice?	no		no	no <sup>6</sup>	no <sup>11</sup>	yes <sup>14</sup>	yes <sup>20</sup>	no	
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:									
a. required?	no		no <sup>4</sup>	no	no	no	no	no	
b. made as a matter of practice?	no		no	no <sup>6</sup>	no	yes <sup>14</sup>	no <sup>21</sup>	no	
		<b>INSUFFICIENT</b>							





**EQUITABLE ADJUSTMENTS**

	D I S T. O F C O L U M B I A	F L O R I D A	G E O R G I A	H A W A I I	I D A H O	I L L I N O I S	I N D I A N A
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:							
a. required?	no	yes <sup>27</sup>	no	no	no <sup>28b</sup>	no	no
b. made as a matter of practice?	no <sup>24</sup>	no	yes <sup>28</sup>	no <sup>28a</sup>	no <sup>28c</sup>	no <sup>29</sup>	no
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:							
a. required?	no	no	no	no	no <sup>28b</sup>	no	no
b. made as a matter of practice?	no <sup>24</sup>	no	no	no	no <sup>28c</sup>	no <sup>29</sup>	no
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:							
a. required?	no	no	no	no	no <sup>28b</sup>	no	no
b. made as a matter of practice?	no <sup>24</sup>	no	no	no	no <sup>28c</sup>	no <sup>29</sup>	no
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:							
a. required?	no	no	no	no	no <sup>28b</sup>	no	no
b. made as a matter of practice?	no <sup>24</sup>	no	no	no	no <sup>28c</sup>	no	no



**Equitable Adjustments**

	I O W A	K A N S A S	K E N T U C K Y	L O U I S I A N A	M A I N E	M A R Y L A N D	M A S S A C H U S E T T S
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:							
a. required?	no	no	no	no	no	yes <sup>38</sup>	no
b. made as a matter of practice?	no	no	yes	no <sup>36</sup>	no	yes <sup>38</sup>	yes
2. When income beneficiaries are taxable on D. N. I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:							
a. required?	no	no	no	no	no	no	no <sup>40</sup>
b. made as a matter of practice?	no	no	no	no <sup>37</sup>	no	no	no <sup>40</sup>
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:							
a. required?	no	no	no	no	no	no	no <sup>40</sup>
b. made as a matter of practice?	no <sup>34</sup>	no	no	no <sup>36</sup>	no	yes <sup>39</sup>	no <sup>40</sup>
4. In other situations, when a distribution of principal carries out D. N. I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:							
a. required?	no	no	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no <sup>37a</sup>	no	no	no



**Equitable Adjustments**

	M I C H I G A N	M I N N E S O T A	M I S S I S S I P P I	M I S S O U R I	M O N T A N A <sup>47</sup>	N E B R A S K A	N E V A D A <sup>48</sup>
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:							
a. required?	no	no	NA	no	no	no <sup>47a</sup>	no
b. made as a matter of practice?	no	no	no <sup>43</sup>	no <sup>44</sup>	no	no <sup>47a</sup>	yes <sup>48</sup>
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:							
a. required?	no	no	no	no	no	no <sup>47a</sup>	no
b. made as a matter of practice?	no	no	no	no <sup>44</sup>	no	no <sup>47a</sup>	yes <sup>48</sup>
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:							
a. required?	no	no	no	no	no	no <sup>47a</sup>	no
b. made as a matter of practice?	no	no	no	no <sup>44</sup>	no	no <sup>47a</sup>	yes <sup>48</sup>
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:							
a. required?	no	no	no	no	no	no <sup>47a</sup>	no
b. made as a matter of practice?	no	no	no	no <sup>45</sup>	no	no <sup>47a</sup>	yes <sup>48</sup>



**Equitable Adjustments**

	N E W H A M P S H I R E	N E W J E R S E Y	N E W M E X I C O	N E W Y O R K	N O R T H C A R O L I N A	N O R T H D A K O T A	O H I O
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:							
a. required?	no	no <sup>49</sup>	no	yes <sup>51</sup>	no	no	no
b. made as a matter of practice?	no	no	no	yes <sup>51</sup>	yes <sup>58</sup>	no	no <sup>66</sup>
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:							
a. required?	no	no	no	no <sup>52</sup>	no	NR	no
b. made as a matter of practice?	no	no	no	no <sup>52</sup>	no <sup>59</sup>	NR	no
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:							
a. required?	no	no	no	yes <sup>55</sup>	no	no	no
b. made as a matter of practice?	no	no	no	yes <sup>55</sup>	no <sup>59</sup>	no	no
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:							
a. required?	no	no	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no	no	no	no





**Equitable Adjustments**

	O K L A H O M A	O R E G O N	P E N N S Y L V A N I A	R H O D E I S L A N D	S O U T H C A R O L I N A	S O U T H D A K O T A <sup>77</sup>	T E N N E S S E E
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment: a. required? b. made as a matter of practice?	no no	no yes <sup>68</sup>	no <sup>70a</sup> no <sup>70a</sup>	no yes <sup>71</sup>	no no	no no	no no
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment: a. required? b. made as a matter of practice?	no no	no no	no no <sup>70b</sup>	no no	no no	no no	no no
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment: a. required? b. made as a matter of practice?	no no	no yes <sup>68</sup>	no no <sup>70c</sup>	no yes <sup>72</sup>	no no	no no	no no
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment: a. required? b. made as a matter of practice?	no yes	no yes <sup>68</sup>	no no <sup>70d</sup>	no yes <sup>73</sup>	no no	no no	no no

5. When an estate tax valuation date election produces a greater estate tax and a higher income tax basis and thus less potential capital gain (or ordinary income) on a future disposition of property, is an adjustment: a. required? b. made as a matter of practice?	no yes	no no <sup>69</sup>	no no	no no	no no	no no	no no	no no
6. When there is a non-pro rata distribution from an estate, so that low basis assets are distributed to one beneficiary and high basis assets are distributed to another, is an adjustment: a. required? b. made as a matter of practice?	no no	no no <sup>69</sup>	no no	no no	no no	no no	no no	no no
7. When a fiduciary who is receiving benefits under a qualified plan does not represent the party in interest who bears the estate tax, what duty is there for the fiduciary to consider or adjust for an increase in the estate tax burden occasioned by an election to take the distribution in a lump sum? a. none b. see footnote	X	X	NR	X	X	X	X	X
8. When as a result of the realization of a capital gain by a grantor trust, the settlor becomes liable for the tax in his taxable year in which the gain is realized, is an adjustment: a. required? b. made as a matter of practice?	no no	no no	no <sup>70e</sup> no <sup>70e</sup>	no no <sup>74</sup>	no no	no no	no no	no no
9. Are there any other similar inequities for which adjustment is required to be made or is made as a matter of practice? a. no b. yes c. see footnote	X	X	X	X	X	X	X	X
10. What is the practice in your jurisdiction in making provision in the instrument regarding equitable adjustments? a. required b. prohibited c. the fiduciary may be given discretion to make or not to make adjustments d. the fiduciary may determine conclusively the details of each adjustment (if acting reasonably) e. none				X <sup>75</sup>		X <sup>76</sup>	X <sup>76</sup>	X

**Key:** NR—No response NA—Not applicable X—Answer applies

**Equitable Adjustments**

	TEXAS <sup>79</sup>	UTAH	VERMONT	VIRGINIA	WASHINGTON	WEST VIRGINIA	WISCONSIN	WYOMING <sup>80</sup>
1. When a fiduciary elects to treat estate administration expenses or losses as income tax deductions instead of estate tax deductions, is an adjustment:								
a. required?	no	no	no <sup>79a</sup>	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no	no	no	no	no
2. When income beneficiaries are taxable on D.N.I. which has been reduced by principal charges and in the same year there are items of income attributable to corpus which do not receive the benefit of a deduction for these principal charges, is an adjustment:								
a. required?	no	no	no	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no	no	no	no	no
3. When a trustee pays income tax on estate taxable income transferred to trust principal in the form of a corpus distribution, and the associated (state law) accounting income is later distributed to the income beneficiaries of the trust, is an adjustment:								
a. required?	no	no	no	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no	no	no	no	no
4. In other situations, when a distribution of principal carries out D.N.I. subjecting the recipient to tax on income which is enjoyed by others, is an adjustment:								
a. required?	no	no	no	no	no	no	no	no
b. made as a matter of practice?	no	no	no	no	no	no	no	no

5. When an estate tax valuation date election produces a greater estate tax and a higher income tax basis and thus less potential capital gain (or ordinary income) on a future disposition of property, is an adjustment:	a. required?	no	no	no	no	no	no	no	no	no	no	no	no
	b. made as a matter of practice?	no	no	no	no	no	no	no	no	no	no	no	no
6. When there is a non-pro rata distribution from an estate, so that low basis assets are distributed to one beneficiary and high basis assets are distributed to another, is an adjustment:	a. required?	no	no	no	no	no	no	no	no	no	no	no	no
	b. made as a matter of practice?	no	no	no	no	no	no	no	no	no	no	no	no
7. When a fiduciary who is receiving benefits under a qualified plan does not represent the party in interest who bears the estate tax, what duty is there for the fiduciary to consider or adjust for an increase in the estate tax burden occasioned by an election to take the distribution in a lump sum?	a. none	X	X	X	X	X	X	X	X	X	NR	X	X
	b. see footnote												
8. When as a result of the realization of a capital gain by a grantor trust, the settlor becomes liable for the tax in his taxable year in which the gain is realized, is an adjustment:	a. required?	no	no	no	no	no	no	no	no	no	no	no	no
	b. made as a matter of practice?	no	no	no	no	no	no	no	no	no	no	no	no
9. Are there any other similar inequities for which adjustment is required to be made or is made as a matter of practice?	a. no	X	X	X	X	X	X	X	X	X	X	X	X
	b. yes												
10. What is the practice in your jurisdiction in making provision in the instrument regarding equitable adjustments?	a. required												
	b. prohibited												
c. the fiduciary may be given discretion to make or not to make adjustments					X	/	X	X	X	X	X	X	X
	d. the fiduciary may determine conclusively the details of each adjustment (if acting reasonably)				X								X
e. none		X	X	X	X	X	X	X	X	X	X	X	X

Key: NR—No response NA—Not applicable X—Answer applies

## FOOTNOTES

*Alabama*

1. While there appears to be no general practice with respect to making any adjustments, some of the more sophisticated attorneys and corporate fiduciaries will make adjustments in certain instances. Instruments drawn by more experienced practitioners give fiduciaries discretion to make adjustments, but the vast majority of instruments have no such provisions.

*Arizona*

2. ARIZ. REV. STAT. § 14-3715 (Uniform Probate Code) allows a personal representative to allocate items of income or expense either to estate income or principal as permitted or provided by law. Ordinarily, no adjustment is made, but usually this is discussed with the beneficiary.

3. ARIZ. REV. STAT. § 14-7302, the Prudent Man Rule, provides that if a person has special skills or expertise, he has a duty to use them. In this situation no adjustment would be made nor would the personal representative be liable, unless it was imprudent to so act.

4. Should income be realized, it might be a violation of the Arizona Prudent Man Rule.

*Arkansas*

5. The Arkansas Uniform Principal & Income Act contains some general language giving a fiduciary latitude in the way he charges receipts and expenditures to achieve equity between the income and principal interests. Arkansas recognizes a fiduciary's duty of impartiality between multiple or successive trust beneficiaries. *Alexander v. Alexander*, 262 Ark. 612, 561 S.W. 2d 59 (1978). In the absence of a provision contained in many wills and trusts concerning equitable adjustments, the duty of a fiduciary to make such adjustments as a result of tax elections is unclear.

6. No adjustment appears to be required. It is not common practice to make adjustments absent a provision in the governing instrument either requiring or authorizing them.

7. ARK. STAT. ANN. § 62-2909.2, dealing with distribution of assets in satisfaction of a pecuniary marital deduction provision in kind at federal estate tax values or any values other than date of distribution or allocation ones, requires that the assets be fairly representative of appreciation and depreciation, although the repeal of carryover basis has minimized the problem caused by provisions in instruments authorizing distributions of assets in kind without reference to income tax bases.

8. It is fairly common to include some provisions in the governing instrument regarding equitable adjustments. The usual approach is not to require such adjustments, but rather to authorize the fiduciary to make them, in its discretion.

*California*

9. Principal must be made whole if administration expenses are taken as income tax deductions. *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956). Generally there is no adjustment made for losses except those deductible for estate tax purposes.

10. Some practitioners believe that a *Bixby* type of adjustment should be made.

11. Despite the absence of clear authority, under CAL. C.C. §§ 730.13(a)(7) and (c)(4) (The Revised Uniform Principal & Income Act), it is arguable that tax paid by a trustee is on "ordinary income." The income beneficiary is entitled to net probate income (See *Estate of de Laveaga*, 50 Cal. 2d 480, 326 P.2d 129 (1958)). While probate income may be determined in the estate, the trustee also has power to determine net income. The general practice is to charge the tax paid on "trapping distributions" to trust income. However, there are lawyers who do not follow these practices, while under the *Bixby* rationale (see footnote 9) an equitable adjustment is necessary to prevent corpus depletion.

12. While no adjustment is generally made in practice, if the fiduciary is also the beneficiary, California courts would probably require an adjustment, although if the election is made by an independent fiduciary, the ultimate decision is uncertain.

13. Cal. Probate Codes §§ 970 et seq.

*Colorado*

14. Some fiduciaries will make a "Bixby-Warms Adjustment" in this situation to make principal whole (see Howard Parks Probate and Practice Manual), although it is of dubious value to have

done this, absent specific provision authorizing or directing the personal representative to achieve the greatest tax savings. However, others make no adjustment, since most instruments do not require any adjustment for this, and instead take the various brackets (estate tax, estate's income tax and beneficiary's income tax) into consideration when deciding where to take the elective deductions.

15. Although non-pro rata distributions are now authorized to be made by statute (C.R.S. 1973, 15-1-804(2)(u) as amended by Section 20, House Bill 1230, 1979) effective for estates of persons dying on or after July 1, 1979, a fiduciary has a duty "to act reasonably and equitably with due regard for his obligations and responsibilities toward the interests of beneficiaries and creditors, the estate or trust involved and the purposes thereof and with due regard for the manner in which men of prudence, discretion, and intelligence would act in the management of the property of another." Any non-pro rata distribution would place a burden on the fiduciary to satisfy the beneficiaries or the Court that he had acted properly. Non-pro rata distributions are generally not made, unless the beneficiaries request it, or where tax situations might warrant it (getting low basis stock to a charity). These distributions open up all kinds of problems, including possible gift tax consequences.

16. It is appropriate to consider the tax consequences resulting from the elections available to the trustee of a distribution from a qualified plan. If the fiduciary is receiving the benefits in his individual capacity, there would be a duty on him to make the principal whole by virtue of the increases in the estate tax, since he has a conflict. Better the named fiduciary should waive acting as such. On the other hand, if they are received by the fiduciary in his fiduciary capacity, then presumably, he would make the election that is in his best interest, regardless of estate tax. If the fiduciary makes the election less favorable to him, then the personal representative might agree to some equitable adjustments.

17. Some fiduciaries regard income in respect of a decedent as principal to be retained, whereas others make distribution of it to income beneficiaries. This seems the more reasonable approach, despite a lack of uniform treatment and the existence of estate tax attributable to the IRD.

18. C.R.S. 1973, 15-1-405(2) states: Absent any law or direction in the instrument to the contrary, the fiduciary shall determine income and principal "in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal."

C.R.S. 1973, 15-1-804(2)(s) grants to fiduciaries the specific power "to determine all matters of estate and trust accounting as the fiduciary deems to be proper and equitable."

C.R.S. 1973, 15-1-804(2)(u) grants to the fiduciary the specific power to make non-pro rata distributions in accordance with language cited above, but again the exercise of both of these latter powers is subject to the fiduciary's duty to act reasonably and equitably in the manner stated above.

The following are examples of provisions used in granting powers to the fiduciaries in wills and trust agreements:

"Determine what is income and what is principal, and all other accounting matters, not otherwise controlled by statute."

"Set aside from income reserves for taxes, assessments, . . . and for equalization of payments to or for beneficiaries."

"Make elections which are available under any tax law in accordance with the fiduciary's judgment as to the best interests of the beneficiaries as a group, . . . and offsetting adjustments, if any, to income and principal accounts or to distributive shares shall be made solely in the discretion of the fiduciary."

"Except as otherwise provided herein, divide and distribute my estate in cash and/or in kind with shares differently or similarly composed at values determined by the fiduciary."

### *Connecticut*

19. Connecticut's Fiduciary Powers Act includes as one of the powers which may be incorporated by reference in a will or trust instrument an authorization to make various tax elections dealing with the alternate valuation date and the deduction of administration and other expenses, without being required to make any adjustments between income and principal or between the property interests passing to any beneficiaries which may be affected on account of these elections, except that where one or more residuary legatees of a will containing a pre-residuary marital or orphans deduction formula is a charity, and the fiduciary elects to treat administration and other expenses wholly or partly as income tax deductions, thus increasing the federal estate taxes, an amount equal to the difference in the estate taxes shall be reimbursed to principal from income. CONN. GEN. STAT. § 45-100e(35)(B).

Occasionally, Fairfield County corporate fiduciaries are inclined to make adjustments, if the amounts involved are particularly large.

20. Adjustment ordinarily only made where amounts involved substantial, with manner and timing varying. Income may be used to reimburse principal over a period of time to minimize the distortion to income.

21. In rare instances, unequal principal distributions have been intentionally made to pass estate income to a low bracket beneficiary, with an adjustment made by having higher bracket beneficiaries reimburse the lower bracket one by the amount of the increase in the lower bracket beneficiary's tax.

21a. Connecticut's Fiduciary Powers Act (CONN. GEN. STAT. § 45-100e(35)(G) ), which may be incorporated by reference, permits various tax elections with respect to qualified plans, but makes no provision for equitable adjustments.

#### *Delaware*

22. A non-pro rata distribution would not be made, absent an agreement by the beneficiaries concerning the distribution.

23. Prevailing local practice would require the fiduciary to consider the tax consequences of any election and to act impartially, with a view to a minimization of tax for all beneficiaries.

#### *District of Columbia*

24. If unusual circumstances seem to warrant it, equitable adjustments may be made in certain cases, but the usual practice is not to make equitable adjustments.

25. A somewhat unusual adjustment, known as the Slocum adjustment, requires that income collected on assets used to pay debts and legacies be transferred from income to principal unless waived (as frequently done) in the instrument.

26. While no standard practice exists, most instruments are either silent or specifically prohibit equitable adjustments.

#### *Florida*

27. Florida case law recognized that a Warns-type adjustment should be made under certain circumstances. *In re Kent's Estate*, 23 Fla. Supp. 133 (Palm Beach County Judge's Court 1964). *In re Veith's Estate*, 26 Fla. Supp. 145 (Dade County Judge's Court 1965) (not reported elsewhere).

#### *Georgia*

28. Although there is some practice of transferring from income to principal an amount equal to the additional estate tax incurred by reason of the non-deduction of expenses on the estate tax return at the time of the final distribution, some fiduciaries would do so only where there are conflicting interests and with the advice of counsel or with consent of all beneficiaries.

a. It is probably safe to assert that the majority of Georgia attorneys are simply unaware of the problem.

b. In general, Georgia probate law is relatively unsophisticated, primarily because of the ability of Georgia testators to remove their estates from direct court supervision of any sort by testamentary provisions relieving executors and trustees from all reporting requirements; and it is the all but universal practice of attorneys so to provide. Also, it is the exception, rather than the rule, for a Georgia Probate Judge to have legal training, so that even where no such relief is given, court oversight of the acts of fiduciaries does not necessarily provide any guidance in matters of this complexity.

c. It is the practice of the more sophisticated attorneys to provide the widest possible discretion to executors and trustees to make, or to refrain from making, equitable adjustments; and, since the models for most Georgia wills and trusts are drawn from form books written for the major banks by the most sophisticated of our estate planners, this practice has become general.

d. In general, manipulation of Subchapter J to achieve optimum tax consequences is a rarity in estate administration in Georgia, so that the necessity for equitable adjustments arising from such actions is equally rare.

#### *Hawaii*

28a. Adjustments are made where the amount involved is sufficient so that someone would object if no adjustment is made.

*Idaho*

28b. Idaho Code Section 68-1002 (Uniform Principal & Income Act) authorizes the trust instrument to make provision for allocations and adjustments between principal and income. If there is no provision in the instrument or if the act itself does not contain instructions in a specific situation, then the Trustee is to act "in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs."

28c. This is beyond the degree of sophistication of most Idaho practitioners so probably would go unnoticed in most cases. However, in view of the duties described in Idaho Code Section 68-1002 (see footnote above), the practice would be to make an adjustment if there is a significant effect on the interests of the parties when the fiduciary is aware that the disparity actually exists.

28d. None. Note: However, under Idaho Code Section 68-108 (Uniform Trustees & Powers Act), if an individual's duty as Trustee and his individual interest conflict regarding the exercise of a Trust power, the power may only be exercised by Court authorization upon petition of the Trustee. If a Trustee is also beneficiary of a Trust, it appears that a decision under some of these questions must be made only after consultation with the Court.

*Illinois*

29. Absent a provision excusing adjustments, a Warrms adjustment would probably be recognized for administration expenses taken as income tax deductions. James, *Illinois Probate Law & Practice*, 1975 Pocket Parts §§ 43.104(b) and 289.8, since beneficiaries in a particular class are considered entitled to equal treatment. *In re Estate of Comiskey*, 24 Ill. App. 2d 199, 164 N. E. 2d 535 (1960). Since administration expenses are chargeable from principal (ILL. REV. STAT. 1979, Ch. 30, § 163), there seems to be a consensus that principal beneficiaries should receive the benefit of the tax deduction attributable to these expenses.

30. Such a non-pro rata distribution would have to be authorized by instrument or agreed to by beneficiaries. If authorized, no adjustment is probably required in the absence of a clear abuse of discretion and ascertainable damages, while if not authorized, an aggrieved beneficiary could complain.

31. A fiduciary should either obtain an agreement or court instructions. See *Roe v. Farrell*, 69 Ill. 2d 525, 372 N.E. 2d 662 (1978), which establishes equitable apportionment for non-probate assets in Illinois.

32. Adjustments are often made if a distribution is made to a low income bracket residuary legatee in a year of high D.N.I. and to a wealthy legatee in a short final year of an estate with low D.N.I. (or excess deductions).

33. Adjustments are almost always excused or prohibited by will. Even when they are not, none are usually made except in rare adverse interest cases involving large sums.

*Iowa*

34. Trapped income is allocated to principal and taxes are paid out of it without adjustment.

A fiduciary should obtain beneficiary consents or seek court approval after court ordered notice to all beneficiaries.

35. Problems are beginning to arise when § 2032A property is distributed.

*Kentucky*

35a. May be said to be required by an extension of the holding in *Hurst v. First Kentucky Trust Company*, 560 S.W.2d 819 (Ky. 1978), but seldom, if ever, is any adjustment made in these circumstances and few, if any, trust officers in Kentucky appear to be concerned about it.

35b. Perhaps no such duty exists (see *Brodie v. DeVatz*, 556 S.W.2d 444 (Ky. 1977)). At any rate seldom, if ever, is any duty recognized.

35c. A fiduciary must deal fairly and impartially with all beneficiaries. *Hurst v. First Kentucky Trust Company*, 560 S.W.2d 819, 821 (Ky. 1978); *McBride v. McBride*, 262 Ky. 452, 90 S.W.2d 736, 741 (1936). This rule dictates that adjustments be made whenever inequities would otherwise result.



*Louisiana*

36. Article 1573 of the Louisiana Civil Code generally prohibits an executor from determining how an estate is to be divided. This prohibition may prevent the executor from making a tax election which will affect the portions of the estate divided among the heirs or legatees. Therefore tax-related elections are generally made with the approval of all competent parties.

37. Principal charges should not be made against income without the approval of the income beneficiary.

37a. Until 1982 Article 1573 of the Civil Code was understood to prevent non-pro-rata distributions, unless the recipients consented thereto. The 1982 revision allows the executor to select assets to fund formula marital deduction bequests, and it may be applicable to other bequests as well.

37b. Unless the decedent stipulates otherwise the party receiving the qualified plan benefit will owe the estate tax under the Louisiana Estate Tax Apportionment law.

*Maryland*

38. Maryland Statutes, Estates & Trusts, § 11-106(a), requires reimbursement of principal from income when there is an election to treat administration expenses as either income or estate tax deductions, and the fiduciary elects to treat them as income tax deductions, unless the instrument provides otherwise. However, § 11-106(b) specifies the adjustment is unnecessary where a maximum marital deduction provision exists in an instrument, whether the marital gift is increased by an election to take administration expenses as income tax deduction or because of an alternate valuation date election.

39. Maryland Statutes, Estates & Trusts, § 14-210 seems to require this result.

*Massachusetts*

40. *New England Merchants National Bank v. Converse*, 373 Mass. 639 (1977), held that no such adjustment was required to be made by a fiduciary. The court observed that it is not the usual practice of Massachusetts fiduciaries to do so. The court also stated, however, that its decision is not intended to question such adjustments made by a fiduciary in accordance with its own established practice, or an adjustment made for the first time by a fiduciary "on some intelligent basis." There is no rule requiring such an adjustment nor is one made as a matter of practice. The consensus of those practitioners polled was that the problem should be avoided by proper drafting.

41. Practice of the responding firm is to make only pro rata distributions.

42. Whether any such duty exists was not ascertainable.

*Mississippi*

43. Expenses or losses are payable from estate income and any net income remaining is distributable to the beneficiaries.

*Missouri*

44. No consensus or practice, majority of those polled believe no adjustment necessary.

45. Problem frequently avoided by making equalizing distributions to all beneficiaries or by timing distributions to ameliorate the income tax burden. If not, no adjustment thought necessary. Furthermore, in Missouri, under *Bohan*, 456 F.2d 851 (8th Cir. 1972), a partial distribution to a residuary legatee does not carry D.N.I. with it, Treasury regulations to the contrary notwithstanding.

46. Absent a contrary provision or an agreement of the parties, each asset is distributed pro rata, and this is required by metropolitan probate courts.

*Montana*

47. Questions of this nature are rarely considered and are of little concern to practitioners.

*Nebraska*

47a. The Nebraska Principal and Income Act, R.R.S. Sections 30-3101 to 30-3115, inclusive, became effective January 1, 1981. Prior to 1981, there was little, if any, reference to equitable adjustments in the cases, and no standard practice regarding such adjustments. The provisions of

the Principal and Income Act give directions for identifying receipts, which will govern the fiduciary, and may require adjustments to be made.

#### *Nevada*

48. Fiduciary ordinarily has absolute power to make decisions with respect to equitable adjustments on an ad hoc basis so long as done reasonably.

#### *New Jersey*

49. A New Jersey court rule, 4:87-2(b)(5), requires a statement, in accounting the actions of "allocation" where principal expenses have been taken as income tax deductions, but there is no indication of just what, if any, adjustments would be required. No statute, case or rule requires any adjustment to be made. The prevailing practice (with, however, some dissents) is that no adjustments are made.

50. While most practitioners give broad discretion, allowing fiduciaries to make one or more of the various elections, they then indicate that there is to be no adjustment between income and principal because of any such election.

#### *New York*

51. Beneficiaries receiving income tax benefits must reimburse principal in an amount equal to the additional estate taxes payable because of the executor's election under *Matter of Warms*, 140 N.Y.S. 2d 169 (Surr. Ct. N.Y. Co. 1955), as codified in N.Y.E.P.T.L. § 11-1.2(a). A provision in the instrument to the contrary may override this requirement.

52. Several cases are inconclusive as to whether an adjustment is actually required, leaving the picture somewhat confused; thus New York fiduciaries tend not to make such adjustments as a matter of practice even when the instrument contains a provision allowing apportionment of taxes between principal and income. *Matter of Dick*, 29 Misc. 2d 648, 218 N.Y.S. 2d 182 (Surr. Ct. N.Y. Co. 1961); *Matter of Adler*, N.Y.L.J. (June 21, 1974 p. 15) (Surr. Ct. N.Y. Co.); *Matter of Lecompte*, 52 Misc. 2d 549, 276 N.Y.S. 2d 208 (Surr. Ct. N.Y. Co. 1966); and *Matter of Pross*, 90 Misc. 2d 895, 396 N.Y.S. 2d 309 (Surr. Ct. West. Co. 1977).

53. *Matter of Holloway*, 68 Misc. 2d 361, 327 N.Y.S. 2d 865 (Surr. Ct. Nassau Co. 1972), *reversing on rehearing*, 67 Misc. 2d 132, 323 N.Y.S. 2d 534 (Surr. Ct. Nassau Co. 1971), first imposed such an adjustment, although *Matter of Coe*, 80 Misc. 2d 374, 363 N.Y.S. 2d 265 (Surr. Ct. Nassau Co. 1975), did not give it retroactivity. The adjustment requires reimbursement of principal by income beneficiaries in an amount equal to income taxes payable when a principal distribution carries out taxable income from an estate. Prior to these decisions, many New York fiduciaries followed the practice of making this adjustment, and it is now almost universally followed although there has been no codification of its rule.

54. Absent authorization in the instrument or consent of the beneficiaries, New York fiduciaries generally seek to avoid making non-pro rata distributions from an estate. *Matter of Mann*, 4 Misc. 2d 387, 152 N.Y.S. 2d 348 (Surr. Ct. N.Y. Co. 1956), held that the power to distribute in kind is limited by the obligation to deal fairly and equitably with all legatees.

55. N.Y.E.P.T.L. § 7-1.11 permits distribution by a fiduciary of the capital gains tax paid by the grantor. This statute was enacted in response to *Matter of Cowen*, N.Y.L.J. (February 13, 1964 p. 16), and *Matter of Goldman*, N.Y.L.J. (April 7, 1964 p. 13), which directed reimbursement from the trust of the grantor for capital gains taxes paid by him on gains taxable to him but allocable to corpus, where the instrument was silent with respect to reimbursement. The courts shifted the tax burden from the settlor to the corpus, which actually benefitted by the gains under equitable principles. The statute was then enacted to provide that a trustee of an express trust may reimburse the settlor from corpus for any income taxes paid by him on any portion of the corpus, unless the instrument provides to the contrary or there is a vested remainder passing to a charity or other named entities.

56. N.Y.E.P.T.L. § 11-1.2(b)(1) provides that, in the absence of a controlling will provision, no adjustment need to be made (i) where a marital deduction bequest is increased by an election to deduct expenses for income tax (rather than estate tax) purposes, and (ii) where such a bequest is increased or decreased by a valuation date election. Many New York wills do not mandate adjustments in these situations and some wills specifically prohibit such adjustments. The valuation date issue addressed in the above section is related to the issue raised by Question No. 5, above; i.e., the valuation date election will often affect the amount of estate tax and the income tax basis of inherited

property as well as the size of the marital deduction bequest. While the statute does not address the estate tax or basis questions, they are really just corollaries of the "size-of-the-marital-share" issue, and the statute clearly resolves the latter in favor of no adjustment, in the absence of a contrary direction from the testator.

A series of New York cases has considered the question of how income taxes, either on ordinary income or capital gains, should be charged as between charitable and non-charitable interests during estate and trust administration; i.e., whether such taxes should be treated as administration expenses and thus be shared ratably by all beneficiaries or whether an adjustment should be made to exonerate the charitable interests from taxation. The only case requiring an adjustment of this sort is *Matter of Eidlitz*, 21 Misc. 2d 218, 192 N.Y.S. 2d 711 (Surr. Ct. N.Y. Co. 1959), but the most recent case, *Hewlett*, 77 Misc. 2d 38, 352 N.Y.S. 2d 406 (Surr. Ct. Nassau Co. 1974), disapproves of the *Eidlitz* result and indicates that no such adjustment should be made in the absence of legislative action. See also *Matter of Hanover Bank*, N.Y.L.J. (May 12, 1969 p. 2) (no adjustment).

57. Most forms provide that determinations are to be made in the fiduciary's sole and/or absolute discretion without explicitly imposing a standard of reasonableness. This appears to limit the grounds for objections by beneficiaries to lack of good faith. See *Scott on Trusts* (3rd Ed.), § 187.2.

#### North Carolina

58. Some corporate fiduciaries re-calculate the estate tax and reimburse principal from income (a Warms adjustment), while others make an adjustment only if a substantial distortion would otherwise occur.

59. In exceptional situations of obvious inequities (uncommon occurrences), adjustments are made to remedy the inequity.

60. Some fiduciaries make no adjustment because they consider the capital gains tax to be one on principal.

61. Pro rata distributions are made unless the instrument provides otherwise or the beneficiaries agree. In such cases no adjustments are made on account of the non-pro rata distributions.

62. If, as a result of an election, plan benefits were includable for estate tax purposes and the instrument had no tax allocation clause, the proceeds could be subject to contribution for their proportionate share of federal and North Carolina death taxes. See *First National Bank of Shelby v. Dixon*, 38 N.C. App. 430, 248 S.E. 2d 416 (1978).

63. Where an inequity is of consequence, an adjustment will be made.

#### North Dakota

64. The immediate (estate) tax is reduced unless tax brackets are substantially different, since future asset values are uncertain.

65. Averaging income tax rate for income and discretionary distributions to beneficiaries.

#### Ohio

66. There is no uniform practice, since most instruments deal with this point. Because of the weight of authority in other jurisdictions and because it is "good estate planning," if an adjustment is made, the amount equal to the increase in estate tax resulting from taking expenses as income tax deductions would be transferred from income to principal. However, no such election would be made if the marital share would be increased and the decedent leaves a *second* wife and children by a first wife. If, however, there is a compatible family situation and expenses are utilized as income tax deductions, B trust income would be transferred to principal.

67. Corporate fiduciaries would not make a non-pro rata distribution and would only consider such a distribution if it was approved by the trust committee of the bank and then only if the disparity in basis was small (less than 10%).

#### Oregon

68. Adjustment would be made where the amount is substantial.

69. No, but such a distribution would not be made without the consent of the beneficiary adversely affected.

70. Fiduciary usually given discretion to determine whether or not to make adjustment, except that instrument may require adjustment where marital or charitable deduction would be adversely affected by the election made.

### Pennsylvania

70a. In *Bell Estate*, 7 Pa. Fid. Rep. 1 (O.C. Chester Co. 1956), *aff'd on another issue*, 393 Pa. 623, 144 A.2d 843 (1958), an Orphans' Court judge followed the "trend of thought" (particularly as illustrated by California authority) that equity between the parties required that principal be compensated by income for the increase in federal estate tax. Absent controlling appellate court authority, most lawyers seem not to follow *Bell*, recognizing, however, that in the case of antagonism between the income and principal interests a court would be likely to make an equitable adjustment in the resolution of a dispute.

70b. *Rice Estate*, 8 Pa. D.&C. 2d 379, 6 Pa. Fid. Rep. 225 (O.C. Montgomery Co. 1956), held that equitable principles required income to reimburse principal for a capital gains tax which would not have been payable had principal charges been deductible against the capital gains. Such adjustments are not normally made absent antagonism among beneficiaries.

70c. Absent any Pennsylvania authority on the subject, the more knowledgeable practitioners and institutions use trapping distributions to spread income among beneficiaries (including trusts) to minimize overall income taxes and allow the income tax burden to fall on principal to the extent a trapping distribution gives rise to tax.

70d. If the governing instrument is silent, most practitioners and institutions use care in timing principal and income distributions to avoid inequitable results. *Salesky Estate*, 15 Pa. Fid. Rep. 213 (O.C. Montgomery 1965), required an adjustment (equal to lesser of the estate's income tax savings or the distributee's tax burden) where a wife elected to take against a will and received a principal distribution which carried out D.N.I.

70e. A grantor of an irrevocable 1910 trust obtained reimbursement from the trust for her capital gains tax. *French Trust*, 61 Pa. D. & C. 2d 654, 23 Pa. Fid. Rep. 296 (O.C. Philadelphia 1963). The court held that equity required a reimbursement but, for administrative convenience, measured the reimbursement by the capital gains tax the trust would have paid had it been taxable on the gain.

### Rhode Island

71. Only where large amounts are involved is an adjustment made, usually after consultation with counsel.

72. The *Holloway* adjustment is sometimes made before the executor closes the estate, usually when the executors and the trustees are the same. See also *Rhode Island Hospital Trust Co. v. Sanders*, 84 R.I. 347 (1956).

73. *Rhode Island Hospital Trust Co. v. Sanders*, 84 R.I. 347 (1956), would probably be interpreted as requiring an adjustment, since it held that a charitable beneficiary with share of residue received estate income without reduction for federal income taxes on accumulated estate income where there were other common non-charitable beneficiaries. The adjustment would be made only if the amount were material.

74. Lower courts have approved an adjustment in an accounting under which trust principal reimburses the grantor at least for a portion of the tax incurred by him.

75. In estates over about \$1,000,000 the instrument is often drafted so that an adjustment is required. Usually the instrument provides that no adjustment is to be made. In some cases discretion is conferred on the fiduciary with respect to an adjustment.

### South Carolina

76. Absolute discretion is frequently given in South Carolina wills. However, adjustments to compensate for the consequences of tax decisions or elections are not presently being made as a matter of practice. Apparently, the inequities which result from these tax decisions and elections are largely being ignored.

### South Dakota

77. On the infrequent occasions when any of these issues arise, each lawyer or fiduciary decides them on a case by case basis.

### Tennessee

78. Due to lack of statutory authority to make an adjustment, Tennessee practitioners and fiduciaries appear to be reluctant, but believe there should be a statutory provision allowing one.

*Texas*

79. Equitable adjustments are made very infrequently. Situations arising which would lead to these being necessary are generally avoided by knowledgeable practitioners and overlooked by the rest.

*Vermont*

79a. I am not aware of any "practice" with regard to equitable adjustments in Vermont. They are not required by statute or case law. It is not uncommon for a Will or Trust Instrument to specifically exonerate the fiduciary from any liability in the good faith exercise or non-exercise of any discretionary power conferred by the Instrument or by federal or State law. This implies that the draftsman or fiduciary fears that some day our Courts may impose liability for failure to make equitable adjustments.

*Wyoming*

80. Since Wyoming Probate Law is derived originally from that of California, several Wyoming cases have acknowledged that California precedents will be given great weight. Thus, when a deduction is taken on an income tax return, the income beneficiary's share would probably be reduced to restore principal as if a deduction had been taken on the estate tax return, in harmony with California's *Bixby* case. Other income/principal problems, such as allocation of stock dividends or non-taxable dividends to the income beneficiary, may receive similar treatment. Knowledgeable practitioners draft provisions dispensing with the need for adjustments and granting the fiduciaries discretion to handle these questions; most practitioners overlook these questions in practice.