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James J. Freeland

Richard B. Stephens

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# LEGATEES: TAXABLE INCOME AND DEDUCTIONS ARISING OUT OF THEIR PERIPHERAL RIGHTS*

JAMES J. FREELAND AND RICHARD B. STEPHENS**

Testamentary disposition of personal property generally falls into one of three categories:[1] (1) a specific legacy, similar to a specific devise of real estate, passes designated items of personal property to the legatee named in the will;[2] (2) a general pecuniary legacy, instead of designating specific property, provides for a fixed amount of money to be paid to a named beneficiary;[3] and (3) a residuary legacy passes the residue of the estate (after debts and claims and other testamentary dispositions) to the residuary legatees.[4] This article does not attempt to detail the technical differences and variations in testamentary dispositions of money or property.[5] Instead, it is the income tax consequences of these various dispositions that are given consideration. Moreover, we ignore here the tax significance of the payment of the very thing bequeathed[6] so as to focus our attention on certain collateral rights of the recipient.

*This article is one part of a book entitled *Federal Income Taxation of Estates and Beneficiaries*, to be published by Little, Brown & Co. in 1968.

**James J. Freeland, A.B. 1950, Duke University; LL.B. 1954, University of Florida; Member, The Florida Bar; Visiting Associate Professor 1962-1963 and Professor of Law 1964-1965, New York University; Professor of Law, University of Florida.

Richard B. Stephens, A.B. 1939, University of Rochester; LL.B. 1942, University of Michigan; Member, Bars of Illinois and the District of Columbia; Visiting Professor of Law 1958-1960, University of Illinois; Professor of Law, University of Florida.

1. Demonstrative legacies, not mentioned here, are described in ATKINSON, WILLS 734 (2d ed. 1953).

2. *Id.* at 732-33. In many instances the classical terminology distinctions between "bequests" or "legacies" of personal property and "devises" of real property have been obliterated by usage. The terms are frequently used interchangeably. *Id.* at 4. See also, *e.g.*, FLA. STAT. §§731.03 (2), (5), (6), (10), (11) (1965), providing that the words "bequest," "devise," and "legacy" may be used interchangeably.

3. See ATKINSON, WILLS 733-34 (2d ed. 1953).

4. *Id.* at 736.

5. For detailed consideration of the nontax aspects of such dispositions see 6 BOWE-PARKER: PAGE ON WILLS §§48.1-.10 (3d ed. 1962) [hereinafter cited as BOWE-PARKER].

6. In many instances brief reference is made in this article to matters dealt with comprehensively in other parts of a book, of which this article is a part, entitled *Federal Income Taxation of Estates and Beneficiaries*, to be published by



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What are the income tax consequences of rules of local law that require the estate, in the case of pecuniary legacies, to pay *interest* to the legatees, or in the case of specific legacies, to pay the *income* earned by the specific property during the course of administration to the legatee of such property? In the ensuing discussion, which deals first with the *interest* and then the *income* question,[7] it is assumed that the subject matter of the bequest is a part of the estate.[8]

INTEREST ON LEGACIES

A general pecuniary legacy may bear interest in the absence of a will provision directing that it be paid without interest.[9] Variations among the several states, reflected both in statutes and in judicial decisions, concern mostly the period during which the interest is deemed to accrue.[10] The requirement that interest be paid on pecuniary legacies, at least in some circumstances, is well established in most jurisdictions.[11] One logical approach is to say that interest runs from the end of the nonclaim period when general pecuniary legacies may become payable.[12] In some states, interest is deemed to accrue only from the time fixed by order of the probate court for distribution of the legacy.[13] There are other variations.[14] We make no attempt in this article to deal with the varied provisions of state law, which include differences in rates as well as interest periods. The discussion

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Little, Brown & Co. in 1968. It should be said here, for example, that a bequest of a specific sum of money or of specific property is generally received tax-free by the recipient. INT. REV. CODE OF 1954, §§102, 663 (a) (1). Obviously, no attempt is made here to analyze the specific bequest concept or its limitations.

7. See discussion in text following heading INCOME ON SPECIFIC LEGACIES *infra*.

8. Just as some property owned by a decedent, such as tenancy-by-the-entirety property, passes outside the probate estate, some property passes outside the estate recognized for federal income tax purposes. This matter is explored in Stephens & Freeland, *The Federal Tax Meaning of Estates and Trusts*, 18 TAX L. REV. 251 (1963), also a part of the forthcoming book mentioned at note 6 *supra*. Suffice to say here that the problems discussed in this article do not arise with respect to property that is not considered a part of the estate for federal income tax purposes.

9. 6 BOWE-PARKER §59.11, at 414.

10. *Id.* §59.13; 3 SCOTT, TRUSTS §234.2, at 1783 (2d ed. 1956) [hereinafter cited as SCOTT]. See RESTATEMENT (SECOND), TRUSTS §234, comments *c*, *e* (1959); Lewis, *When Does Interest Begin To Run on Legacies?*, 16 MINN. L. REV. 226 (1932).

11. *Ibid.*

12. 6 BOWE-PARKER §59.11, at 412.

13. Note 10 *supra*; see, *e.g.*, FLA. STAT. §§731.22, 733.01 (2) (b) (1965); *cf.* Estate of Harry S. Bond v. United States, 164 Ct. Cl. 180, 326 F.2d 999 (1964), involving Connecticut law.

14. See 6 BOWE-PARKER §59.13, at 111.

that follows assumes that an amount of interest is required to be paid to a beneficiary entitled to a pecuniary legacy.

For income tax purposes, the pecuniary legacy itself may or may not qualify for the inheritance exclusion under section 663 (a) (1) of the Internal Revenue Code of 1954.[15] For example, a pecuniary formula bequest does not qualify for the protection of that section because the amount of money, although ultimately determinable as a fixed amount, is not ascertainable as of the date of the decedent's death. It therefore lacks the specificity required by the exclusion provision. Whenever a pecuniary legacy itself does not qualify for the inheritance exclusion, it becomes an amount required to be paid within the general distribution rules and attracts a ratable amount of the estate's "distributable net income,"[16] usually resulting in gross income to the beneficiary and a deduction to the estate.[17] However, the income tax consequences of the estate's payment of interest on a pecuniary legacy are not determined by the tax classification accorded the bequest itself and in some respects are not as clear.

If an amount paid on a pecuniary legacy is accurately identified as interest for tax purposes, the payment by the estate should give rise to an interest deduction under section 163.[18] From the standpoint of the recipient, the statutory language raises some doubt,[19] but the symmetry of Subchapter J, which presents the Code provisions applicable to estates, would be destroyed if an amount deductible as interest by the estate were includible in the gross income of the recipient only within the limitations of D.N.I. and the distribution rules. Thus, such amounts should be treated as gross income to the recipient under section 61 (a) (4).[20] But even if an amount is denominated interest under local law, that may not be its correct characterization for federal income tax purposes.[21] A question may

15. See note 6 *supra*.

16. INT. REV. CODE OF 1954, §643 (a). Distributable net income [hereinafter abbreviated D.N.I.] is the estate's taxable income with some adjustments, and it fixes the *amount* of distributions that is taxable to beneficiaries. See INT. REV. CODE OF 1954, §662 (a). In this quantitative function it is like the "earnings and profits" concept, which determines the extent to which a corporate distribution gets divided treatment. See INT. REV. CODE OF 1954, §§301 (c) (1), 316. But it has a qualitative function as well and works to *characterize* the income taxable to the beneficiary, *i.e.*, as ordinary income or capital gain.

17. INT. REV. CODE OF 1954, §§662, 661. Estate distributions are accorded extended coverage in the forthcoming book mentioned at note 6 *supra*.

18. INT. REV. CODE OF 1954, §641 (b) provides for computation of an estate's taxable income generally in the same manner as in the case of individuals.

19. See INT. REV. CODE OF 1954, §§662 (a), 661 (a) (2).

20. See Treas. Reg. §1.61-7 (a) (1957), as amended, T.D. 6723, 1964-1 CUM. BULL. 73, as amended, T.D. 6873, 1966 INT. REV. BULL. 8, at 11.

21. See Stephens & Freeland, *The Role of Local Law and Local Adjudications in*

be raised whether the so-called "interest" is simply an amount "properly paid" within the meaning of the distribution rules. If so, the payment would not be deductible or includible as interest, but the estate's deduction would have to meet the tests of section 661 and the includibility of the amount by the recipient would be governed by section 662. What *is* the proper characterization of payments of this type?

An attempt may be made to answer the question by a close analysis of the nature of the payment. This would suggest the inquiry in each case whether the pecuniary legatee is being compensated for the estate's continuing use of money to which he is entitled. A payment made for the use of money is considered interest for income tax purposes. This would clearly stamp as "interest" amounts payable only after some delay in the payment of the pecuniary legacy itself and, even more clearly, increments accrued after the beneficiary had acquired an immediate right to be paid. Query as to "interest" accrued from the date of death or any other time before the beneficiary can be viewed as having a possessory right?[22]

State law on administration of a decedent's estate may, as a general rule, contemplate payment of pecuniary legacies within one year after the decedent's death. It may also, however, recognize that within such time administration may not have advanced to the point where payment would be proper. In such circumstances the executor may be given the right to defer payment, but the legatee may be given a compensatory right to interest running from the date one year after death.[23] This was the situation in a very early ruling. In I.T. 1720,[24] the Commissioner held that interest was received by the beneficiary, "not as such beneficiary but as the designated payee of a sum certain . . . for the use of an amount due him . . . the payment of which has been deferred."[25] Since this payment was considered truly interest, the payment by the estate entitled the estate to a deduction, whether the amount was paid out of principal or out of income. Since the interest received by the beneficiary was received by him as a creditor, it constituted gross income to him, likewise without regard to the distribution rules. Although the Ruling reflects very little analysis of the state law requirement, the result seems

*Federal Tax Controversies*, 46 MINN. L. REV. 223 (1961), also constituting a part of the book mentioned at note 6 *supra*.

22. See ATKINSON, WILLS 751-52 (2d ed. 1953); note 10 *supra*. See also FLA. STAT. §731.22 (1965) providing for interest to accrue only *after* an order of distribution. See also Matter of Trescott, 199 Misc. 1087, 104 N.Y.S.2d 478 (Surr. Ct. 1951); Matter of Stanfield, 135 N.Y. 292, 31 N.E. 1013 (1892).

23. See BOWE-PARKER §59.13, at 111.

24. II-2 CUM. BULL. 54 (1923).

25. *Ibid.*

sound as the rights in question arose out of a delay in the payment of a legacy beyond the usual date of payment. However, care should be exercised not to read the ruling more broadly.

Under the current statute, and even under prior revenue acts, the interest increment does not qualify as an excluded inheritance of property,[26] even if the pecuniary legacy itself does qualify. But whether the interest is properly characterized as simply an inheritance of income from property, taxable under the distribution rules,[27] or as interest, taxable under section 61 (a) (4), remains obscure in many cases. An answer to this question, which would cover even the doubtful areas, could be furnished by Congress. In the absence of specific provisions in the Code, this issue must be resolved by reference to the *nature* of the right under state law and the federal tax definition of "interest," even though the result may be hostile to a uniform application of the taxing statute.[28]

The nature of the right and the reason for the interest requirement may vary in different jurisdictions or, in some cases, even within the same jurisdiction concerning different beneficiaries. Thus, for example, in Florida, in the absence of a will provision to the contrary, interest at the legal rate is required to be paid and accrues only "after the time fixed by the county judge in an order of distribution. . . ."[29] Although the legacy is considered to "vest" in the beneficiary as of the date of the testator's death,[30] his actual right to *receive* payment begins only when the county judge issues his order. It appears, therefore, that in states such as Florida the interest should be treated as compensation for accepting a delay in the receipt of the legacy[31] if the amount is paid under the statute. This is consistent with the conclusion reached by the Court of Appeals for the Fifth Circuit in the case of *United States v. Folckemer.*[32] There, a benefic-

26. See,*e.g.*, Harrison v. Commissioner, 119 F.2d 963 (7th Cir. 1941), holding that under Illinois law the interest received by a surviving spouse pursuant to a compromise agreement settling a will contest has its source in the will; that, on the facts presented, the interest is sufficiently similar to an income interest of a trust beneficiary to be taxable to the beneficiary under what would now be §102 (b) of the 1954 Code. The court applied the rule of Irwin v. Gavit, 268 U.S. 161 (1925).

27. INT. REV. CODE OF 1954, §§102 (b), 662 (a).

28. See Stephens & Freeland, *supra* note 21; note 38 *infra* and accompanying text.

29. FLA. STAT. §731.22 (1965).

30. FLA. STAT. §731.21 (1965).

31. *Cf.* Foster's Estate v. Commissioner, 131 F.2d 405 (5th Cir. 1942), *affirming* 45 B.T.A. 126 (1941); W. W. Clarke, 3 CCH Tax Ct. Mem. 758 (1944).

32. 307 F.2d 171 (5th Cir. 1962), *reversing the district court,* 61-1 U.S. Tax Cas. 79639 (S.D. Tex. 1961). The United States district court found that the interest qualified as an increment to the specific legacy and concluded erroneously that it was within the protection of §102 (a). The so-called interest could not

iary to whom 100,000 dollars was bequeathed received an additional 13,000 dollars under a California statute that provides for interest on pecuniary legacies if such legacies are not paid prior to the first anniversary of the testator's death. Interest accrues at the rate of four per cent from the date of such first anniversary. The legacy itself qualified as a tax free inheritance under section 102(a),[33] but the Court of Appeals for the Fifth Circuit properly held that the interest was not within the inheritance exclusion of that section.[34]

In holding the interest taxable *as interest,* outside the distribution rules, the court in *Folckemer* noted that the taxpayer was "not an income beneficiary of the estate."[35] While apparently true, this was an unfortunate remark, for it is certainly clear that one who *is* an income beneficiary could in another capacity receive *interest* on a pecuniary bequest to him. The court's comment, really aimed only at the one transaction, goes on to say:[36]

> He was the recipient of a money legacy. The statutory interest payable to him is for the detention of his legacy beyond the first anniversary of the testator's death. The conduit theory . . . deals with the income tax treatment of estate income distributable to a beneficiary . . . . Here, the statutory interest . . . has no relation to the scheme of distribution of estate income. . . .

It is correct to say that in *Folckemer* the distribution rules did not determine either taxability or deductibility of the interest payment. However, the payment would affect the operation of the distribution rules and the determination of the estate's tax liability, as the interest would reduce taxable income and, correspondingly, D.N.I.[37]

The mere fact that an amount is called "interest" is not enough to make it interest for tax purposes.[38] For federal income tax pur-

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possibly qualify under INT. REV. CODE OF 1954, §663(a)(1).

33. This is for the reason that it met the provisions of INT. REV. CODE *of* 1954, §663(a)(1).

34. The court of appeals, holding that the interest payment was not within INT. REV. CODE OF 1954, §663(a)(1), required a reversal of the district court decision. The court then concluded that the interest was fully taxable on the basis of the general "definition" of gross income, §61, and specifically §61(a)(4), and with reference to Treas. Reg. §1.61-7(a) (1957), as amended, T.D. 6723, 1964-1 CUM. BULL. 73, as amended, T.D. 6873, 1966 INT. REV. BULL. 8, at 11, providing that the term "interest" includes "interest on legacies."

35. United States v. Folckemer, 307 F.2d 171, 173 (5th Cir. 1952).

36. *Ibid.*

37. INT. REV. CODE OF 1954, §§163, 643(a). See also note 16 *supra.* The recipient of the interest in *Folckemer* was taxed on the full amount received under §61(a)(4).

38. *Cf.* Johnson Locke Mercantile Co. v. Commissioner, 51 F.2d 434 (D.C.

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poses, interest has been defined to mean "compensation allowed by law or fixed by the parties for use or forebearance, or retention of money."[39] The court of appeals in *United States v. Folckemer*[40] found that the tax definition embraced the statutory interest there involved.

Suppose in a jurisdiction such as Florida the will provides for payment of interest on a general pecuniary bequest *from the date of death.* Ordinarily, it will be recalled, interest would run only from the time of the county judge's distribution order,[41] but the will may provide otherwise. Here it would seem that the arrangement for so-called "interest" contemplates something other than a mere payment of the legacy plus compensation for delay, and amounts paid in addition to the legacy itself should be viewed as distributions, at least amounts attributable to periods prior to the time at which payment of the legacy itself is ordered.

Thinking along this line seems to have prompted the result in *Minnie L. Wolf.*[42] There, the Board had to determine the tax nature of "interest" paid under Pennsylvania law to the testator's widow, a pecuniary legatee. The state statute[43] in general provided that interest on all pecuniary legacies should begin to run one year after the date of the testator's death unless there was an earlier decree of distribution, in which case interest was to run from the date of the decree. Interest paid under such a provision would be recognized as interest for tax purposes;[44] but the Pennsylvania statute goes on to provide:[45]

> [T]hat where a pecuniary legacy is bequeathed to or for the use of the widow of the testator or any child . . . or for the maintenance of any person, interest shall . . . begin to run *from the date of the death of the testator.*

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Cir. 1931).

39. Fall River Elec. Light Co., 23 B.T.A. 168, 171 (1931); Deputy v. DuPont, 308 U.S. 488, 497-98 (1940). Thus, in Anna M. B. Foster, 45 B.T.A. 126 (1941), *aff'd,* 131 F.2d 405 (5th Cir. 1942), the executor withheld distribution pursuant to an agreement between himself and the beneficiary. Four years later the executor paid $10,000 "as interest" to the beneficiary. The court held that the payment constituted interest since it was paid for the privilege of keeping securities in the estate rather than having to sell them on an unfavorable market.

40. 307 F.2d 171 (5th Cir. 1962).

41. FLA. STAT. §731.22 (1965); see text accompanying note 29 *supra.*

42. 32 B.T.A. 959 (1935), *aff'd,* 84 F.2d 390 (3d Cir. 1936).

43. Pennsylvania Fiduciaries' Act of 1917, Pa. Laws 1917, Act 447, §21.

44. See note 39 *supra* and accompanying text.

45. Pa. Laws 1917, Act 447, §21. (Emphasis added.) The interest provision of the Pennsylvania statute quoted in the text is not uncommon. See 3 SCOTT, TRUSTS §234.2, at 1779 (2d ed. 1956). *Cf.* Treas. Reg. §1.661(a)-2(e) (1956).

Pursuant to this further provision of the statute, the executor paid the taxpayer 29,000 dollars as interest, which she did not report as gross income. The taxpayer argued that the entire amount of so-called interest received by her was properly excluded from gross income either as a tax-free bequest or as an allowance for maintenance and support, which also might have escaped tax under then prevailing federal income tax doctrine. The Commissioner did not seek to tax the entire 29,000 dollars, as he might have done if it could properly have been viewed as interest for tax purposes. Although the opinion is obscure, his successful assertion of tax liability for 25,000 dollars of the 29,000 dollar payment makes it clear that he viewed the transaction as a *distribution*. For the year in issue the estate had received income of 40,000 dollars subject to tax and nontaxable income of 6,000 dollars. The 25,000 dollars taxed is the portion of the 29,000 dollars which the amount of estate income subject to tax (40,000 dollars) bears to the total estate income (46,000 dollars), including 6,000 dollars of nontaxable income.[46] Thus it is implicit in the *Wolf* opinion that the so-called interest was regarded as a distribution and not as *interest*.[47]

If the *Wolf* case arose now, presumably the so-called interest payment would likewise be treated as a distribution, probably within the second tier.[48] If so, the estate's deduction and the amount taxable to the beneficiary would be circumscribed by the amount and character of the estate's D.N.I.

But even so, the question may properly be raised whether an amount that is interest in the tax sense within all the conventional tests[49] should *invariably* be treated as interest for income tax purposes. At times such treatment may be quite contrary to the conduit philosophy of Subchapter J.[50] Rules of state law requiring interest

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46. $\frac{\$40,000}{\$46,000} \times \$29,000 = \$25,217.40.$

47. Compare United States v. Folckemer, 307 F.2d 171 (5th Cir. 1962).

48. The present provisions of the Code, in effect since 1954, set up a priority system under which estate distributions are (1) fully taxable to the extent of D.N.I. (the so-called first tier), (2) taxable to the extent of D.N.I. *after* first-tier distributions are subtracted (the so-called second tier), or (3) possibly in an equivocal status encompassing some annuity payments (sometimes called the variable tier). Conceivably, the *Wolf* payments would escape second-tier status as a tax-free widow's support allowance not required to be paid out of income. See Treas. Reg. §1.661 (a)-2 (e) (1956).

49. See note 39 *supra* and accompanying text.

50. The congressional approach to the taxation of income of estates (and trusts, too) is essentially an either-or approach. Income of the entity is taxed *either* to it (if the income is retained) *or* to beneficiaries (if income is distributed). In general, distributions do not *generate* income; they merely *allocate* it, al-

to be paid to pecuniary legatees do not limit payment to instances in which the estate has earned interest on the amount of the legacy or, indeed, has earned any income whatever.[51] In general, Subchapter J seeks to prescribe the *tax* allocation of income between the estate and the beneficiaries.[52] The D.N.I. concept, the distribution rules, and the taxing pattern of Subchapter J effecting a conduit approach are expressly designed so as to preclude harsh results reached under the prior statute.[53] But, if an amount of interest required to be paid to a *beneficiary* is treated as interest outside the taxing pattern of Subchapter J, the effect is interest income taxable to the beneficiary,[54] even though the estate may have no taxable interest or indeed any gross income. Are there not at least some circumstances in which this is quite inappropriate?

The problem is illustrated by the case of *Davidson v. United States.*[55] In that case, the estate had earned only 20,907.06 dollars of taxable income during 1947, the year in issue, but in that year it paid 189,000 dollars to the pecuniary legatees as "interest" on their legacies. Under the law of Ohio, if administration of a will that provides for pecuniary legacies is protracted, interest is added to the legacy beginning one year after the appointment of the executor and running to the date on which the legacy is paid. Holding the legatees taxable on only 21,000 dollars, the court reasoned that although the payments had interest characteristics and were called "interest," they were nevertheless more like estate distributions. The opinion indicates that even under prior law, as at present, interest treatment of the payments would be contrary to the statutory plan. The court said: "The purpose of the statutory ensemble is to make certain that the

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though in some rare instances transactions between the entity and its beneficiary *produce* income on which one or the other may have to pay tax. See, *e.g.*, Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D.C. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936) (involving possible realization of gain through the satisfaction of a pecuniary bequest by a transfer of appreciated property). Again, these concepts are fully explored in the forthcoming book mentioned in note 6 *supra.*

51. 6 BOWE-PARKER §59.11, at 413-14. "Whether such interest is a penalty for . . . [delay] in payment, or merely an incident of the legacy, is a question on which [local] courts have differed." *Id.* at 412.

52. See note 50 *supra.*

53. See H. R. REP. No. 1337, 83d Cong., 2d Sess. A197 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 346-47 (1954). At an earlier time, the statute compelled some anomalous results. See, *e.g.*, Johnston v. Helvering, 141 F.2d 208 (2d Cir. 1944), *cert. denied*, 323 U.S. 715 (1945), in which a trust beneficiary was held taxable on his distributable share of proceeds received by the trust from a defaulted mortgage although the total proceeds were less than the principal of the mortgage and the trust therefore realized no gross income.

54. INT. REV. CODE OF 1954, §61 (a) (4).

55. 137 Ct. Cl. 416, 149 F. Supp. 208 (1957).

income of an estate is taxed, as income, either to the estate or to the beneficiaries."[56]

Where do these considerations lead? First, it is conceded that, under the law as it is now, payments that are made to compensate a legatee for delay in payment of his legacy, which therefore meet the tax tests for interest,[57] must usually be treated as *interest*. Often this works no great distortion. If the estate has income subject to tax which exceeds the payment (and all other distributions as well), the interest would be taxed to the beneficiary anyway; the estate gets an interest deduction[58] that has much the same effect as a distribution deduction. Admittedly, there may be some differences—with respect to timing and to characterization of income and regarding priorities between the two tiers[59]—but in many circumstances the statutory plan is not violated by according interest treatment to the payments in question.

However, it is equally clear that in some circumstances interest classification for the payments in question is not supported at all by the philosophy of Subchapter J. Perhaps there is still sufficient latitude in the statute to permit a court to label equivocal "interest" payments "distributions," as was done in *Davidson,* when not to do so would yield anomalous results.[60]

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56. *Id.* at 419, 149 F. Supp. at 210.

57. See note 39 *supra* and accompanying text.

58. INT. REV. CODE OF 1954, §163.

59. An amount treated as interest for federal tax purposes would be entirely outside the taxing pattern of Subchapter J. The estate's interest deduction, authorized by INT. REV. CODE OF 1954, §§163, 641 (b), would reduce the amount of D.N.I. See INT. REV. CODE OF 1954, see §643 (a). This in turn could reduce the amount of income tax required to be paid by the estate, or by beneficiaries in the case of estate *distributions.* If the amount is treated as interest, the tax on an equivalent amount of estate income is in effect shifted to the recipient. Qualitatively the interest deduction authorized by §163 is not affected by §265, which disallows a deduction for expenses allocable to exempt income. *Cf.* Rev. Rul. 61-86, 1961-1 CUM. BULL. 41. No part of the deduction need be allocated to items of D.N.I. accorded special treatment. See, *e.g.,* INT. REV. CODE OF 1954, §643 (a) (5). The interest, a floating or general deduction, can be entirely allocated to items of income subject to tax, reducing *such* items in D.N.I. to the tax advantage of the estate or its beneficiaries.

With respect to the recipient, there may be a timing difference depending on whether the so-called interest is treated as interest or as a distribution. If interest, the amount is gross income to a cash method recipient in the taxable year in which it is received by him. United States v. Folckemer, 307 F.2d 171, 173 (5th Cir. 1962); INT. REV. CODE OF 1954, §451 (a). If the amount is accorded distribution status, the amount is gross income to the beneficiary in his taxable year with or within which the estate's taxable year in which the distribution was made ends. INT. REV. CODE OF 1954, §§662 (a), (c). See, e.g., Hay v. United States, 67-1 U.S. Tax Cas. 83578 (N.D. Tex. 1967).

60. But the need for such judicial treatment may be mitigated, at least

Finally, there is every reason for amending the statute to provide that the payments here under consideration should always be treated as distributions. This could be accomplished by providing in section 662 (a) (1) that any amount to which a legatee becomes entitled by reason of the estate's nonpayment of his legacy, and whether accruing from death or only from a later date, shall be treated as an amount required to be paid out of income or corpus. This would place such payments within the variable tier,[61] which seems to be where they belong, and reduce the uncertainty presently illustated by the seemingly conflicting decisions in the *Davidson*[62] and *Folckemer*[63] cases.

## INCOME ON SPECIFIC LEGACIES

Specific legacies do not give rise to a claim for interest.[64] Since such a legacy is deemed to pass specific property together with accretions and income derived from the property itself,[65] the bequest is fully satisfied when the property together with accrued income is paid to the beneficiary. The subject of the bequest is not just generally an amount, but property in kind. Similarly, a residuary legacy does not pass an amount; it governs the disposition of the residue of the estate, whatever its form may be, remaining after the payment of claims and specific and pecuniary legacies.[66] Such a residuary bequest does not bear interest[67] but, much like a specific legatee, the "residuary legatee is entitled to receive any income earned by the estate during the period of administration which is not otherwise disposed of."[68]

In most cases, a bequest of specific property will qualify for the protection of section 663 (a) (1) [69] and, if so, the transfer of the property has no immediate income tax consequences either to the estate or to the beneficiary. The general distribution rules of Subchapter J are not applicable, and the receipt of the bequest by the beneficiary is regarded as a tax-free inheritance of property for federal tax purposes.[70] If, however, the subject of the specific legacy is property that

in part, in the year of termination of the estate. See INT. REV. CODE OF 1954, §642 (h), which in general passes unused estate deductions on to the beneficiaries.

61. See INT. REV. CODE OF 1954, §622 (a) (1) (last sentence); Treas. Reg. §1.662 (a)-2 (c) (1956); note 48 *supra*.

62. 137 Ct. Cl. 416, 149 F. Supp. 208 (1957).

63. 307 F.2d 171 (5th Cir. 1962).

64. 6 BOWE-PARKER §59.11, at 413.

65. *Ibid*; see also 3 SCOTT §234.1, at 1778-79.

66. 6 BOWE-PARKER §59.11, at 413.

67. *Ibid.*

68. 3 SCOTT §234.3, at 1784.

69. See note 6 *supra*.

70. INT. REV. CODE OF 1954, §102 (a).

produces income during administration of the estate, question arises concerning the income tax treatment of any income produced by such property.

If, as is usually the case, a legatee of specific property "is entitled to any income accruing thereon from the death of the testator, even though the legacy . . . is not payable until the expiration of the period of administration,"[71] who is taxed on such income, the estate or the legatee? The answer to this question depends in part on the answer to a further question: Is the property an asset of the Subchapter J estate, or does the property pass outside the estate directly to the beneficiary? The fact that under state law certain property of the decedent may be considered vested at death in the heirs, legatees, or devisees[72] does not necessarily mean that such property passes outside the estate. If, under state law, the right of possession and control of such property lodges in the personal representative during administration of the estate for purposes of paying debts, expenses, and claims, as is often the case,[73] the property is considered part of the estate for federal tax purposes. This concept cannot be fully developed in this short article.[74]

The income from all property of a decedent, which legally comes into the possession of the personal representative during the period of administration, is includible in the gross income of the estate.[75] The income could not sensibly for tax purposes be attributed initially to the beneficiary because his rights are contingent and assured only when administration of the estate is completed. Moreover, because the beneficiary's claim is contingent, if the income were not ascribed to the estate, it might escape tax altogether.[76] Therefore, during administration of the estate, the income from such property is gross income of the estate, possibly taxable to beneficiaries[77] but only within

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71. 3 SCOTT §234.1, at 1778, See, *e.g.*, ARK. STAT. ANN. §62-2907 (Supp. 1965); FLA. STAT. §§733.01, 731.22 (1965); PA. STAT. ANN. tit. 20, §320.753 (1949). *Cf.* Baldwin v. United States, 214 F. Supp. 16 (E.D. Mo. 1962).

72. See, *e.g.*, FLA. STAT. §731.21 (1965).

73. See, *e.g.*, FLA. STAT. §733.01 (1965).

74. See note 8 *supra*.

75. See INT. REV. CODE OF 1954, §641 (a) (3); Treas. Reg. §1.641 (a)-2 (1956).

76. *Cf.* United States v. Cooke, 228 F.2d 667 (9th Cir. 1955). *But cf.* United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960).

77. In Estate of S. P. McBirney, 11 P-H BTA-TC Mem. 879 (1942), it was contended that under Oklahoma law all property of a decedent was owned by his heirs and that they, not the estate, should be taxable on the income arising from the property after deduction of administration expenses. Denying this contention and holding the estate taxable, the board stated: "It is immaterial that ownership of the property in question may have vested in the heirs at the time of the decedent's death. It is plain that all of the decedent's property was subject to administration as a part of the estate and that the administratrix was entitled

the distribution rules. Although a specific legatee is slated eventually to be the economic owner of some such income, this income is initially considered part of the gross income of the estate.

For the moment, let us make the unlikely assumption that the income produced by property that is the subject of a specific bequest is paid to the beneficiary in the same year that it is received by the estate. If so, the taxpayer, with respect to income produced by such property, is the beneficiary. Although the transfer of the property itself may qualify under section 663 (a) (1), the income therefrom which is paid to the beneficiary clearly does not.[78] Thus, for example, assume that the decedent specifically bequeathed 1,000 shares of *X* corporation stock to *B*. If in one year during administration, the estate receives 500 dollars in dividends on the *X* stock, it has income on which it may very well have to pay tax.[79] But, when the estate transfers the stock to the specfic legatee in the same year, together with dividends received on the stock, the distribution rules apply, not to the stock which is received tax-free, but to the dividends. Thus, the estate is entitled to a distribution deduction and the beneficiary is deemed to have dividend income.[80] The amount of such income, at least if paid to the beneficiary in the same taxable year in which it is received by the estate, has no effect on the estate's income tax liability.[81] As a result of the distribtion rules, the tax liability is in effect passed along with the income to the beneficiary.

The tier position[82] of the beneficiary depends upon whether local law or the terms of the governing instrument require such income

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to possession of the property under the control of the court having probate jurisdiction until the administration was completed." See also Kuldell v. Commissioner, 69 F.2d 739 (5th Cir. 1934) (relating to Texas law). See also Rev. Rul. 59-375, 1959-2 CUM. BULL. 161; Rev. Rul. 59-154, 1959-1 CUM. BULL. 160; Rev. Rul. 57-133, 1957-1 CUM. BULL. 200. By contrast, of course, if the property is not subject to any of the incidences of administration, passing by operation of law to the "beneficiary," then any income produced by such property is considered gross income of the beneficiary and not the estate. See, *e.g.*, Rev. Rul. 64-101, 1964-1 CUM. BULL. 77; I.T. 1596, II-1 CUM. BULL. 130 (1923); *cf.* Hibernia Nat'l Bank v. Donnelly, 121 F. Supp. 179 (E.D. La. 1953), *aff'd*, 214 F.2d 487 (5th Cir. 1954). See also note 8 *supra*.

78. INT. REV. CODE OF 1954, §102 (b). See, *e.g.*, Kuldell v. Commissioner, 69 F.2d 739 (5th Cir. 1934); Wooley v. Malley, 30 F.2d 73 (1st Cir. 1929); Estate of Catherine Donnelly, 31 B.T.A. 577 (1934). *But cf.* Foellinger v. Smith, 41-2 U.S. Tax Cas. 10380 (N.D. Ind. 1941).

79. INT. REV. CODE OF 1954, §§641 (b), 61 (a) (7). INT. REV. CODE OF 1954, §116 may exclude part of the divided from gross income.

80. INT. REV. CODE OF 1954, §§661, 662.

81. *Ibid.* In these circumstances the estate is a pure conduit. See, *e.g.*, Estate of J. M. Jameson, 20 B.T.A. 103 (1930); Estate of Charles L. Grigg, 3 CCH Tax Ct. Mem. 166 (1944).

82. See note 48 *supra*.

to be distributed currently. In the unlikely event that such income is *required* to be distributed currently,[83] it is in the first tier of taxable priority.[84] But if, as would more likely be the case, such income merely *may* be distributed within the discretion of the executor, it is within the second tier and considered as an amount properly paid to such beneficiary.[85] In either case, the amount *distributed*, perhaps reduced by the amount of the dividend exclusion,[86] is deductible by the estate.[87]

Even continuing to assume *current* distribution, the characterization provisions of the distribution rules do not work as smoothly here as the quantitative provisions. Generally all distributions are deemed to consist of ratable amounts of net D.N.I. items with the result that an estate beneficiary is considered to receive a ratable share of each class of income entering the D.N.I. computation.[88] This means that generally beneficiaries receiving distributions are deemed to receive ratable portions of all the classes of income received by the estate. If this general rule is applied to amounts paid to a specific legatee, distortion may occur. For example, a specific legatee of state bonds, the interest on which is tax exempt,[89] would be charged with (and possibly taxed on) a prorata share of all types of estate income, which might include, in addition to tax exempt interest, dividends, taxable interest, and rent.[90] This in turn could affect the amount of the estate's distribution deduction, for the estate would not be viewed as merely making a nondeductible distribution of exempt income.[91]

As an economic fact, the beneficiary of a specific bequest may be entitled only to the income produced by the property that is the subject

83. *Ibid*; see, *e.g.*, FLA. STAT. §§734.02-.04 (1965).

84. If in the first tier, such income would be taxable to the beneficiary whether distributed or not. INT. REV. CODE OF 1954, §662 (a) (1).

85. INT. REV. CODE OF 1954, §662 (a) (2). See, *e.g.*, First Nat'l Bank, 7 T.C. 1428 (1946), *aff'd sub nom.* Smith's Estate v. Commissioner, 168 F.2d 431 (6th Cir. 1948).

86. INT. REV. CODE OF 1954, §116. To the extent that an estate is treated as distributing exempt income, its distribution deduction is disallowed. INT. REV. CODE OF 1954, §661 (c). Under the either-or approach to the taxation of estate income, note 50 *supra*, *neither* estate *nor* beneficiary is taxed on exempt income.

87. INT. REV. CODE OF 1954, §661. Of course any amount of such income used by the estate to pay claims would not be distributable and would not give rise to a distribution deduction. As to such amounts, the estate would be required to pay the income tax, *cf.* Carrie G. Cox, 31 B.T.A. 819 (1934), unless the nature of the claims paid qualify them for deductions under some other provisions of the Code. *Cf.* Rev. Rul. 66-201, 1966 INT. REV. BULL. 29, at 6.

88. See INT. REV. CODE OF 1954, §662 (b) and text accompanying note 96 *infra*.

89. INT. REV. CODE OF 1954, §103.

90. INT. REV. CODE OF 1954, §662 (b).

91. See note 86 *supra*.

of the specific bequest. The statute states that the *ratable* characterization rule shall apply "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries."[92] The Regulations broaden this provision by adding that the ratable rule shall not apply if "local law requires . . . [a specific] allocation."[93] It would seem that if pursuant to local law a beneficiary is entitled to the income produced by designated property—the subject of a specific bequest—this would be a specific allocation of such income within the meaning of the Regulations.[94] It is our conclusion that such income, although entering the D.N.I. computation, is identified or traced to the legatee, *if* distributed in the year in which it is received by the estate, and that it retains its same character in the hands of such legatee. This in turn will affect the determination of the estate's distribution deduction since, if the income should be tax exempt interest, the estate will get no deduction as a result of the distribution.[95]

Two further consequences flow from the conclusion reached. First, when the amount paid to a specific legatee is identified as income from the property that is the subject of the specific legacy, the payment of such amount effects a *quantitative* reduction of D.N.I. and, second, the D.N.I. class made up of income with the *character* of such income is reduced for purposes of applying the general characterization rules of section 662 (b). Although there is no statutory authority for the first adjustment, and little more than an inference drawn from administrative pronouncements in support of the second adjustment,[96] such adjustments are necessary to avoid results not consistent with the plan of Subchapter J. Thus, if the executor should make distributions to beneficiaries other than a specific legatee during the same taxable year in which the income of the specific legacy is distributed, such other distributions, although clearly subject to quantitative and qualitative D.N.I. limitations, cannot properly be viewed as containing any *amount* or *character* of the income accruing on a specific legacy which has been paid to a

92. INT. REV. CODE OF 1954, §662 (b).

93. Treas. Reg. §§1.662 (b)-1, 1.661 (b)-1 (1956).

94. *Ibid.*

95. See note 86 *supra.*

96. See note 93 *supra* and accompanying text. INT. REV. CODE OF 1954, §§662 (a), (b) would of course be applicable, but the quantitative and qualitative allocation would apply without taking into account the income from the specific property. See 3 SCOTT §234.2. In Baldwin v. United States, 214 F. Supp. 16 (E.D. Mo. 1962), the district court held, under Missouri law, that the income beneficiaries of residuary trusts were not entitled to the income received by the estate during probate which was attributable to assets subject to specific bequests. *Cf.* Estate of J. M. Jameson, 20 B.T.A. 103 (1930).

specific legatee. Therefore, to avoid distortion as to other distributions, it is necessary to reduce the amount *and* character of D.N.I. by the amount and class of income attributable to the property comprising the specific legacy.

The present statute also copes poorly with the more likely situation in which the income generated by property specifically bequeathed is retained by the estate during administration and distributed to the specific legatee later, possibly within one taxable year. Taxable income of the estate for the *current* year, as modified by the D.N.I. definitional provision,[97] serves as the measuring rod for determining the amount and character of amounts distributed to estate beneficiaries. Amounts of income earned in prior years by property that is the subject of a specific bequest do not affect the amount or character of estate distributions. The so-called "throw-back" rule,[98] which would alter this conclusion, while applicable to trusts, does not apply to estates.[99] Thus, income accumulated by the estate, even if earned by property specifically bequeathed, is taxed to the estate. On termination of the estate, the beneficiaries are taxed on *distributions* not protected by section 663 (a) (1) to the extent of the amount and character of income comprising D.N.I., and the estate is entitled to a corresponding deduction.[100] *But*, only D.N.I. for the year of distribution is taken into account for this purpose.

Suppose a beneficiary is entitled to specific property together with the income attributable to such property. Thus, beneficiary *B* might be entitled to receive certain state bonds as a specific bequest, and the receipt of the bonds themselves would escape income tax under section 663 (a) (1).[101] The interest received by the estate during the year of distribution would be traced directly into *B*'s hands, as previously indicated. As to such interest, the estate is a pure conduit.[102] However, what about the interest on such bonds received by the estate in preceding years? Should that also flavor the amount received by *B*? That is, should *all* he receives have that satisfying tax-exempt flavor? At present the statute makes no provision for such a logical result. However sensible it might be to look upon *B*'s entire receipts (beyond the bequeathed property itself) as tax exempt interest, the fact remains that under the present statute it is only income of the current year that is taken into consideration in measuring *and characterizing* what he receives.

97. INT. REV. CODE OF 1954, §643 (a).

98. See Subpart D of Subchapter J, INT. REV. CODE OF 1954, §§665-69.

99. See INT. REV. CODE OF 1954, §665; Treas. Reg. 1.665 (a)-*o* (1956).

100. INT. REV. CODE OF 1954, §§662, 661.

101. See note 6 *supra*.

102. See note 81 *supra* and accompanying text.

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The problem is compounded if during preceding years the executor made distributions to other beneficiaries, none of whom had any interest in or right to the income attributable to property that is the subject of a specific bequest.[103] In economic reality, no part of income attributable to specific bequest property can be viewed as paid to residuary or other beneficiaries other than *the* specific legatee. But the distribution rules make a ratable allocation of such income, along with all other income of the estate, quite without regard to who has an ultimate right to it. Thus, other beneficaries may have enjoyed an exemption with respect to state bond interests that belongs to a specific legatee. Even if this is an anomaly, there is a question, however, whether amendments designed to provide a nicer allocation and to provide also an estate throw-back rule would not unmercifully complicate the statute.

103. *Cf.* Baldwin v. United States, 214 F. Supp. 16 (E.D. Mo. 1962); note 96 *supra.*

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