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Marilyn Cimino

V. Anne Douthit

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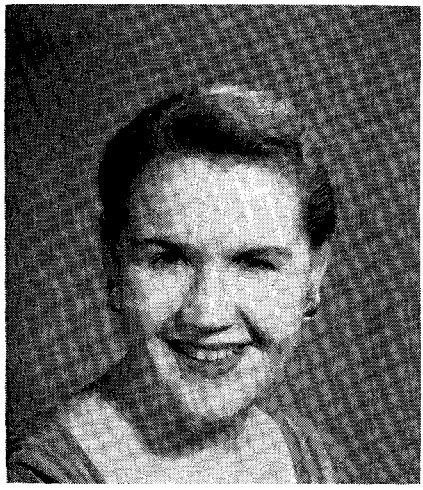
BY MARILYN CIMINO and V. ANNE DOUTHIT



V. Anne Douthit received her B.S. degree in Business Administration from the University of Denver in 1951. She is a Registered Accountant and is past president of the Denver Chapter, American Society of Women Accountants. Presently she is a student at the College of Law and a member of the DICTA staff.

Marilyn Cimino is a senior at the University of Denver College of Law and a member of the DICTA staff.

The broad effect of today's income tax laws is placing an ever-increasing burden on executors in the intelligent administration of estates. Since the fiduciary is charged with the duty to treat the beneficiaries equally,[1] he must determine in advance whether or not the elections he is entitled to make under federal tax law will inure to the benefit of one beneficiary over others.

Where the testamentary trust created gives income to certain bene-

[1] In re James' Estate, 189 Misc. 7, 65 N.Y.S.2d 756 (Surr. Ct. 1946).

ficiaries for life and the principal to remaindermen, the election to deduct administrative expenses for income tax purposes rather than for estate tax purposes creates just such a problem. Under sections 162 and 212 of the Internal Revenue Code of 1954,[2] administrative expenses qualify for deduction from the income in computing the estate's income tax, and also qualify as deductible for estate tax purposes.[3]

Thus the executor is given a choice to claim the expense deduction either to reduce the estate tax *or* the income tax, but he is limited by section 642 (g) [4] to one deduction or the other. Should he choose to make use of the deduction in computing income taxes, it is clear that the amount of estate taxes payable by the corpus beneficiary will be raised by the resulting increase in the amount of the adjusted gross estate.[5] In other words, the set-off against the estate tax is precluded by the election, and the remainderman must make up the difference. Substantial over-all tax savings may result from the election, however, because income tax rates can be much higher than estate tax rates. The positive duty falls upon the executor to preserve the estate by the greatest tax saving possible. But, the executor may be guilty of a breach of duty if he does not allocate the savings to equally benefit the life tenant and remainderman—*unless* the testator has given him the authority to make the election without restoring principal.

In situations where the marital deduction formula bequest is not involved, the problem is relatively simple. In a will directing the establishment of a trust from which the income is to go to one beneficiary, and the remainder to others, exercise of the tax option will result in a benefit to the income beneficiary to the detriment of the remainderman. However, the amount of the detriment to the remainderman is simply the difference between the actual estate tax liability, and the amount which would have been payable had the administrative expenses been deducted from the gross estate in computing the tax. For instance, assuming an adjusted gross estate of $560,000 before deduction of administrative expenses of $60,000, the federal estate tax liability before state death tax credit would be $167,700 if administrative expenses were deducted for income tax purposes, and $145,700 if deducted for estate tax purposes. The detriment to the remainderman would be the difference between these two amounts, or $22,000. Further assuming that this same estate had income which was not distributed to the extent of $56,000 per year for two years, against which the administrative expense was applied at the rate of $30,000 per year, the income tax savings in two years' time would amount to $40,968.

The problem becomes much more complex in cases where the marital deduction[6] formula bequest enters the computation. The fol-

[2] Int. Rev. Code of 1954, § 162 defines expenses which may be taken as deductions against income; § 212 allows deduction of expenses incurred in the production of income. These two sections are the basis for deduction of administration expenses from the income of the estate.

[3] Int. Rev. Code of 1954, §§ 2053-54 provide that administration expenses may be deducted from the gross estate.

[4] Int. Rev. Code of 1954, § 642(g) provides that deductions allowable under §§ 2053-54 may not be used for both income and estate tax purposes. Use of such deductions against the income tax requires a waiver of the right to deduct under §§2053-54.

[5] See note 3 supra.

[6] Int. Rev. Code of 1954, § 2056. In determining the taxable estate, the amount which passes to the surviving spouse may be deducted, but this deduction cannot exceed one-half the adjusted gross estate.

lowing hypothetical example will help in illustrating what is here involved:

COMPUTATION OF FEDERAL ESTATE TAX

	Administrative Expense Deducted	Administrative Expense Not Deducted
Gross Estate	$480,000	$480,000
Less: Administrative Expenses	40,000	-0-
Adjusted Gross Estate	440,000	480,000
Deduct:		
Marital deduction (50% of Adjusted Gross Estate)	220,000	240,000
Specific Exemption	60,000	60,000
	280,000	300,000
Taxable Estate:	$160,000	$180,000
Federal estate taxes (before credit for state death taxes)	$ 38,700	$ 44,700

Claiming the deduction for income tax purposes will result in an additional estate tax burden of $6,000 on the principal of the estate. In cases where the decedent has bequeathed to his surviving spouse an amount equal to fifty per cent of the value of his adjusted gross estate as finally determined for federal estate tax purposes, and has provided that administrative expenses are to be paid from the principal of the

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estate, claiming the deduction for income tax purposes will also result in an additional detriment to the residuary beneficiary in the amount of $20,000. That is the additional amount received by the widow in order to obtain the maximum marital deduction.[7]

If the income of the estate is $40,000 the first year after death, and $50,000 the second year the following income tax consequences will result:

COMPUTATION OF FEDERAL INCOME TAX

	First Year	Second Year
Deducting Administration Expenses from Income:		
Net taxable income before deduction of administration expenses and fiduciary exemption	$40,000	$50,000
Deduct:		
Administration expenses	20,000	20,000
Exemption	600	600
	20,600	20,600
Net taxable income	$19,400	$29,400
Federal income tax	$ 6,942	$12,848
Without Administration Expense Deduction:		
Net taxable income	$39,400	$49,400
Federal income tax	$19,362	$26,388
Income tax savings effected through use of election	$12,420	$13,540

Net tax savings to the estate effected through use of election:	
Total income tax savings	$25,960
Less: Additional estate tax payable	6,000
Net savings in taxes	$19,960

The cases which have dealt with the problems arising in these situations have made it clear that the remainderman is entitled to reimbursement for the detriment suffered by him through the use of this election.[8] However, they have not outlined a method for adjustment which will operate to the maximum advantage of all parties.

Two of the cases, *Estate of Edwin H. Warms*[9] and *In re Bixby's Estate,*[10] dealt with the first of the problems outlined, where the marital deduction formula bequest does not enter the picture. All that is neces-

[7] Rev. Rul. 55-643, 1955-2 Cum. Bull. 386.
[8] In re Bixby's Estate, 140 Cal. App. 2d 326, 295 P.2d 68 (2d Dist. 1956); In re Levy's Estate, 167 N.Y.S.2d 16 (Surr. Ct. 1957); Estate of Warms, 140 N.Y.S.2d 169 (Surr. Ct. 1955).
[9] 140 N.Y.S.2d 169 (Surr. Ct. 1955).
[10] 140 Cal. App. 2d 326, 295 P.2d 68 (2d Dist. 1956).

sary here in order to effect an equitable solution is to reallocate enough of the income beneficiary's tax saving to the principal account to cover the amount of the additional estate tax payable from the corpus. In the example set out in the fourth paragraph of this Note, a $22,000 transfer from the income account to the principal account would accomplish the desired result, and still leave the income beneficiary with a substantial tax saving.

A New York case, *In re Levy's Estate,*[11] dealt with the additional problem involved under the marital deduction formula bequest. Here the testator had bequeathed to his surviving spouse fifty per cent of the adjusted gross estate as computed for federal estate tax purposes. The court held that the election permitted by the internal revenue code should not alter the respective interests of the legatees, and the residuary estate should have the benefit of all deductions which are available to the estate principal.

From the examples outlined above, it can be readily seen that in order to completely reimburse the residuary beneficiary, a transfer of $26,000 ($20,000 plus $6,000) would have to be made. In this particular example, transfer of this amount would exceed the total income tax savings effected under the election. This result would not be uncommon unless the income of the estate is large enough to put it into an extremely high income tax bracket. It should also be noted that reimbursement of the $20,000 to the residuary beneficiaries actually results in the surviving spouse's receiving only $220,000 rather than the $240,000 claimed as a marital deduction. There is always the possibility of the marital deduction of $240,000 being disallowed in such cases. The apparent result here would be the receipt of $20,000 by the residuary beneficiary free from federal estate taxation.

Another way to handle the problem would be to limit the marital deduction to $220,000 even though the administration expenses are deducted for income tax purposes. The result of this method of adjustment would be as follows:

Gross estate	$480,000
Deduct:	
Marital Deduction	220,000
Specific Exemption	60,000
	280,000
Taxable estate:	$200,000
Federal estate taxes:	$ 50,700

[11] 167 N.Y.S.2d 16 (Surr. Ct. 1957).

This would require reimbursement to the principal account of $12,000 which is the difference between the actual tax liability of $50,700 and the $38,700 which would be due if the election had not been taken. The net savings in taxes would be $13,960. This is not as advantageous to the income beneficiary because it results in a higher estate tax liability, which must be reimbursed from the savings in income taxes.

The question may arise whether or not the executor has, by reason of this right to elect between the taxable estates, a power of appointment. But, once it is realized that this election is merely for tax purposes, and does not affect the fiduciary accounting principles involved, it would seem that the election is merely one of the incidental consequences of trust administration.[12] This is especially true where there is an express provision in the will authorizing the executor to make the election in his sole discretion and relieving him from making adjustments. Most wills today contain a clause allowing the executor to choose to deduct administrative expenses from either the corpus or the income, but the provision exonerating him in case he does not adjust savings has not been so common. The testator's presumed wish is to prefer his surviving spouse over the remaindermen. Therefore, a direction to the executor to that end would eliminate the necessity for compensatory allocations. The following proposed clause will clarify the executor's duty and seems to give weight to the testator's intention:

> "If my executors shall have an election whether to take expenses of administration of my estate as a deduction for federal estate tax or income tax purposes, I direct that they elect to take such expenses as an income tax deduction if they believe this will minimize the total tax burden on my estate, irrespective of the effect such decision may have upon the value of the respective trust funds provided for hereunder, and without any compensating adjustments by reason of the increase in the net income of the life tenant resulting from giving the income account the benefit of a deduction, for income tax purposes, of a payment out of corpus."

The substantive rights of the beneficiaries would not be prejudiced by this provision, and the executor would have an unequivocal guide on which to rely in choosing the most advantageous tax methods.

[12] Proposed U.S. Treas. Reg. § 20.2041-1(b) (1956) provides that the mere power to allocate receipts and disbursements as between principal and income, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.