


Spring 1969

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## Recommended Citation

Trautman, Herman L. (1969) "The Income Taxation of Estate Distributions - A Need for Reform," *Indiana Law Journal*: Vol. 44 : Iss. 3 , Article 3.

Available at: <http://www.repository.law.indiana.edu/ilj/vol44/iss3/3>

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# THE INCOME TAXATION OF ESTATE DISTRIBUTIONS— A NEED FOR REFORM

HERMAN L. TRAUTMAN†

## INTRODUCTION

In few areas of tax law are the rewards for careful tax planning more dramatic than those which can be achieved in arranging the distributions of a decedent's estate. The fiduciary may select any fiscal year; he may split the estate's taxable income between the estate and its beneficiaries by making appropriate distributions; and in a proper case he can create additional taxpayers by making partial distributions of the estate's corpus items to the marital deduction trust, the non-marital deduction trust, and other residuary trusts.

In few other areas are there so many horrible tax traps, however. Most lawyers become calloused to the complexities of the tax statutes and the twists and turns of legislative policy, administrative interpretation, and judicial tinkering. When he surveys the various tax options available to the fiduciary of a decedent's estate, however, the most hardened practitioner must steel himself for the remarkably intricate interplay of state probate law and federal tax statutes.<sup>1</sup>

I confess to a very genuine desire to improve the law concerning the income taxation of decedents' estates. I believe that estate income ought to be treated differently and separately from the income taxation of trusts, and I hope very much for the day when simplicity will again become a predominant value, particularly, at least, for the smaller estates.

Having made this confession, I propose to discuss below the important problem areas concerning the income taxation of estate distributions, to show how wise and sophisticated estate planning and fiduciary administration can indeed manage them; I will also point out the important traps for the unwary; and then I would like to return to my first love, which, as indicated, is to seek to improve the law concerning the income taxation of decedents' estates. In this latter role I shall present a survey

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†Professor of Law, Vanderbilt University. This article is a revision of a paper presented by the author at the Third Annual Institute on Estate Planning sponsored by the University of Miami and its Institute of Estate Planning at the Hotel Americana, Bal Harbour (Miami Beach), Florida on Jan. 10, 1969. See 3 INSTITUTE ON ESTATE PLANNING, UNIVERSITY OF MIAMI LAW CENTER (1969), to be published by New Kirk Associates, Inc.

1. Compare Soll, *Tax Elections of a Decedent's Estate*, UNIVERSITY OF MIAMI SECOND INSTITUTE ON ESTATE PLANNING 68.800 (1968).

of the suggested alternatives for taxing the income of decedents' estates, some of which just might be the law of tomorrow.

## I. HISTORICAL BACKGROUND AND PERSPECTIVE

From the very outset of our tax history the income of estates has been taxed under the same rules applicable to trusts. The Revenue Act of 1916 contained the essential idea that fiduciaries should be taxed as individuals except on the amounts distributed to beneficiaries.<sup>2</sup> The idea was reinforced in the Revenue Act of 1918<sup>3</sup> and continued on to become firmly established in the 1939 Code.<sup>4</sup> Please note, however, that this original scheme for taxing the income of estates and trusts permitted the executor and the trustee to determine the income tax consequences of distributions to beneficiaries by designating the source of each distribution as either income or corpus. When to this was added the 1954 Code policy decision that all distributions, whether out of corpus or income, should be taxable income to the recipient beneficiaries to the extent of distributable net income, there developed a fundamental and an important need to provide a separate scheme for the income taxation of decedents' estates. This need is fundamental because the very purpose of estate administration is to settle the affairs of a deceased person, to pay his debts and taxes, and to distribute as quickly as possible the net assets to his beneficiaries, who are often his immediate family. Such is not the usual case with a trust where the purpose is primarily to create a continuing management arrangement to last for several years, oftentimes for lives in being plus the minority of children. Early distribution of corpus assets is not a typical purpose of the trust management arrangement. This fundamental difference between estates and trusts was not recognized, however, in the haste of compiling the 1954 Code.<sup>5</sup> The result is a kind of chaos and distortion in which a particular distribution of estate assets is regarded as an obvious corpus distribution for the purposes of state probate law, a federal

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2. Revenue Act of 1916, § 2(b), 39 Stat. 756, 757 (1916). See Sugarman, *Estates and Trusts*, 3 TAX REVISION COMPENDIUM 1749, 1750 (House Committee on Ways and Means 1959); Fillman, *Selections From Subchapter J*, 10 TAX. L. REV. 453, 454 n.8 (1955).

3. Revenue Act of 1918, § 219, 40 Stat. 1057, 1071 (1919).

4. Fillman, note 2 *supra*.

5. The draft statute prepared by the American Law Institute in its income tax project, which was often used as a reference work in the compilation of the Internal Revenue Code of 1954, provided that decedents' estates should be taxed under the "entity" rule for a fixed period of time (fifty-one months was suggested), permitting any estate to elect, however, to be taxed as a trust. During the period the estate would be taxed as an individual; no tax deduction would be permitted the estate for distributions to beneficiaries, and such distributions would be tax-free to the recipients. See 2 ALI FED. INCOME TAX STAT. §§ 147-48 (Feb. 1954 Draft).

income tax deduction to the distributing estate,<sup>6</sup> and as federal gross income tax deduction to the distributing estate,<sup>4</sup> and as federal gross income to the estate beneficiaries under section 662. This remarkable interplay of state probate law and federal tax law in the treatment of estate distributions in a baffling puzzle, not just to the country lawyer and the general practitioner, but indeed to some Wall Street tax lawyers educated under the 1939 Code and perhaps to the authors of some existing Treasury Regulations.<sup>7</sup>

No doubt you have noticed in recent months that some Treasury regulations have been judicially declared to be invalid with respect to estate distributions.<sup>8</sup> I predict there will be more of this with respect to estate distributions, and I shall discuss one important regulation which seems to me to be ready for a similar judgment.<sup>9</sup> These developments are simply a reflection of the completely separate policy values of Subchapter J and their ineptness in the context of decedent estate distributions.

## II. THE POLICY VALUES OF SUBCHAPTER J

What precisely are the policy values of Subchapter J? It is believed that there are two separate policies as indicated below.

### A. *The Gift Exclusion from Gross Income Policy*

Section 102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise or inheritance. This has always been the Congressional policy since the Revenue Act of 1913.<sup>10</sup> In *Irwin v. Gavit*,<sup>11</sup> however, the taxpayer received a testamentary gift of a part of the income of a trust for a period which could not exceed fifteen

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6. INT. REV. CODE of 1954, § 661 [hereinafter citations to sections refer to the 1954 Code unless otherwise indicated].

7. Treas. Reg. § 1.661(a)-2(e) (1956) states that amounts paid by a decedent's estate pursuant to a court order under state probate law for the support of the widow or other dependent during the administration of the estate is not deductible by the estate and taxable to the recipients under the conduit system of Subchapter J when the source of payment is estate corpus; only when amounts are to be charged to estate income would the regulations apply the deduction-inclusion system. The regulation was recently held invalid in *Estate of McCoy*, 50 T.C. 562 (1968). The court reasoned that the source of distribution was an important consideration under the 1939 Code, but not under sections 661 and 662 of the 1954 Code.

8. *Hay v. United States*, 263 F. Supp. 813 (N.D. Tex. 1967) holding invalid the Treas. Reg. § 1.662(c)-1 (1956) which interprets the word "during" in section 662(c) to read "for any taxable year . . . of the estate . . . ending with or within his taxable year." See also *Estate of McCoy*, 50 T.C. 562 (1968) holding invalid Treas. Reg. § 1.661(a)-2(e) (1956) as indicated in note 7, *supra*.

9. Treas. Reg. § 1.663(a)-1(b) (1956) insofar as it is applied to the satisfaction of a pecuniary formula marital deduction gift.

10. Del Cotto, *The Trust Annuity as Income: The Constitutional Problem of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231, 232 (1968).

11. 268 U.S. 161 (1925).

years. The courts below had held that the income payments to the taxpayer were property acquired by bequest and were therefore not gross income subject to tax. The Supreme Court reversed in a majority opinion which drew a distinction between a gift of corpus and a gift of income, holding that the latter is taxable and not within the gift exclusion policy. Section 102(b) is thus a statutory codification of the rule of *Irwin v. Gavit*.

It seems appropriate to emphasize that Subchapter J of the 1954 Code, like its predecessors, is first, and perhaps primarily, an implementation of the policy to exclude gifts of corpus from gross income and an embodiment of the doctrine of *Irwin v. Gavit* in the factual context of estates and trusts.

No doubt this policy was more clearly apparent in the 1939 Code and its predecessor revenue acts under which a fiduciary was allowed to label distributions as either corpus or income. The policy is still, however, an important part of the 1954 Code and, as such, the idea that distributions of corpus should be excluded from gross income while distributions of income should be included in gross income should be brought forth into sharper focus. I submit that keeping in mind this original policy of the statutory scheme will serve one well in helping to evaluate some of the razzle-dazzle and confusion encountered in this area of the law.

B. *The 1954 Policy to Deny the Fiduciary the Power to Determine the Sources of Estate Distributions for Income Tax Purposes*

In 1954 a second policy value was added to the statutory scheme; it is completely separate and perhaps foreign to the mores of estates and trusts, which have traditionally distinguished between the corpus account and the income account. The new policy was based upon an analogy to section 316 in the corporate context. This was the idea that fiduciaries ought not to be allowed to determine for federal income tax purposes whether it is corpus or income that is being distributed, because to do so is to determine the income tax consequences to the beneficiaries under the gift exclusion policy. Instead, under the 1954 Code all distributions by estates and trusts, whether out of corpus or income, are taxable to the beneficiaries to the extent of distributable net income. Section 661(a) accordingly provides for a distribution deduction to the estate or trust not only for income distributed but also for "any other amounts properly paid" to beneficiaries, a phrase which is construed to be broad enough to cover corpus distributions.

The tax deduction of section 661(a) is limited to the "distributable net income" of the estate, a chameleon-like concept which, as Fillman suggested, changes color almost every time "it is obliged to perform some

duty.”<sup>12</sup> Nevertheless, it is the key concept of Subchapter J with respect to those trusts and estates which are recognized as valid tax entities, serving several very different purposes, *e.g.*: (1) to provide a maximum measuring rod for determining the extent to which distributions to beneficiaries will be deductible to the estate or trust under section 661(a), and taxable to the beneficiaries under section 662(a); (2) to compute the net component elements of distributable net income with respect to dividends, tax exempt interest, rent, etc., so that the amount each beneficiary receives shall be treated as having the same tax character in his hands as in the hands of the fiduciary; and (3) to avoid the tracing power of the fiduciary to determine the source of distributions as between corpus and income.

It thus appears that there are two completely separate policy values in Subparts A, B and C of Subchapter J. They are (1) to provide the traditional gift exclusion from gross income policy in the context of estates and trusts, and (2) to deny the fiduciary the power to determine the source of distributions to beneficiaries to the extent of distributable net income. These are applied substantially alike to both decedents' estates and trusts.

### III. THE REMARKABLE INTERPLAY OF STATE PROBATE LAW AND FEDERAL TAX LAW WITH RESPECT TO ESTATE DISTRIBUTIONS

#### A. *The Statutory Trap for Decedents' Estates*

As indicated in the introductory discussion, when the second policy value was added by the 1954 Code, an important need arose for a separate scheme of income taxation for decedents' estates. The reason this is true is that in decedents' estates, differently from trusts, executors are supposed to make, and should be encouraged to make, early distributions of those corpus assets of the estate which are no longer needed for the administration of the estate. Among the members of a family group some assets need to be distributed to certain individuals sooner than others. The family car and tangible personal property to the widow, close corporation stock to a son, farm equipment and live stock to another are well-known examples of obvious corpus distributions which executors are encouraged to make early in the estate administration. Yet it is precisely here where one of the most frequent of the several, horrid tax-traps exists for the unwary with respect to estate distributions; the residuary beneficiary who receives an early distribution of these corpus assets for the maintenance of the decedent's home, the operation of his farm, or the continuance of his business will be liable for an income tax to the extent of the estate's dis-

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12. Fillman, *supra* note 2, at 485.

tributable net income because of the second policy value added by the 1954 Code. The chances are quite likely that he will be burdened with a disproportionately large share of the tax. For example, if an executor should have 15,000 dollars of distributable net income in his first taxable year, a distribution to the widow, as a residuary beneficiary, of the family car and the farm equipment will carry to her the income tax liability for the 15,000 dollars of probate income held by the executor.

*B. How Do Smart People Avoid This Problem?*

This common tax trap for the many, the good, but the unwary can be easily avoided by the smart and knowledgeable, either before death by good estate planning for the testator, or after death by capable, alert fiduciary administration.

1. *Estate Planning*: Section 663(a) provides for certain exclusions from the conduit system of Subchapter J. Of primary importance here is an exclusion for any gift or bequest of a specific sum or a specific property which is paid all at once or in not more than three installments, provided it is not a gift which can be paid only from income. Here again we see an example of the basic policy of Subchapter J drawing the traditional distinction between a gift of corpus and a gift of income, but limiting even the former to gifts of a "specific sum" or a "specific property."

Wise estate planning for the testator will dictate a separate testamentary provision for gifts of specific sums of money and specific items of property to the surviving spouse and other members of the immediate family even if they are also the residuary beneficiaries of his estate. During the executorial period a family needs enough money to live on, a house, furniture and contents, the family car or cars, farm equipment and other items they have been accustomed to living with. Many, if not all of these, may well be the subject matter of specific legacies in the testator's will, and thus avoid the unfortunate application of the Subchapter J conduit system to their early distribution.

2. *Fiduciary Administration*: If the decedent's will was not well planned in this respect so that there are no specific legacies to his nearest and dearest residuary beneficiaries, an alert fiduciary can still save the day. The estate is a new taxpayer and as such it may choose any annual accounting period ending on the last day of any month without obtaining the prior approval of the Internal Revenue Service.<sup>13</sup> By choosing a short fiscal year in which there is little or no distributable net income as yet received by the executor, early distribution of the family car, furniture, farm equipment and other needed items of estate assets can be effectuated

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13. Treas. Reg. § 1.441-1(b)(3)(1957).

without income tax consequences. For example, if a decedent dies on April 10, the executor can choose a fiscal year ending on April 30, which will probably be prior to the receipt of very much taxable income by the executor; during this short fiscal year the needed corpus items can be distributed to the family without substantial income tax consequences.

*C. Post-Mortem Tax Planning by the Sophisticated Fiduciary*

As indicated, sections 661 and 662, the estate deduction-beneficiary inclusion sections, can be a trap for the unwary in the settlement of a decedent's estate. But they can also be the vehicle for substantial tax benefits in the hands of the alert, knowledgeable executor. In this section we will consider the important traps to be avoided and the important benefits to be gained by good fiduciary administration. Before taking these up under separate headings, however, the following ground rules for decedents' estates should be kept clearly in mind. First, the separate share rule of section 663(c) applies only to trusts; it does not apply to decedents' estates. Second, estate distributions are generally tier two distributions because they are made at the discretion of the executor. The typical estate is thus taxed as if it were a single entity with multiple beneficiaries of the same class. Third, section 663 provides an exception to the deduction inclusion sections for gifts of a specific sum of money or of specific property. Fourth, these rules can obviously have no application to assets which are not part of the probate estate, such as life insurance and real property passing directly to the devisees under local law.

1. *Avoid Disproportionate Distributions*: Attention has been called to the typical trap where one of several residuary beneficiaries needs an early distribution of estate assets while the others do not. Where the estate has distributable net income, the recipient beneficiary will experience a disproportionate burden for the income tax on the estate's distributable net income. This can be avoided or ameliorated in a proper case by equalizing estate distributions among the several beneficiaries of an estate so that the income tax burden is spread evenly among them.

2. *Non-Liquid Distributions*: Suppose the executor had received dividend income in the amount of 20,000 dollars. He later distributes close corporation stock to Son, a residuary beneficiary, having a value of 100,000 dollars. No other distributions were made during the year. The estate is entitled to a distribution deduction under section 661 in the amount of 20,000 dollars and Son must include this 20,000 dollars in his gross income, even though he has not received one dollar of cash. An alert and thoughtful executor would consider also the need to distribute enough cash to pay the tax on the estate distribution in kind.



3. *Tax-Free Basis Adjustment*: Treasury Regulation 1.661(a)-2(f) provides that where property is distributed in kind, the basis of the property in the hands of the beneficiary is the fair market value at the time of distribution to the extent that this value is included in the gross income of the beneficiary. The regulation explains the adjustments to basis among several items distributed in kind and where the value thereof exceeds the amount included in the gross income of the beneficiary, and *Revenue Ruling 64-314*<sup>14</sup> elaborates instructively upon the regulation.

The following will illustrate how the regulation may be used advantageously by an executor: The Smith Estate has dividend income of 30,000 dollars and no expenses. The two beneficiaries feel the need for a distribution and the executor decides to make distributions of 15,000 dollars to each A and B. The executor has Stock X in his portfolio which has a fair market value of 30,000 dollars and a basis of 10,000 dollars to the estate. Thus the executor has a choice between distributing 30,000 dollars in cash from the income account, or distributing Stock X from the corpus account. The estate will receive a distribution deduction of 30,000 dollars under section 661 in either event, and the beneficiaries will be taxable under section 662 on a total of 30,000 dollars in either event. By distributing Stock X to A and B, the beneficiaries are entitled to increase their basis for it to 30,000 dollars so that their sale of it will result in no gain to them. The executor can retain the 30,000 dollars in cash which he may invest in new securities having a basis of that amount. By distributing the stock instead of the cash the executor has saved the capital gains tax on 20,000 dollars of profit on the stock, and can up-grade his investment portfolio.

It should be understood that the holding period of A and B in the above example would presumably begin on the date of distribution to them since their basis is not determined by reference to the transferor's basis—i.e., the estate's. Also, it is imperative that the executor realize that these basis provisions can be detrimental as well as beneficial. Suppose the executor should distribute stock to A and B with a basis of 30,000 dollars and a fair market value of 10,000 dollars? The latter figure would be the distribution deduction to the estate, the inclusion by the beneficiaries, and the basis for the stock in their hands. In this instance, the executor should have sold the stock first and distributed the cash.

4. *Distributions of the Right to Receive Section 691 Items*: Suppose an executor with 30,000 dollars of distributable net income should distribute to A and B, residuary beneficiaries, the right to income in respect of a decedent to the extent of 30,000 dollars. Bear in mind that the

predecessor of section 691 was added to the 1939 Code when the distribution of such a corpus item did not have Subchapter J conduit consequences. Now that it does, a distribution of the right to receive income in respect of a decedent would appear to give the executor a deduction under section 661 for its value as well as the right to exclude the income when later received by the distributees. On the other hand, the recipients, A and B, seem to be taxed twice, once on the receipt of the right to the extent of the estate's distributable net income under section 662, and again on the collection of the income item under section 691. While section 1014(c) prohibits a step-up in basis for income in respect of a decedent, the first sentence of Treasury Regulation 1.661(a)-2(f)(3) states that the recipient of distributed property obtains a basis for it to the extent that its value is included in the gross income of the beneficiary. If the latter applies to an estate distribution of the right to receive income in respect of a decedent, there should be very little if any tax when the item is collected. There seems to be no litigation or administrative determination involving the application of Treasury Regulation 1.661(a)-2(f)(3) to a distribution of a section 691 item.

5. *The Use of Testamentary Trusts As Income Taxpayers:* The term "beneficiary" as used in the Code and regulations includes a trust created by the decedent's will.<sup>15</sup> This definition permits, in many cases, the creation of one or more additional income taxpayers provided the gifts to the trusts are not of a specific property or a specific sum of money.

To illustrate the tax management opportunities, assume that the estate has distributable net income of 40,000 dollars, and that the decedent's will creates a marital deduction trust for W and a non-marital deduction residuary trust in which the trustee has discretion to accumulate income or pay income and corpus among the family group, which includes W, during the life of W. It is possible for the executor to distribute 10,000 dollars of corpus assets as a partial funding to each of the two trusts, and pay 10,000 dollars of estate income directly to W from estate income. The estate will receive a distribution deduction of 30,000 dollars under section 661 and pay a tax on the remaining 10,000 dollars of distributable net income. Each of the two trusts will show the receipt of 10,000 dollars of distributable net income for federal tax purposes, but when measured by state probate law, each trust has received corpus assets which cannot be distributed as trust income. Each trust will pay the tax on its distributable net income, presumably from corpus cash. It is said that most corporate fiduciaries have adopted the practice of charging the tax paid to the income account so that the corpus account can be reim-

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15. Treas. Reg. § 1.643(a)-1 (1956).

bursed when the executor ultimately distributes accumulated probate income upon termination of the estate.<sup>16</sup> For purposes of probate accounting for income the executor may prefer to distribute 10,000 dollars of corpus assets and 5,000 dollars of estate income to each trust, and allow each trust to distribute 5,000 dollars to W. The result is the same: the 40,000 dollars of estate income has been split four ways at an income tax savings of 8,020 dollars (the difference between 16,322 dollars and 8,302 dollars) and half of it represents the partial funding of the two testamentary trusts with corpus assets. This can be repeated annually while the estate is in administration.

The technique of splitting estate income taxes by making partial funding distributions to testamentary trusts of assets which under state trust law are corpus assets has many possible advantages. An estate with 50,000 dollars of taxable income may distribute 25,000 dollars of corpus assets to a residuary trust distributing assets with a basis to the estate of 20,000 dollars and a fair market value of 25,000 dollars. The estate will receive a distribution deduction of 25,000 dollars; the trust will include 25,000 dollars in its taxable income and receive a stepped-up basis for the assets distributed; the income beneficiaries will include no income in their returns. The income tax savings is some 5,620 dollars plus the step-up in the basis of 5,000 dollars on the assets distributed to the trust.

A word of caution is in order. While the throwback rules<sup>17</sup> do not apply to decedents' estates, they do apply to the trusts used as additional income taxpayers. Each trust receiving a partial funding will have "undistributed net income" for the year. The trustee having the power to invade corpus should be alert in the exercise of the power during the five-year period next succeeding the taxable year in which the trust received the principal distribution. Such invasions may be considered accumulation distributions under section 666, taxable to the recipient as if received on the last day of each of the five preceding years. The exceptions to the throwback rules in section 665(b) then become the important area of tax management in this respect.

6. *Funding a Charitable Remainder Trust—How to Save Big Money for the Income Beneficiaries of a Substantial Estate:* The executor of a decedent's estate has a tremendous opportunity to save money for the taxable income beneficiaries of a charitable remainder trust, and perhaps a tremendous surcharge liability if he neglects to take advantage of it.

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16. Covey, *The Advantages and Disadvantages of the Revocable Trust in Estate Planning*, N.Y.U. 26TH INST. ON FED. TAX. 1379, 1394 n.44 (1968); Parr, *Distributions By Estates, A Review of the Tax Consequences*, 107 TRUSTS AND ESTATES 97, 98 n.9 (1968).

17. §§ 665-69.

Assume an estate with 3 million dollars worth of securities producing 150,000 dollars in estate income annually. The decedent's will bequeathes his entire estate in trust to pay the income to A, B and C in equal shares for their lives and upon the death of the survivor, remainder to charity. The executor can distribute 150,000 dollars per year in corpus assets as a partial funding of the trust, thereby receiving a distribution deduction for that amount under section 661, and have a zero taxable income. The trust will have 150,000 dollars of gross income under section 662, but because the distribution consists of corpus assets under state trust law, the trust must hold these assets as corpus, and would be prohibited under state law from distributing the assets to the income beneficiaries. Since the corpus assets are held for the charitable remainder beneficiary, the trust is entitled to a charitable deduction under section 642(c) for an amount of the gross income, without limitation, which is permanently set aside for a charitable purpose.<sup>18</sup> The result is that the executor can avoid paying any income tax at all during the entire period of estate administration by making corpus distributions to the trust equal to the estate's distributable net income. Upon termination of the estate, the accumulated income can be distributed to A, B and C tax free, except to the extent of the last year's current income, which is likely to be very little if a short fiscal year of termination is used.

In the case of *United States v. Bank of America Nat'l Trust & Sav. Ass'n*,<sup>19</sup> the Government argued that because the corpus distribution is gross income to the trust for purposes of the federal income tax under section 662, it must be treated as income distributable by the executor to the income beneficiaries, and since it was not distributed to them, it is taxable in the hands of the trustee. In rejecting the Government's position the court said:

The recipient is required, by the same sections [ §§ 661 and 662 ], to include in its gross income the amount of the income deemed distributed. These sections, however, do not take the additional step which the Government asks this court to take. They do not purport to change the rule that the disposition of the income deemed to have been received by the distributee, here the trust, is governed by local law, and the Code makes clear that tax consequences attach according to the actual disposition of that income pursuant to local law. Here, it was required by local law to be treated as and held as corpus, for charitable pur-

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18. *United States v. Bank of America Nat'l Trust & Sav. Ass'n*, 326 F.2d 51 (9th Cir. 1963).

19. *Id.*

poses. It was thus permanently set aside for charitable purposes within the meaning of section 642.<sup>20</sup>

The decision seems irrefutable under the existing Code. It seems perfectly clear that local law controls the determination of what constitutes "income" for purposes of distribution and when it is distributable.<sup>21</sup> Here the local probate court had already designated the distribution as corpus, and the trustee could not have treated it as trust income and paid it out to the individual beneficiaries without violating the mandate of that court. The principle here is the same as in the previous sub-section where corpus distributions are made to testamentary trusts for the purpose of splitting the estate income. The only difference is that instead of converting local law corpus into taxable income for the purpose of splitting it among multiple beneficiaries, the purpose in *Bank of America* is to convert local law corpus into gross income for the purpose of qualifying it for the charitable deduction allowed to estates and trusts under section 642(c).<sup>22</sup> Both of these incongruous results flow naturally from the 1954 policy decision that all distributions, whether out of corpus or income, should be taxable income to the recipient beneficiaries to the extent of the estate's distributable net income.

7. *Selecting Fiscal Years and Planning for the Termination of an Estate*: Reference has been made above to the executor's ability to choose a short fiscal year at the beginning of administration when little or no distributable net income has as yet been received, during which the distribution of needed assets can be made to residuary beneficiaries without income tax consequences. It was there pointed out that the estate, being a new taxpayer, may select any fiscal year the fiduciary wishes. The fiscal year chosen must not be longer than twelve months and must end on the last day of the month.<sup>23</sup>

The short fiscal year may be used advantageously to obtain the benefits of an additional taxable period and exemption off the front end of the estate's executorial period. A second taxable period and exemption deduction can be accomplished off the tail end of the estate's executorial period when final distribution of estate assets and the payment of termination expenses are made immediately after the close of a regular fiscal year, so that the year of final termination is a short taxable year. Thus, the management of the estate's fiscal years and planning for the termina-

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20. *Id.*, at 54.

21. § 643(b); Treas. Reg. § 1.651(a) (1956); S. REP. No. 1622, 83d Cong., 2d Sess. 345 (1954).

22. Somers, *Estate Corpus Distribution is Converted into Charitable Income Tax Deduction*, 20. J. OF TAX. 228-29 (1964).

23. § 441(d) & (e).

tion of the estate's administration becomes an important and perhaps crucial responsibility for the executor; the possibilities for tax benefits are so substantial that there may be a correlative surcharge for failure to take advantage of them.

In the first fifteen months of a large estate's administration, before payment of the federal estate tax, the estate will probably receive more income than thereafter. A fiscal year of seven or eight months may well contain as much taxable income as the second full twelve months year. If the tax plan contemplates that the estate will accumulate the income annually during administration, the short fiscal year technique is an important management tool indeed.

Selection of a January 31 fiscal year for marital and residuary trusts will provide the income beneficiaries almost a full year of deferment of the time in which to pay tax on the trust income. Some individuals, however, may dislike being a year behind in paying their taxes. Also, the Government catches up in the year of the beneficiary's death when, according to the regulations, there must be included in the decedent's final return his share of the trust's income for the full year ending January 31, and in addition, his share of the trust's income for the current year that has been paid to him.<sup>24</sup>

Planning for the termination of an estate should include careful consideration of the income tax consequences under sections 661 and 662. Since these sections are blind to the differences between corpus and income, when termination distributions are made to estate beneficiaries, adjustments are often required under state law between income and corpus beneficiaries with respect to income tax liabilities.<sup>25</sup> To reduce these adjustments to the minimum, and to obviate the technical necessity for making the mandatory basis adjustments required by Treasury Regulation 1.661(a)-2(f) when the value of property distributed in kind is included in the beneficiary's gross income, the final distribution of the estate should be planned to occur as soon after the close of the estate's fiscal year as possible. This will reduce, or eliminate entirely, taxable income of the estate for the year of final distribution.

A new development in the 1954 Code is section 642(h) which makes available for the first time excess deductions and unused net operating and capital loss carry-overs to the "beneficiaries succeeding to the estate or trust." Termination expenses may well be paid right after the close of the estate's fiscal year so that the excess deductions can be passed through to the beneficiaries, who may need to plan accordingly to acceler-

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24. Treas. Reg. § 1.652(c)-2 (1956).

25. See, e.g., note 16 *supra*.

ate income, realize gains or postpone the making of deductible payments in order to avoid the loss of the estate's excess deductions.

#### IV. SPECIFIC PROBLEM AREAS OF CURRENT INTEREST IN SUBCHAPTER J

##### A. *Is a Pecuniary Formula Marital Deduction Gift a Specific Sum Excluded from the Conduit of Subchapter J?*

Section 663(a)(1) excludes from the conduit system of Subchapter J gifts of a "specific sum of money" and a "specific property." Treasury Regulation 1.663(a)-1(b)(1) undertakes to define these quoted phrases of the statute. After stating that bequests to his son of a decedent's partnership interest and to his daughter of a sum of money equal in value to the decedent's partnership interest do qualify for the exclusion, the regulation takes the position that distributions in satisfaction of pecuniary and fractional share formula marital deduction gifts do not qualify for the exclusion, either as a gift of "a specific sum of money or of specific property." The reasons given in the regulation are as follows:

The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).<sup>26</sup>

There is a wide-spread feeling among knowledgeable tax lawyers that the regulation is not a valid interpretation of section 663(a)(1), and this is particularly true with respect to the pecuniary formula gift. One hears increasingly of reports that the regulation is not being obeyed and that the recipients of such formula marital deduction gifts are not being advised that the payment of the bequest carries with it a share of the estate's distributable net income.<sup>27</sup> Lawyers in nationally known firms have recently experienced the surprise of the double-tax consequence when a pecuniary formula gift is satisfied by a distribution in kind of appreciated property; the executor has realized a capital gain on the distribution, and the recipient beneficiary is held to have received income to the extent of the estate's distributable net income. In a recent case that came to the

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26. Treas. Reg. § 1.663(a)-1(b)(1) (1956).

27. Zimmerman, *The Effect of In-Kind Settlements*, N.Y.U. 22D INST. ON FED. TAX. 1111, 1118 (1964). One hears other reports of this behavior, indicating that the feeling is fairly wide spread.

writer's attention, the estate had no income except for the gain realized by satisfying a formula marital deduction bequest in kind with property which had appreciated in value. The discharge of the pecuniary obligation to the legatee caused a realization of gain to the estate, and the same discharge of indebtedness was thought to be a distribution to the beneficiary of that capital gain.

You will recall that the cases of *Suisman v. Eaton*<sup>28</sup> and *Kenan v. Commissioner*<sup>29</sup> held that a legacy of a specific sum of money creates a debt from the estate to the legatee, and that a transfer of appreciated property in satisfaction of such a legacy is a "sale or other disposition" in which the estate realizes income. Thus, if the will makes a gift of 200,000 dollars, a transfer by the executor to the legatee of Xerox stock worth 200,000 dollars at distribution, but having a basis to the executor of 150,000 dollars would result in the realization of 50,000 dollars of capital gain to the executor. In *Revenue Ruling 56-270*<sup>30</sup> it was held that a pecuniary formula marital deduction trust was a gift of a "fixed and definite dollar amount" so that capital gains were realized by the estate when appreciated property was distributed in kind in satisfaction of the bequest, citing the cases above.<sup>31</sup> In *Revenue Ruling 60-87*<sup>32</sup> the result reached in *Revenue Ruling 56-270* was affirmed and "clarified." The question raised again was whether capital gain was realized by the estate as a result of a transfer of property which had appreciated in value to a marital deduction trust, which was construed to be a pecuniary formula gift. It was again held that the gain was realized because the transfer was a satisfaction of an obligation of a "fixed and definite dollar amount." The writers of this ruling felt compelled, however, to compare *Revenue Ruling 56-270* with Treasury Regulation 1.663(a)-1(b)(1); they argued that the ruling is not concerned with a specific amount *at date of death*, but rather with satisfaction of a fixed amount *at date of distribution*. Thus, it was said that the regulation prescribed an entirely different test, and that the last sentence of the regulation quoted above recognizes that a different rule applies for capital gain purposes, so that the ruling and the regulations are not considered to be inconsistent.

Does this satisfy you? If a pecuniary formula gift is admittedly a "specific sum of money" for one purpose, *e.g.*, the realization of capital gain, is it within the rule of reasonable interpretation to say that the formula is not a "specific sum of money" under section 663(a)(1)? Up-

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28. 15 F. Supp. 113 (D. Conn. 1935), *aff'd*, 83 F.2d 1019 (2d Cir. 1936).

29. 114 F.2d 217 (2d Cir. 1940).

30. 1956-1 CUM. BULL. 325.

31. See cases cited at notes 28 & 29 *supra*.

32. 1960-1 CUM. BULL. 286.



on what basis does the Treasury Regulation add the requirement that the sum must be specific *as of the date of death*? The phrases "specific sum of money" and "specific property" do not in and of themselves seem to imply the requirement that the sum or the property be ascertainable at the date of the decedent's death, as distinguished from some later point of time in the orderly administration of the estate.<sup>33</sup> Instead the central focus in section 663(a)(1) is the fundamental distinction between corpus and income.<sup>34</sup>

The "date of death" language is of course well known in the context of the estate tax marital deduction under section 2056. The Supreme Court in *Jackson v. United States*<sup>35</sup> relied substantially on the admonition of the Senate Finance Committee that in considering what is a terminable interest for the purposes of the estate tax marital deduction "the situation is viewed as at the date of the decedent's death."<sup>36</sup> While this language is a part of the *warp and woof* of both the policies and rules of the estate tax marital deduction, it seems improper and unreasonable to inject the language and its technical requirement as an interpretation of the policies of Subchapter J and section 663, where the basic policy is to exclude corpus gifts from gross income. Subchapter J seeks to tax as income only gifts that can be paid from income; it is not concerned with the policies or the problems of the estate tax marital deduction. Treasury Regulation section 1.663(a)-1(b)(1) erroneously confuses the policies and rules of the estate tax marital deduction with the income tax exclusion provided in section 663 concerning the Subchapter J conduit system. Further, even within the context of the policies and rules of the estate tax marital deduction, *Revenue Procedure 64-19*<sup>37</sup> is an administrative recognition that the date of death requirement concerning terminability will not disqualify pecuniary formula gifts as estate tax deductions if their determination is based upon responsible fiduciary administration which guarantees either ratable sharing or minimum value safeguards.

The Committee on Income of Estates and Trusts, Section of Taxation, American Bar Association is preparing to ask the Treasury Department for an amendment to Treasury Regulation 1.663(a)-1(b)(1) with respect to pecuniary formula marital deduction gifts. In the meantime, it would seem that the regulation ought to be challenged as an erroneous in-

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33. See Note, *Income Taxation of Estates and Trusts—Gift of Specific Property*, 43 IND. L.J. 791, 795-98 (1968). The author concludes that "[m]athematical precision at the date of death has no necessary relevance." *Id.*, at 796.

34. *Cf. id.*, at 805.

35. 376 U.S. 503 (1964).

36. S. REP. No. 1013, 80th Cong., 2d Sess. (pt. 2) 10 (1948).

37. 1964-1 CUM. BULL. 682.

terpretation of section 663(a); the focal point at issue is whether the date-of-death-requirement is a reasonable interpretation of that Code section.

The regulation states that bequests to a son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership are indeed gifts of "specific property" and a "specific sum of money." Can anyone tell a son or daughter an hour after a decedent's funeral precisely how much in property or money the decedent's partnership interest is? Is the orderly liquidation of a partnership after a partner's death a more responsible fiduciary administration than the orderly settlement of a decedent's estate under the supervision of a state court?

### B. *Other Needed Adjustments to the Existing Code Scheme*

Set forth briefly below is a list of suggested technical adjustments to the existing scheme of the Subchapter J conduit system, the need for which has either been demonstrated in the cases, or recognized by tax practitioners. They should be considered as adjustments to the existing code structure, and distinguished from the alternative schemes for taxing the income of estates to be discussed in the next section. Some of the adjustments listed here will be equally relevant to alternative schemes of taxation, but not all.

1. *Estate of McCoy*<sup>38</sup> held that a widow's allowance paid pursuant to a probate court decree and charged to corpus was nevertheless taxable as income to the extent of the estate's distributable net income. Treasury Regulation 1.661(a)-2(e) was held invalid for providing that such allowances are not taxable under sections 661-662 conduit system "except to the extent such amounts are payable out of and chargeable to income." This was a remarkable regulation indeed and, perhaps, a reflection of a 1939 hang-over within the Treasury Department. In promulgating this regulation, the Treasury Department made an obvious error by applying a principle of the 1939 Code which is inconsistent with the second policy decision of the 1954 Code. Nevertheless, the case does demonstrate a need to expand the current list of exclusions from the Subchapter J conduit system of taxation. An exclusion for the family allowance would be particularly appropriate.

2. *Hay v. United States*<sup>39</sup> held that there is a lack of co-ordination between sections 661(a)(2) and 662(a)(2) on the one hand, which apply the deduction-inclusion conduit to amounts of the distributable net in-

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38. 50 T.C. 562 (1968).

39. 263 F. Supp. 813 (N.D. Tex. 1967).

come paid or credited "for" the taxable year of the estate or discretionary trust, and section 662(c), on the other hand, which provides that the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust paid or credited "during" any taxable year or years of the estate or trust ending "within or with" his taxable year. The court held Treasury Regulation 1.662(c)-1 invalid insofar as it attempts to finesse this lack of coordination by interpreting the word "during" in section 662(c) to mean "for any taxable year . . . ending with or within" the beneficiary's taxable year.

In the *Hay* case the taxpayer was the beneficiary of a discretionary trust which was involved in the management of certain ranching and oil and gas operations. The trust used the accrual method of accounting and a fiscal year ending November 30, 1962. Because of the magnitude of its operations the trust was unable to determine its 1962 net income for distribution purposes until January 31, 1963. It made a distribution of 10,000 dollars to the taxpayer beneficiary on December 1, 1962, and a distribution of 56,478.25 dollars on February 1, 1963, both of which represented trust income for fiscal 1962. The court held that the trust was entitled to a distribution deduction under section 661(a)(2) for these two payments for its fiscal year ending November 30, 1962, because there is no question that the distributions were "for" that year, and also because there is no other provision in the 1954 Code relating to deductions taken by discretionary trusts for distributions to beneficiaries. Continuing, the court said that the provision found in section 162(c) of the 1939 Code restricting the distribution deduction to amounts distributed "during" its taxable year was not carried over to the 1954 Code. On the other hand, section 662(c) expressly provides that the beneficiary is to report only such income as was properly paid "during" the taxable year. Thus, while the trust was allowed a distribution deduction for fiscal 1962 ending November 30, 1962, the beneficiaries were taxable in calendar year 1963.

Prior to 1954 the only statute providing for different taxable years was restricted to simple trusts in which the annual income was required to be distributed currently to the beneficiary.<sup>40</sup> It had no application to complex trusts and decedents' estates. Section 162(c) of the 1939 Code provided in a single sentence for both the deduction to the estate or complex trust and the inclusion by the beneficiary, and both were determined by the amount of income which was "properly paid or credited *during* such year to any . . . beneficiary." It seems clear that the error was inadvertently made in the haste of compiling the 1954 Code, and that the rules of the

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40. INT. REV. CODE of 1939, § 164, 53 Stat. 67 (1939) (now §§ 652(c) & 662(c)). See Fillman, *supra* note 2, at 479.

1939 Code should be written into the 1954 Code.

3. *In re Estate of Nissen*<sup>41</sup> held that where the executor made discretionary distributions to the income beneficiaries of two residuary trusts, the estate was nevertheless entitled to the entire depreciation deduction on an office building under section 167(h) because the words "heirs, legatees, and devisees" in the last sentence of section 167(h) do not include individuals who are discretionary income beneficiaries of residual trusts. Under the 1939 Code it was held that the estate was entitled in all cases to the full amount of the depreciation deduction. The provisions of section 167(h) were first enacted by the 1954 Code in order to prevent the wasting of the depreciation deduction where the estate or trust income was exhausted. This seems to be the first case interpreting the portion of section 167(h) applicable to estates. As indicated by the case, the statute seems to provide a rule for estates different from that provided for trusts. The sentence on trusts provides for apportionment of the depreciation deduction in accordance with the trust instrument, whereas the sentence on estates does not. The *Nissen* case adds the additional difference that in the case of a trust, where it is not provided otherwise, the depreciation deduction is allocated between the trust and the beneficiaries on the basis of the trust income allocated to each, whereas in the case of an estate there is the additional requirement that the recipient of estate income must also qualify under local law as an heir, legatee or devisee. Because they were only discretionary income beneficiaries of their respective trusts the recipients in *Nissen's Estate* failed to qualify on the latter point under North Carolina law.

The Section of Taxation of the American Bar Association has recommended that sections 167 and 611 be amended to provide that depreciation and depletion deductions on property held by an estate be apportioned between the estate and the income beneficiaries in the same manner as if the property were held in trust.

4. *The Separate Share Rule Should be Extended to Estates*: There is general agreement that the separate share rule should be extended to decedents' estates, and not limited to trusts as is true now under section 663(c). This would reduce somewhat the trap for the unwary when a distribution of estate assets is made to one of several estate beneficiaries in a year when the estate has distributable net income.

5. *Installment Payments of a Specific Sum or Specific Property*: Both the Advisory Group on Subchapter J and the Ways and Means Committee in H.R. 9662 agree that the three installment limitation on gifts of a specific sum and specific property is too narrow. The income tax

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41. 345 F.2d 230 (4th Cir. 1965).

avoidance feature of installment payments of a specific sum or a specific property is not in the number of installments, but rather it is in the number of taxable years in which the installment payments can be made. It is recommended therefore that section 663(a)(1) be amended to provide that gifts of a specific sum of money or specific property which are paid all at once or in not more than thirty-six calendar months after the date of the decedent's death should be excluded from the conduit system of Subchapter J.

#### V. SUGGESTED ALTERNATIVES FOR THE INCOME TAXATION OF ESTATE DISTRIBUTIONS—THE NEED FOR REFORM

As indicated in the introductory discussion, when there was added to the 1954 Code the policy decision that all distributions, whether out of corpus or income, should be taxable income to the recipients to the extent of the estate's distributable net income, there came to be an important need for a separate scheme of income taxation for decedents' estates. Section 663(a)(1) excludes from the conduit system of sections 661(a) and 662(a) gifts of a specific sum of money or specific property paid or credited all at once or in not more than three installments, other than amounts which can be paid only from income. This exclusion has proved to be too narrow in scope for the necessary and desirable distributions of decedents' estates. As examples, section 663 does not exclude from the rules of sections 661(a) and 662(a) distributions of corpus to residuary legatees, payments solely out of corpus to will contestants, payments out of corpus to widows for support and family allowance, or payment of intestate shares of inheritance. In many instances distributions to a residuary beneficiary in the ordinary course of administration and not prompted by any tax motive results in the beneficiary being taxed on a disproportionate share of the estate's income. While extension of the separate share rule of section 663(c) to estates will ameliorate the hardship in some cases, complete relief can be afforded only by designing a separate scheme for taxing the income of decedents' estates.

Presented below is a survey of the suggested alternatives for taxing the income of estates and their distributees. In evaluating these proposals we would do well to remind ourselves that prior to 1954 our basic policy in this area of tax law was simply to distinguish between gifts of corpus and gifts of income—the policy of section 102(a) as modified by the doctrine of *Irwin v. Gawit*.<sup>42</sup> Do we really need to do anything more than this for the two to three year period generally needed to administer a decedent's estate? Because the problems of an executor differ from those of

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42. 268 U.S. 161 (1925).

a trustee, and because a decedent's estate is not intended to be of long duration, it is clear that separate consideration needs to be given to estate distributions.

#### A. *The Advisory Group Report*

The Advisory Group on Subchapter J established by the Chairman of the Committee on Ways and Means filed its final report for publication on December 30, 1958. This was an illustrious group of scholarly and experienced men, who gave a very great amount of time and hard work in their efforts to improve Subchapter J. Professor A. James Casner served as Chairman. With respect to estate distributions, in addition to extension of the separate share rule to estates as indicated, seven of the nine members of the Advisory Group recommended that for a period of thirty-six months following the decedent's death a distribution by an executor should not carry the estate's distributable net income to the distributee if the distribution is properly charged against corpus and designated as a distribution of corpus on the books of the estate by the executor.<sup>43</sup> It was recognized that this is a return to the 1939 Code for estate distributions and that it would give the executor the power to identify and control the source of the distribution for the three year period involved. It was believed, however, that the possibility of tax avoidance in this area for the limited period of time involved is too slight to justify the continued application of the present arbitrary, inequitable, and complex rules for attributing estate income to residuary beneficiaries.

It has since been pointed out that under the present rules the executor controls the income tax consequences of estate distributions by his decision to distribute or not to distribute a part of the residue. Under the Advisory Group proposal he determines such consequences by the designation he gives to the distribution as income or corpus.<sup>44</sup>

As indicated by the earlier discussion in this paper, under the present inept rules applicable to estates, the sophisticated, professional executor can split the estate's distributable net income in a typical, proper case between four taxable entities—the decedent's estate, the marital deduction trust, the non-marital residuary trust, and the income beneficiary. This can be accomplished in every year of the executorial period, which might be many years longer than the three years, or thirty-six months, recommended in the Advisory Group Report. The opportunities for tax avoidance through income splitting during the period of administration are now

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43. Final Report From The Advisory Group on Subchapter J. of the Internal Revenue Code of 1954, at 31-33 (1958). See Casner, *Income Tax Results of Interim Estate Distributions to Beneficiaries*, 98 TRUSTS AND ESTATES 200, 201 (1959).

44. Casner, *supra* note 43, at 201.

so attractive that the sophisticate-professional has in many instances become less than enthusiastic about the need for reform. One could conceivably create several residuary trusts to terminate with the end of the estate administration in order to split the income during the executorial period. On the other hand, there are countless estates in which there is either a neglect or an inability to take advantage of the income splitting permitted by the present rules. There is thus a great lack of uniformity in the income taxation of decedents' estates with relatively equal income, and a substantial break-down of the policy value added by the 1954 Code as applied to decedents' estates.

### B. *The Entity Rule*

The *Federal Income Tax Statute* prepared by the American Law Institute recognized the ineptness of the trust conduit system to decedents' estates for the period of normal administration. The draft statute on this income tax project provided that the tax imposed upon individuals shall apply to estates of deceased persons during the period of the settlement of the estate. The tax was to be paid by the executor or administrator and computed in the same manner as in the case of an individual for a fixed period of time (fifty-one months was suggested, permitting any estate to elect, however, to be taxed as a trust).<sup>45</sup>

This is referred to as the "entity" method of taxing the income of estates.<sup>46</sup> Two distinguished members of the Advisory Group, Kenneth W. Bergen and Laurens Williams, favored the adoption of the entity rule for estates for a period of thirty-six months after the decedent's death plus the remainder of the taxable year in which the thirty-six month period expires.<sup>47</sup> During this period no deduction would be permitted the estate for distributions made to beneficiaries, and such distributions would be tax free to the recipients. After the thirty-six months period the present trust conduit rules of Subchapter J would be applied for the balance of the period of estate administration.

If the entity rule is adopted, the only way estate income could be shifted or spread among the beneficiaries and the estate during the thirty-six month period would be by the early distribution of corpus assets to the beneficiaries before taxable income is realized by the estate. This is not always feasible or practical under either state probate law or federal tax

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45. See 2 ALI FED. INCOME TAX STAT. § 147-48 (Feb. 1954 Draft).

46. See Sugarman, *Estates and Trusts*, 3 TAX REVISION COMPENDIUM 1749, 1757 (House Committee on Ways and Means 1959). Cf. Johnson and Vernon, *Income of Estates and Trusts*, *id.*, at 1766.

47. Final Report of Advisory Group on Subchapter J of the Internal Revenue Code of 1954, at 85 (1958).

law. Thus, the entity rule would subject the beneficiaries of large estates to a substantial disadvantage to the extent that the estate would be subjected to higher income tax rates than those applicable to the beneficiaries.

The virtue of the entity rule is its relative simplicity. This is an important value in the current scene of income tax revision in the United States. An executor would be relieved of the onerous and time consuming job of planning the income tax consequences to the estate and its beneficiaries of distributions, or the lack of distributions. The executor is frequently put under pressure by some beneficiaries to make distributions, and by others to accumulate income. It was suggested that these same pressures will continue under the recommendation of the majority of the Advisory Group. Executors of small estates, who are frequently unfamiliar with tax laws, would have far less difficulty with the income tax return under the entity rule.<sup>48</sup>

### C. *The H.R. 9662 Proposal*

The Trust and Partnership Income Tax Revision Bill of 1960, known as H.R. 9662, was introduced by Chairman Wilbur D. Mills and passed in the House of Representatives and reported to the Senate on June 18, 1960. It was not enacted into law, however.

In addition to extending the separate share rule to decedents' estates and liberalizing the installment payment of specific gifts as indicated, H.R. 9662 would have excluded from the conduit system of sections 661 and 662 distributions by the executor of real property, tangible personal property (other than money) and close corporation stock made within thirty-six months after the decedent's death. Closely held stock was limited to stock in a corporation of ten or less stockholders, where twenty per cent or more in value of the voting stock of the corporation is included in the decedent's gross estate and the value exceeds either thirty-five per cent of the gross estate or fifty per cent of the value of his taxable estate. This latter test is taken from section 6166. It was also proposed that in the case of an estate in which the value of the gross estate is 100,000 dollars or less the majority proposal of the Advisory Group be adopted, *i.e.*, any amount charged to corpus by the executor would be excluded from the conduit system even though it consisted of cash and marketable securities. The valuation would be determined on the date of death, regardless of the valuation date chosen for the estate tax return, and the "gross estate" for this purpose would be defined as the items included in the gross estate for federal estate tax purposes less the value of any property in-

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48. See the comments of Sugarman, note 46 *supra*, and Bergen and Williams, in the Final Report, note 47 *supra*.



cludible therein only by reason of sections 2035, 2036, 2037, 2038, 2039, 2040, 2041 and 2042(2).

There is considerable objection to the H.R. 9662 alternate proposal for estates of 100,000 dollars or less because of the traditionally difficult valuation problem which could invalidate the income tax returns of the executor and the beneficiaries. There is also objection to the definition of close corporation stock for this purpose. On the other hand, exclusion from the conduit system of sections 661 and 662 for estate distributions of real property in those states where it is a part of the probate estate, tangible personal property other than money and close corporation stock plus amounts distributed in satisfaction of a widow's family allowance for support would go far to alleviate the present unfortunate traps for the unwary in estate distributions. There is no doubt that it would constitute a substantial improvement over the existing law concerning estate distributions, and it would relieve the professional fiduciary from some of the pressures of planning the tax consequences of estate distributions.

#### D. *A Distribution in Kind Approach*

At the request of Chairman Mills of the Ways and Means Committee the Advisory Group presented for consideration, but without recommendation, a distribution-in-kind approach to the taxation of estate income.<sup>49</sup> This proposal would exclude from the conduit system of sections 661 and 662, for a period of thirty-six months after the decedent's death, the distribution by an executor or administrator of property other than money owned by the decedent at the time of his death, or property the basis of which is determined by the property so owned. The distributions-in-kind approach would certainly broaden for decedents' estates the exclusions from the conduit system of Subchapter J as compared to the present section 663, and it would seem to be relatively easy to apply in the large number of estates which do not contemplate the sale and reinvestment of estate assets during the executorial period. Corpus cash is of course an important need for the fiduciary for the payment of claims, expenses and taxes, and there are many times when the beneficiaries are in need of a distribution of corpus cash during the executorial period. If the distribution of corpus cash is to have income tax conduit consequences to the beneficiaries, the distribution-in-kind approach may complicate somewhat the decisions of the executor in regard to the retention or sale of estate assets.<sup>50</sup>

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49. Final Report of Advisory Group on Subchapter J of the Internal Revenue Code of 1954, at 80 (1958). See also Casner, *Income Tax Results of Interim Estate Distributions to Beneficiaries*, 98 TRUSTS AND ESTATES 200, 202 (1959).

50. Casner, note 49 *supra*.

It is interesting to note that in 1959 a spokesman for the Treasury Department said in response to the majority proposal of the Advisory Group:

We do not agree, however, to the revision suggested by the Advisory Group. Its proposal is that all items payable from corpus of an estate during the thirty-six months following the death of the decedent be exempt from tax in the hands of the distributees. We . . . recommend . . . a 'distribution in kind' approach. . . . Under this approach, a distribution in property (other than money) owned by the decedent at the time of his death would be considered to be a payment from corpus of the estate, and thus would not be considered a distribution of income.<sup>51</sup>

#### CONCLUSION

There is a widespread, general consensus that the 1954 conduit system for taxing the income of estates and trusts produces serious inequities in the treatment of corpus distributions by decedents' estates. Our basic policy values seem to be quite clear and agreed to: in the context of decedents' estates we want to exclude gifts (and distributions) of corpus from gross income, but we want to tax gifts (and distributions) which can only be paid from income. The problem seems to come down to choosing the best mechanism for implementing this policy decision.

There is a general consensus that the separate share rule should be extended to decedents' estates and that the installment payments of specific gifts should not be limited to a specific number of installments, but rather should be restricted to a specified number of taxable years in which the installment distributions are taxfree.

Three of the four proposals, the Advisory Group Report, the Distribution-in-Kind proposal favored by the Treasury Department in an earlier year, and the H.R. 9662 proposal, would improve the income taxation of estate distributions by broadening the exclusions of section 663 to the conduit rules of sections 661 and 662. Under all three proposals, however, the conduit rules of Subchapter J and its key concept of distributable net income will continue to apply for the purpose of determining the income tax liability of both the estate and its beneficiaries with respect to what is in fact taxable probate income. The differences between them have to do only with the scope of the exclusions from the system during

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51. Statement of Mr. David A. Lindsay, Assistant to the Secretary of the Treasury as reported in Stevens, *Drastic Changes in Trust Tax Rules Likely: Treasury Opposes Some*, 10 OF TAX 370, 372 (1959).

the period of three years following the death of the decedent. The fourth proposal, the entity rule, would take the income taxation of decedents' estates completely out of Subchapter J for the three year period. This approach is based upon the argument that simplicity of computation is a more important value in the income taxation of decedents' estates, and this is particularly true with respect to smaller estates.

While the Advisory Group proposal is the broadest of the three, it should be noted that the Distribution-in-Kind proposal is almost as broad, the difference being mostly with respect to distributions of corpus cash, and that both of these are substantially broader than the H.R. 9662 proposal. The latter proposal is subject to criticism with respect to (1) its technical requirements concerning close corporation stock, and (2) the use of a 100,000 dollar valuation as a condition for its approval of the Advisory Group proposal. It would seem that H.R. 9662 would have done better if it had expressed the condition in terms of estates with a gross income not in excess of a designated number of dollars rather than a valuation of the gross estate.

The Section of Taxation of the American Bar Association adopted a proposal in 1963 which is substantially a copy of the recommendation of the Advisory Group Report with respect to estate distributions. As between the Advisory Group Report and the Distribution-in-Kind approach, while either would be a substantial improvement over the present inclusion of corpus distributions in the income tax conduit system, the former seems to provide a lesser problem in fiduciary management because it is based upon the traditional practice of probate accounting. There would not seem to be a significant loss of revenue in preferring the Advisory Group Report over the Distribution-in-Kind approach for the thirty-six month period recommended. Accordingly, it seems now that the Advisory Group Report is probably the most feasible of the four proposals for tax reform for estates with a substantial amount of taxable income, limited to the period actually required for probate administration. It is possible that the Internal Revenue Service could be authorized to extend this period upon application for estates involved in litigation, or in other cases where the executor submitted convincing evidence that the administration of the estate must necessarily be continued, to the extent that it was shown that probate assets could not be distributed.

Lastly, it would seem that there could be a place indeed for the entity rule with respect to smaller estates. As indicated, it seems that this can be better handled on the basis of the gross income of the estate each year rather than the valuation of the estate assets on a given date. The concern of those responsible tax scholars who have advocated the entity rule

has been to provide tax simplicity for the smaller estate. It would seem quite practical to provide that estates with a gross income of some stated amount, *e.g.*, 6,000 dollars or less, could elect to file a 1040 return as an individual and not bother with the chameleon-like concept of distributable net income and the Subchapter J conduit system.

# INDIANA LAW JOURNAL

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Volume 44

Spring 1969

Number 3

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