Planning for the Income of an Estate and Its Heirs

Wilbur H. Friedman

Gerald Silbert

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I. INTRODUCTION

The problem of tax planning for an estate and its heirs has received increasing attention in recent years. While the estate planning problem has received attention primarily from the estate and gift tax viewpoint, the present discussion is limited to the income tax problems involved. It should be borne in mind that income tax planning should never shape the testamentary plan. The plan of disposition contemplated by the testator should first be determined and then put into effect with the minimum tax consequences.

In order to plan intelligently, one should know the cost basis, holding period and present value of all assets owned by the testator and the prospective heirs, and the income tax brackets of the testator, of his potential estate (only a rough estimate, of course) and of the prospective heirs.

With these facts and the desired disposition in mind, the two major principles of estate income tax planning to be applied are: (1) create as many different taxpayers as possible in order to reduce the over-all surtax of the estate and heirs; and (2) arrange for distribution to, or retention of, taxable income by taxpayers with the largest amount of income tax deductions.

* This paper was prepared in connection with a lecture delivered by Mr. Friedman at the New York University Sixth Annual Institute on Federal Taxation and appears in that publication.

† Members of the New York Bar.


2. The term "estate" will be used throughout this article to mean "estate and heirs" unless the context otherwise requires.

3. The operation of these principles will be discussed infra (Parts IV and V), dealing with possible will provisions and the distribution of income by estates and trusts.
II. INTER VIVOS CONSIDERATIONS

A. Partnership Interests

Inter vivos considerations, other than the preparation of a will, affect the income tax of the estate. One of these considerations is the nature of the business interest of the decedent. In a case of a partnership, special problems result from Section 126 of the Internal Revenue Code (introduced in the 1942 Revenue Act), which provides that where the estate receives sums to which the decedent was entitled but which were not reportable in the last return of the decedent and which would have been income if they had been received by the decedent, the amounts are subject to income tax to the estate in the same manner as they would have been taxed to the decedent.¹

From this viewpoint, the estate prefers to receive payments on account of an interest of the decedent in a partnership as payments for the capital or goodwill since such payments would be received without any income tax.⁵ From the survivors' viewpoint, payments made out of current income for the acquisition of the decedent's interest in the capital and goodwill of the partnership would not reduce taxable income.⁷ Thus, in conflict with, the desire of the estate, the surviving partners prefer to continue the estate in the partnership and to make payments to the estate as the distributive share of partnership income (rather than as the purchase price of tangible or intangible assets), in order to reduce the income taxable to the surviving partners.⁸ Payments of

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¹ The history and operation of § 126 are fully discussed in Guterman, op. cit. supra note 1. The statute was designed to lessen the tax burden on the decedent's last income tax return in cases where, under the pre-1942 law, amounts accrued by reason of death (including decedent's share of profits on unbilled and unfinished work of a partnership of which the decedent was a member) were taxed to the decedent.

⁵ The regulations, U. S. Treas. Reg. 111, § 29.126-1 (1943), provide that amounts received on account of the decedent's interest in tangible assets of a partnership are not subject to tax under § 126. Amounts received on account of decedent's interest in profits not includible in the decedent's last return are subject to § 126 tax (cf. Estate of Thomas F. Remington, 9 T. C. 99 (1947), dealing with decedent's interest in insurance commissions—not a partnership case). Amounts received on account of intangible assets are not specifically covered, but it would seem that such assets should be treated in the same manner as tangible assets, and should not be subject to tax under § 126. See Guterman, op. cit. supra note 1, at 34-35.

⁶ Estate of George R. Nutter, 46 B. T. A. 35 (1942); City Bank Farmers Trust Co., 29 B. T. A. 190 (1933). While the decedent would have had to pay an income tax on payments for capital or goodwill in excess of his basis therefor, the estate acquires a new basis (estate tax value) for these items, but not for income items.


⁸ Charles F. Coates, 7 T. C. 125 (1946); Richard P. Hallowell, 39 B. T. A. 50 (1939).
this type received by the estate would be subject to income tax.\textsuperscript{9} These problems exist in mercantile partnerships as well as in personal service partnerships, although more acute in the latter. In a mercantile partnership, if payments in addition to payments for the capital of the decedent are to be made, income tax to the estate could perhaps be avoided if such payments were made for good will.\textsuperscript{10} Whether the partnership agreement can or should provide for such payments as being for good will, or as being the decedent's share of profits on unbilled and unfinished work, or as being the distributive share of partnership income, depends upon the substantive business transaction among the partners worked out with the income tax consequences in mind.

In the case of a personal service partnership, the problem is more acute since capital is usually a small item. While it has been stated that ordinarily there is no good will in a personal service partnership,\textsuperscript{11} even in such a case designation of the payments in the agreement as being for good will has permitted the estate to receive such amounts free of income tax.\textsuperscript{12} Whether such a provision should be incorporated in the partnership agreement again depends on the substantive business arrangement.

Where payments are made of the decedent's interest in uncollected fees\textsuperscript{13} the estate will be taxed on such payments under Section 126. The


\textsuperscript{10} In the example given in the regulations, it is indicated that payments made of the decedent's share of the profits on unbilled and unfinished work, apparently even in the case of a mercantile partnership, are subject to tax under § 126 when received by the estate. A solution from the viewpoint of the estate, suggested in the text, is that instead of making payments for the decedent's interest in profits on unbilled and unfinished work, such payments be made for good will. Whether such handling could be squared with the substantive desire of the parties as to the amount to be paid to the estate would have to be worked out in each case. If payments are to be made for the decedent's interest in profits on unbilled and unfinished work in addition to payments for the capital account and good will, then the estate would (under the regulations) pay income tax on the amount designated as being for the decedent's share of the profits on unbilled and unfinished work. To lessen the tax burden on the survivors, it is suggested that the estate continue in the partnership and receive equivalent amounts as the distributive share of partnership income. See discussion below of Raymond S. Wilkins, 7 T. C. 519 (1946), \textit{af'd}, 161 F. 2d 830 (C. C. A. 1st 1947).

\textsuperscript{11} See Charles F. Coates, 7 T. C. 125, 134 (1946).

\textsuperscript{12} See cases cited in notes 6 and 7 \textit{supra}.

\textsuperscript{13} The term "uncollected fees" as hereafter used in this article means billed but uncollected fees, unbilled fees, and decedent's interest in unfinished work.
estate would ordinarily prefer that the partnership agreement provide that such payments be made over a period of years to avoid bunching the income into one or two years, thereby subjecting it to high surtax brackets. If such payments are made pursuant to agreement executed prior to death, the income tax to the estate may not be under Section 126 since under the agreement the decedent would not have been entitled to the payments. If there is no agreement prior to death and the estate makes an agreement after death for periodic payments of the decedent's interest in uncollected fees, there might be a tax to the estate in the year such agreement is made on the full amount to be received over the years. Such a disposition of the problem is therefore unsatisfactory.

Where an estate can be continued as a member of the partnership, there is ordinarily no conflict between the desire of the estate to receive payments over a period of years and the desire of the survivors to get a deduction from income for the payments to the estate, since the surviving partners would not be subject to tax on income paid to the estate as the distributive share of partnership income. On the other hand, if the estate cannot be continued as a partner, then it is preferable from the survivors' viewpoint that the partnership dissolve upon the death of a partner, followed by liquidation of the partnership. In such case there are no double taxation problems, whereas payments made by surviving partners under a partnership agreement for the decedent partner's in-

14. The major difference between taxation of the income under § 126 and under the general provisions of the Code is that, in the case of income taxed under § 126, there is a deduction for the proportionate part of the federal estate tax which has been paid on the capitalized value of such income.

15. Under § 126 an estate transferring a right to receive income in respect of a decedent is taxed on the fair market value of the right in the year of such transfer. Under this provision, the agreement between the estate and the surviving partners dealing with the decedent's interest in the uncollected fees might be deemed a transfer within the meaning of the statute subject to tax in the year the agreement was made. See Guterman, op. cit. supra note 1, at 40.


17. In many personal service partnerships continuation of the estate as a partner may be prevented by the ethics of the profession. In at least one case this obstacle seems to have been surmounted. See John G. Madden, P-H 1946 TC MEM. DEC. SERV. ¶ 46,158 (1946). See also Boston Safe Deposit & Trust Co. v. United States, 5 P-H 1948 FED. TAX SERV. ¶ 72,307 (D. C. Mass. 1948). In this case an insurance brokerage partnership agreement provided for the executors to continue in the partnership. The court held that the income from the partnership when received by the executors was ordinary income and further that when the income was distributed by the executors to the residuary trusts, the executors were entitled to a deduction for the distribution under § 162(c) of the Internal Revenue Code.
interest in uncollected fees were held not deductible by the surviving partners where the estate of the deceased partner was not a member of the continuing partnership. In Raymond S. Wilkins the partnership agreement provided for payments to a deceased partner's estate of a portion of his percentage of the partnership profits for a period of two years preceding the date of death. The surviving partners contended that their taxable income should be reduced by the payments made pursuant to this agreement. The court recognized that such payments were not for the acquisition of the decedent's interest in the firm, but held that the taxable income of the survivors could not be reduced by the payments on the ground that the payments were the purchase price of the decedent's interest in uncollected fees, and served only to provide a cost basis for such uncollected fees to be deducted from such fees when collected by the surviving partners.

This method of handling the situation is unsatisfactory since it requires detailed bookkeeping, including valuation of the unfinished work on the date of death and apportionment of receipts to the work done before and after date of death. The payments made to the estate must further be allocated to the decedent's interest in all uncollected and un-billed work as of the date of death, and particular receipts must be matched against such allocated amounts to determine what part of such receipts is taxable income. Moreover, it is by no means clear that in some situations there may not be a double tax. The Wilkins case assumes that all payments to the estate will be made prior to the collection of the fees in which the decedent had an interest at the date of his death. But it is possible (and even likely) that the fees will be collected before all the payments to the estate are made, in which case the surviving partners would be obligated to seek tax relief by claiming a deduction to the extent that the basis of the decedent's interest in fees collected during the taxable year (which basis was obtained by payments to the estate made during the taxable year and prior years) exceeds the decedent's interest in fees collected during the taxable year. There is no authority for the allowance of such a deduction other than a dictum in the Wilkins case, and even if the deduction were allowable, whether it would provide full tax relief would depend on varying factors such as the income of the partners for the particular year, the tax rate, etc.

In view of these problems, where the estate or heirs cannot be continued in the partnership, the survivors would be best off by dissolving

19. Ibid.
the partnership on a death and liquidating it. This method has its headaches too; in the case of a large partnership, there may be a dozen or more old partnerships being liquidated at the same time.\(^{20}\) As pointed out above, the liquidation method may conflict with the desire of the estate or heirs to avoid the concentration of income in one or two years.

Apart from the above problems, consideration should be given to the question whether the partnership should be continued to the end of its regular accounting period despite the death of one of the partners during the year. Whether such a provision would be effective to prevent dissolution of the partnership with the death of a partner depends upon local law. In *Darcy v. Commissioner*\(^{21}\) the partnership agreement provided that in the event one of the partners died the partnership continued until the end of the fiscal year and the estate of the deceased partner continued to be credited with profits or charged with losses until that date. The decedent died on June 11, 1924. The fiscal year of the partnership ended on August 31, 1924. The partnership books were not closed on the date of death, but were closed August 31, the end of its accounting period. The Commissioner asserted a deficiency in income tax by including in the decedent’s last return a *pro rata* portion to the date of his death of the partnership’s income for the fiscal year. The second circuit held that in spite of the provision continuing the partnership to the end of its fiscal year, the partnership was dissolved under New York law at the date of death. The Commissioner’s action in including in the decedent’s last return his *pro rata* portion of the profits up to the date of death was sustained.

However, in *Henderson’s Estate v. Commissioner*\(^{22}\) the court held that where the partnership agreement provided for the continuation of the partnership to the end of its normal accounting period such provision would be given effect. In this case the decedent at the time of his death was a member of a Louisiana partnership. The partnership agreement provided that the partnership was to continue, despite the death of a partner, to the end of its normal accounting period. The partnership was on an accrual basis and the decedent on a cash basis. Both reported on a calendar year basis. The decedent died June 21, 1939. From the beginning of the partnership year to the date of decedent’s death, the partnership had a loss of which decedent’s share was $22,000. From the date of death to the end of the partnership year, the partnership

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had income of which decedent's share was $56,000. The estate reported income of $34,000 for the period from the date of death to the end of the year on the ground that since the partnership was continued to the end of the year the income from the partnership taxable to the estate had to be computed on the basis of the full year of partnership operations. The Commissioner contended that the loss of $22,000 had to be taken on the decedent's last return and that the estate's share of partnership income of $56,000 was taxable to the estate. On the strength of the partnership agreement, the fifth circuit overruled the Commissioner and the Tax Court and held that the estate need only report the net income of $34,000 from the full year of partnership operations.23

From the estate's viewpoint,24 if such a provision has the effect under local law of continuing the partnership without dissolution by reason of the death, there are advantages in its use. Where the taxable years of a partnership and a partner differ, the death of a partner (in a case where the partnership does not continue to the end of its fiscal year) may result in the income of two partnership years being taxed in the decedent's final return. In Guaranty Trust Co. v. Commissioner25 such a result was approved by the Supreme Court.26 In this case the partner

23. Cf. Robert E. Ford, 6 T. C. 499 (1946). In this case one partner in a three-man partnership withdrew in 1938, the remaining two partners purchasing the withdrawing partner's interest. In 1941 the partnership sold assets, and the two surviving partners claimed a loss computed with respect to the partnership's basis of the assets. The Commissioner contended that the basis of the assets sold had to be reduced as to the one-third interest acquired by the two partners from the withdrawing partner in 1938, by reference to the amount paid by the remaining partners for such interest, allocated to the assets sold. The court held that, despite the withdrawal, the partnership continued, and the partnership's basis of the assets was unchanged. In Allan S. Lehman, 7 T. C. 1088 (1946), aff'd, 165 F. 2d 383 (C. C. A. 2d 1948), the court followed the Ford case and held that the death of one partner did not dissolve the partnership for the purpose of computing the holding period of a surviving partner's interest in the partnership. A dissenting opinion was filed, citing the Darcy case, and distinguishing the Ford case on the ground that in the Ford case there was a withdrawal of a partner, whereas both the Darcy and Lehman cases dealt with the death of a partner.

24. From the surviving partner's viewpoint, whether the death of a partner results in closing the partnership tax year depends upon whether the death results not only in a dissolution of the partnership, but also in a termination of partnership activities and the immediate liquidation of partnership assets. Unless prior to the end of the normal accounting period, the partnership business is terminated and the assets liquidated, the surviving partners would (despite the death) report their share of partnership income on the basis of accounting regularly employed by the partnership and by the individual partners, other than the decedent. Compare Mary D. Walsh, 7 T. C. 205 (1946), with Anne Jacobs, 7 T. C. 1481 (1946).


reported on a calendar year basis, the partnership on a fiscal year basis. After the end of the fiscal year of the partnership, but before the end of the calendar year, the partner died. The Supreme Court held that the decedent's last return must include his share of the partnership income for the partnership's fiscal year ending in the calendar year of the partner's death, and in addition his share of the partnership income for the period from the end of the partnership's fiscal year to the date of death. Such concentration of income might be avoided by the provision suggested.

One disadvantage of such a provision is the elimination of the possibility of having the partnership income for the year of death split between two taxpayers, the decedent and the estate. If a partner dies during the fiscal year of the partnership, in the absence of such a provision, the decedent's share of the income of the partnership up to the date of death would be taxed to the decedent and his share of the partnership's income for the balance of the partnership's fiscal year would be taxed to the estate.\(^2\)\(^7\) This splitting of income between two taxpayers\(^2\)\(^8\) might result in a lower surtax on the partnership income. Continuation of the partnership to the end of its normal tax year, if effective under local law, would result in all the decedent's share of the partnership income for the partnership's fiscal year being taxed to the estate, probably in higher surtax brackets. On the other hand, this disadvantage might be mitigated by distribution of the partnership income by the estate to the heirs, thereby splitting the partnership income among several taxpayers.\(^2\)\(^9\)

B. Corporations

Because of the stockholder's limited interest in the income of a corporation prior to the declaration of a dividend, many of the above problems disappear if the decedent's business is in corporate form. In such case there would be no income from the corporation which would be subject to tax to the estate under Section 126 except for compensation thereafter paid for services rendered prior to death\(^3\)\(^0\) and for dividends having an ex-dividend date prior to the date of death.\(^3\)\(^1\) The earnings of

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\(^2\)\(^7\) Assuming that the partnership agreement provides for payments to the estate of the deceased partner's share of partnership profits for the balance of the partnership tax year.

\(^2\)\(^8\) Where, as in the Henderson case, the partnership has a loss to the date of the partner's death, such splitting would be disadvantageous.

\(^2\)\(^9\) See discussion of income of an estate during the period of administration in part V infra.

\(^3\)\(^0\) See I. T. 3840, 5 P-H 1947 Fed. Tax Serv. ¶ 76,118 (1947).

\(^3\)\(^1\) Cf. Estate of Putnam v. Commissioner, 324 U. S. 393 (1945).
the corporation might be reflected in the price for which its stock is sold, but the amount received for the stock would not be subject to tax under Section 126.\textsuperscript{32}

Moreover, conducting the business in corporate form might enable the corporation to make payments to the widow of the decedent without subjecting the payments to income tax in the hands of the recipient even though the corporation deducts the amounts paid as business expenses.\textsuperscript{33} While this point is not settled, the possibility exists that payments made pursuant to a corporate resolution adopted after the death of the officer, and not made pursuant to contract or preconceived plan, may be deductible by the corporation and excludible from the widow's income as a non-taxable gift.\textsuperscript{34}

Where the business is to be continued by the estate, the corporate form has the additional advantage of enabling the same taxable entity to deduct carry-overs and carry-backs of net operating losses. Unless the same taxpayer were conducting the business, under the Supreme Court decision in \textit{New Colonial Ice Co. v. Helvering},\textsuperscript{35} the benefit of carry-overs and carry-backs of net operating losses would be lost. For this purpose the decedent and his estate would be treated as different taxpayers.

Another income tax problem which might arise in a partnership, and which the corporate form eliminates, is readjustment of the basis of the assets of the partnership by reference to the purchase price paid by a surviving partner for the decedent's interest. In \textit{Nathan Blum}\textsuperscript{36} two brothers were conducting a mercantile business as a partnership. On

\textsuperscript{32} The Bureau originally took the view that an estate realized income on the sale of stock to surviving stockholders pursuant to a stockholders' agreement, based upon the difference between the basis of the stock to the decedent and the amount realized on the sale, (special ruling, 5 P-H 1945 \textit{Fed. Tax Serv.} \$ 76,080 (1945)). However, this ruling was subsequently revoked (special ruling, 5 P-H 1945 \textit{Fed. Tax Serv.} \$ 76,295 (1945)) and the Bureau now holds that the basis of the stock is the date of death value, so that no income would be realized by the estate unless the proceeds from the sale exceeded the date of death value.

\textsuperscript{33} This point is fully discussed in Oberndorfer, \textit{Payments to Widows of Deceased Employees}, 25 \textit{ Taxes} 711 (1947). In I. T. 3329, 1939-2 \textit{Cum. Bull.} 153, the Bureau ruled that payments made to the widow of a deceased officer (who was also a minority stockholder), pursuant to a resolution of the corporation adopted after the death, providing for discretionary voluntary payment of his salary for the balance of the year in which he died and for the succeeding year, were deductible by the corporation, and non-taxable to the widow as a gift. Mr. Oberndorfer points out that there is no court decision permitting both the corporate deduction and exclusion of the payment from the widow's income.

\textsuperscript{34} See Oberndorfer, \textit{op. cit. supra} note 33, at 719.

\textsuperscript{35} 292 U. S. 435 (1934).

\textsuperscript{36} 5 T. C. 702 (1945).
October 31, 1940, the two brothers agreed to dissolve, and brother A sold his entire interest in the partnership for $16,500 and an assumption of the partnership liabilities of $43,500 by brother B. As of October 31, 1940, the capital account of B was $30,000. The partnership had total assets of $120,000, including $49,800 of accounts receivable and $56,500 of inventory. The Commissioner contended that the basis of the inventory sold by B after October 31, 1940, was not the basis of the inventory to the old partnership, but had to be adjusted downward by reference to the purchase price paid by B. A similar downward adjustment was made by the Commissioner for the accounts receivable. As a result of these adjustments, B had additional income for the period following the purchase. The Tax Court sustained the deficiency resulting from the above adjustments, holding that where a partnership is dissolved, one partner purchasing the interest of the other, the basis of the assets must be adjusted by reference to the purchase price paid. Presumably the Tax Court would apply the same rule where the surviving partner of a two-man partnership buys the interest of the deceased partner, whether or not pursuant to a pre-existing contract.

The scope of the Blum case is questionable where the partnership consists of more than two members (except perhaps where under the local law the partnership is dissolved even as to survivors upon the death of a partner). If the business is conducted in corporate form, the problem of adjustment of the basis of assets on the death of a partner is eliminated since the corporation is a separate and continuing taxable entity.

C. Use of Insurance to Purchase Business

A common method of raising funds for the purchase of a decedent's interest in a business is the use of life insurance policies on the decedent's life. The alternatives are for the insurance to be paid to the business and used by the business to acquire the decedent's interest; or paid to the surviving business associates and used by them to pur-

37. The Commissioner contended that the basis of the inventory was \( \$56,500 \times \frac{90,000}{\$120,000} \).

The $90,000 was the total of the $16,500 paid by B, the $43,500 of liabilities assumed, and the $30,000 of B's capital account in the partnership at October 31, 1940.


39. There is no case holding this and such authority as there is leans to the contrary. Cf. Mary D. Walsh, 7 T. C. 205 (1946).
chase the decedent's interest; or paid to the decedent's estate and applied against the purchase price payable by the business or the business associates of the decedent.

The last alternative seems the least desirable from the income tax viewpoint. In *Paul Legallet* the decedent and the petitioner were in business as partners and had an agreement for the purchase by the survivor of the interest of a decedent. The partnership paid for life insurance policies on the lives of the partners and under the terms of the policies each insured had the right to designate beneficiaries. It was agreed that the amount of any insurance should be applied against the purchase price of the deceased's interest. When one partner died, the insurance proceeds were paid to the estate, and the surviving partner, the petitioner in the proceeding, paid the balance of the purchase price pursuant to the agreement. Subsequently, the surviving partner sold partnership assets and included in the basis of the assets sold the amount of the insurance paid to the deceased's estate. The Board held that since the amounts were paid by the insurance company directly to the estate and were included in the decedent's estate tax return as insurance, they were not part of the purchase price paid by petitioner and could not be included in his basis of assets of the partnership sold by him after the death of the decedent.

The *Legallet* case indicates that in order to secure a higher basis for the survivors, insurance, in a reciprocal purchase plan using insurance, should be paid to the survivors and used by them to pay for the interest of the decedent.

### D. Life Insurance

The proceeds of life insurance paid on the death of the insured are excluded from income subject to tax under Section 22(b) (1) except where there has been a transfer of the policy to a person other than the insured for valuable consideration. If there have been transfers of life insurance policies for consideration to persons other than the insured, then the difference between (1) the total consideration plus the premiums paid by the transferee and (2) the proceeds received on the death of the insured is taxed as ordinary income.

In order to avoid this income tax to the transferee, it is sometimes desirable that the life insurance be surrendered and new policies taken out (assuming that the insured is insurable). In determining whether

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40. 41 B. T. A. 294 (1940).
such an exchange should be made, a comparison between the potential income tax cost and the additional cost of the new policies should be made. Where the potential income tax cost is greater than the additional cost of new insurance, exchange should be considered.

Under Section 22(b)(1), life insurance proceeds paid on the death of the insured are excluded from income whether such proceeds are received in a lump sum at death or are received in installments pursuant to an optional method of payment elected either by the insured during his lifetime or by the beneficiary after the death of the insured.43

This rule can afford substantial tax benefit to heirs of persons with large means since an investment in life insurance with annuity options would permit the receipt by the heirs, income tax free, of that part of each annuity installment consisting of interest.

E. Other Assets

Under Section 113(a)(5) of the Internal Revenue Code, the basis of assets acquired by bequest, devise or inheritance is the fair market value of the property at the date of death, or at the optional valuation date if the estate elects to report for federal estate tax purposes under Section 811(j). The result is that all assets are revalued at the date of death, or at the optional valuation date, without gain or loss being recognized for income tax purposes.44 Where assets owned by a taxpayer are worth less than their cost for tax purposes, no tax benefit can be derived from holding the assets, whereas if the assets are sold before death, the taxpayer may take the loss on his own tax returns. Where assets are worth more than their tax cost, they pick up a new basis at the date of death (or optional valuation date) without any income tax on the gain.

Thus, the estate planner might advise the sale of depreciated assets during taxpayer's lifetime in order to realize the income tax loss and the retention of assets which have appreciated in order to obtain increase of basis without income tax cost.

F. Inter Vivos Charitable Transfers

A person with a large estate and large annual income, who customarily gives 15 per cent of his income to charities, and would like to give more, can benefit from the creation of a trust for charity during his

43. U. S. Treas. Reg. 111, § 29.22(b) (1)-1 (1943); Lola G. Bullard, 5 T. C. 1346 (1945); Katharine C. Pierce v. Commissioner, 2 T. C. 832 (1943), aff'd, 146 F. 2d 388 (C. C. A. 2d 1944).

THE INCOME OF AN ESTATE

life with remainder to his estate or heirs. The charitable trust can either accumulate the income for charitable purposes or pay it out currently to charities. This is a method of satisfying a philanthropic desire without depriving the heirs of the corpus or much of the income of the trusted assets. Suppose that \( A \) owns an estate the top $500,000 of which on his death pay federal and state estate taxes of 64 per cent and that his income is in the 75 per cent bracket. If \( A \) obtains $20,000 of income per year on the $500,000 of principal and has an expectancy of ten years, he will receive $200,000 from the fund during the remainder of his life, or $50,000 net after the 75 per cent income tax. This $50,000 would on his death be subject to the federal and state estate tax of 64 per cent so that of the income of $200,000 only $18,000 would be left; $182,000 would have been consumed in taxes.

If \( A \) puts the $500,000 into a trust for his life with the income payable to or accumulated for charities, he would not be subject to income tax on the $200,000 of income; there would be no estate tax on this sum; he could still give 15 per cent of his income each year to charity; the trusted assets would go to his estate; and the $200,000 fund will be available for charity.

Of course, the trust would have to be drawn in the light of the Clifford case\(^{45}\) and the Clifford Regulations.\(^{46}\) A trust of this type was approved by the eighth circuit in United States v. Pierce.\(^{47}\) In this case the court held the trust valid and the income not taxable to the settlor in spite of the fact that “one of the motives prompting the creation of the trust may have been the diminution of the settlor’s tax liability on charitable gifts which she continued to make in large amounts after the creation of the trust.”

III. GENERAL RULES OF TAX LAW RESPECTING INCOME TAXATION OF ESTATES, TRUSTS AND BENEFICIARIES

Section 162

As a background for the ensuing discussion, the rules respecting the income taxation of estates, trusts and beneficiaries are summarized:\(^{48}\) Section 162 of the Internal Revenue Code governs the taxation of trusts

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\(^{45}\) Helvering v. Clifford, 309 U. S. 331 (1940).

\(^{46}\) U. S. Treas. Reg. 111, § 29.22(a)-21 (1943).

\(^{47}\) 137 F. 2d 428, 432 (C. C. A. 8th 1943).

\(^{48}\) Where an estate receives sums to which the decedent was entitled but which were not reportable in the last return of the decedent and which would have been income if they had been received by the decedent, such sums are, under § 126, subject to income tax to the estate in the same manner as they would have been taxed to the decedent. See supra pp. 2-4; Estate of Thomas F. Remington, 9 T. C. 99 (1947).
and estates. All income of a trust or estate must be taxed either to the beneficiary or to the fiduciary, except non-taxable income and income which is paid to or set aside for charities pursuant to the terms of the will.\textsuperscript{49} The mechanics prescribed in Section 162 for taxing the income either to the fiduciary or to the beneficiary are (1) the allowance of a deduction to the fiduciary for income of the taxable year which is distributable in the case of a trust, or which is properly paid or credited in the case of an estate in administration or a trust providing for discretionary distribution of income, and (2) the inclusion in the beneficiary's income of the amount of the deduction allowed to the estate or trust.

\textit{Estate in Administration}

The income tax liabilities of the fiduciary and beneficiary of an estate in administration are determined under Section 162(c). That Section provides that the estate is taxable on all income except that income of the taxable year which is properly paid or credited during the taxable year to beneficiaries is deductible by the estate and taxable to the beneficiaries.

\textit{Trusts}

After the period of administration, where testamentary trusts are established, the income tax liabilities are determined either under Section 162(b), if the income is absolutely payable to the beneficiaries, or under Section 162(c), if the trust provides for discretionary distribution of income.

\textit{Distributable Income}

Under Section 162(b), the beneficiary is taxed on the income of the trust which is to be distributed currently whether or not it is actually distributed. The fiduciary obtains a deduction for this amount and is taxed on the balance of the income. The question whether the income is to be distributed currently is determined by the applicable state law and the will.\textsuperscript{50} In \textit{Mary Hadley Case}\textsuperscript{51} the petitioner was the beneficiary of a trust of which the "income, profits and proceeds" were payable to her. During 1941 the trustees granted an option to a third party to purchase part of the corpus of the trust. Upon default of the third party, and pursuant to the terms of the option contract, the trustees received a sum which they credited to corpus and which was not dis-

\textsuperscript{51} 8 T. C. 343 (1947).
tributed. In addition, the trustees realized short term capital gain on
the sale of bonds which was credited to principal and not distributed,
and bond interest was credited to principal to amortize a premium on
the purchase of the bonds and was not distributed. The Commissioner
sought to tax the beneficiary on all of these items on the ground that
they were distributable income. The Tax Court held that the petitioner-
beneficiary was not taxable on these items, although they were income
under the Internal Revenue Code, since under state law the amounts
were properly credited to principal and were not distributable.

Discretionary Trusts

If a trust provides for a discretionary power in the trustee to dis-
tribute or accumulate, then the tax liabilities are determined under
Section 162(c) and the beneficiary is taxed on the income of the taxa-
ble year properly paid or credited to him during such year and the
fiduciary is taxed on the balance of the income.

Annuity Trusts

In the case of an annuity trust, where distribution of a fixed amount
is to be made annually either out of income or out of corpus, the tax
liabilities of the beneficiary and the fiduciary are determined under
Section 162(d) (1). The beneficiary is taxed on the amount of the
distribution to the extent of the statutory net income for the taxable
year or the distributable income under state law for such year, which-
ever is greater. If the statutory net income or the distributable in-
come under state law of the trust exceeds the amount of the annuity,
then the beneficiary is taxed on the full amount of the annuity and the
excess income is taxed to the fiduciary.

Prior Period Income

The 1942 Revenue Act added provisions dealing with income of a
prior period paid out during the taxable year. As pointed out above,
Section 162(b) and (c) provide for deductions to the fiduciary for in-
come of the taxable year paid or credited under Section 162(c) or dis-
tributable under Section 162(b) to beneficiaries, and require the bene-
ficiaries to include in income the amount deducted by the fiduciary. Sec-
tion 162(d) deals with distributions of income of a prior period and
draws a distinction between income of a prior period distributed after

53. The operation of this provision is explained in U. S. Treas. Reg. 111, § 29.162-2(a)
(1943).
the first 65 days of the taxable year and that distributed during the first 65 days of the taxable year.

Section 162(d)(2) provides that in determining the deductions allowed to the fiduciary under Section 162(b) and (c) an amount not in excess of the last 12 months' income of periods preceding the taxable year, distributed after the first 65 days of the taxable year, is to be treated as income of the taxable year. The regulation under Section 162(d)(2) presumes that distributions are made from the most recently accumulated income, so that in the absence of earmarking, for the purposes of the 12 months rule, the additional deduction is limited to the income for the months of the preceding period falling within the 12 months preceding the date of distribution.4

An example will illustrate this. Suppose the decedent died on January 1, 1946, and the estate has income of $1,000 per month from that date to May 31, 1947. On June 1, 1947, the fiduciary distributes $12,000 of income. The estate has no other income and makes no further distributions until May 1, 1948, when it distributes $5,000 and the administration terminates. The amount of the deduction allowed the estate on account of prior period income on its 1947 tax return is $7,000, the income for the period June 1, 1946, to December 31, 1946. In this case a deduction of $5,000 would also be allowed for the distribution of the income of the taxable year 1947. If the distribution on June 1, 1947, were earmarked as 1946 income then the deduction on account of prior period income for 1947 would be $12,000 and there would be no distribution of 1947 income.

Section 162(d)(3)(A) provides that income for a period beginning prior to the taxable year distributed within the first 65 days of the taxable year shall be treated as income of the preceding taxable year distributed on the last day of the preceding taxable year, to the extent of the income for the last 12 months of the prior period. In the absence of earmarking the presumption that distributions are made from the most recently accumulated income applies.

Suppose the same facts as in the prior example except that $12,000 is distributed on February 28, 1947. Under the presumption, the income of January and February, 1947, is treated as having been included in the $12,000 distribution and a deduction would be allowed to the fiduciary under Sections 162(d)(3)(A) and 162(c) for the year 1946 of $10,000, which sum would also be taxed to the beneficiary on his 1946 return.

As these Sections were originally enacted in the Revenue Act of 1942,

double taxation was possible, since the amount of the fiduciary's deduction was the measure of the taxable income reportable by the beneficiary, despite the fact that where the amount of the deduction exceeded the income of the fiduciary for the taxable year, income tax would ordinarily have been paid on the excess by the fiduciary in the earlier taxable year. To meet this situation, Section 162(d)(4) was added by the Revenue Act of 1943. It provides that the beneficiary need not include in income the excess of the deductions of the fiduciary over the income of the fiduciary for the taxable year. This provision is effective to eliminate the double tax on fiduciary income.

An example of the operation of Section 162(d)(2) and (3)(A) and (4) follows: Suppose a decedent dies on December 31, 1946. During the calendar year 1947 the estate has income of $10,000. No distribution of this income is made in 1947 nor within 65 days after the end of 1947. Since the fiduciary has no deduction for income paid to beneficiaries, the fiduciary pays the tax on the $10,000. During 1948 the fiduciary has an additional $10,000 of income. On June 1, 1948, he distributes $10,000 earmarked as the 1947 income, and on December 31, 1948, he distributes the $10,000 of 1948 income. The fiduciary return for 1948 would show a deduction of $20,000 for income distributed to beneficiaries. However, the beneficiaries would report only $10,000 on their 1948 returns since Section 162(d)(4) limits the beneficiaries' taxable income to the estate's distributable income for 1948.

Suppose that, instead of making any distribution during 1948, the fiduciary distributes the $10,000 of 1947 income on February 1, 1949, and distributes the remaining $10,000 on June 1, 1949, when the administration is terminated. Assume that the fiduciary has no 1949 income. The fiduciary return for 1948 would show $10,000 of income and $10,000 as a deduction for the 1947 income distributed to beneficiaries. Thus, the fiduciary would pay no tax. The beneficiaries would include in their 1948 income the $10,000 of 1947 income distributed on February 1, 1949. The fiduciary 1949 return would show no income but a deduction of $10,000 for the June 1, 1949, distribution. Since this deduction exceeds the 1949 income by $10,000, the beneficiaries need not include the June 1, 1949, distribution in their 1949 income.

Charitable Deduction

Unlike a corporate or individual taxpayer, a trust or estate is entitled to a deduction for the full amount of its gross income which, pursuant

55. In the example, no adjustment is made for the income taxes that would have been paid by the estate on the income for 1947.
to the terms of the will or trust, is paid to or permanently set aside for a charitable organization or is to be used exclusively for religious, charitable, scientific, literary or educational purposes or for the prevention of cruelty to children or animals or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. The deduction for charities permitted estates or trusts is broader than that allowed to individuals or corporations in two respects: (1) There is no percentage limitation on the amount of income paid or payable to a charity for which a deduction may be obtained. (2) The income need not be paid to a charitable organization, but it is sufficient if the money is used or set aside for charitable purposes.

IV. WILL PROVISIONS

Multiple Trusts

As pointed out above, one of the important principles of estate income tax planning is the use of as many different taxpayers as possible. This may be accomplished by the creation of multiple trusts. Take a simple example: A testator has two minor children. The testamentary plan is to leave the estate in trust to accumulate the income during their minority and pay it to them when they attain 21, corpus to grandchildren, if any. If the income from the estate were $20,000 per year, and the will provided for the creation of a single trust with two beneficiaries, then during the period of minority of the children the trustees would report the $20,000 of income on one tax return and pay a tax of $6,900 (with a top bracket of 53.5 per cent). Capital gains of the trust would be subject to the maximum 25 per cent tax. If the will of the testator provided for the division of his estate in two equal parts, each to be held in trust for the benefit of one child, there would be $10,000 of income for each trust, and each trust would pay a tax of $2,500 (with a top bracket of 36 per cent). Thus, the creation of two trusts in lieu of one would result in a tax saving of $1,900. If each of the trusts had $5,000 of capital gain, then the trusts would not pay at the maximum 25 per cent capital gain rate, but would pay capital gains tax at a 19 per cent rate. Each trust would thus pay a capital gains tax of $950, so that the saving on capital gains tax for the two trusts, as compared to the single trust, would amount to $600. Thus, the total income tax savings by having two trusts instead of one would be $2,500 for one year.

Care must be exercised in drafting the will to create separate trusts,

56. This paper was prepared and type set prior to enactment of the Revenue Act of 1948. Accordingly all tax computations are at the rates in effect in 1947.
if that is the intent. In *United States Trust Co. v. Commissioner* \(^5\) the settlor, by deed in 1913, created one trust for the benefit of three beneficiaries, with a power of amendment in the beneficiaries. In a subsequent year the trust was amended for the purpose of reducing the income tax by providing that the trust estate was to be divided into three equal parts and each part was separately to be held in trust. The bank records were changed to reflect the three separate accounts, but the corpus was held *in solido* without any physical segregation. The Supreme Court held that since it was the clear intention that three separate trusts be created, that being the purpose of the amendments made by the beneficiaries, and since separate accounts were kept, there were three separate trusts for tax purposes in spite of the fact that for administration purposes the property of the trusts was not physically segregated. \(^5\)

To be contrasted with the decision in the *United States Trust Co.* case is the recent decision of the Tax Court in *Garrard E. Kelly*. \(^5\) In this case trusts were set up for X for life, and after X's death, for Y for life, and after Y's death, for A and B, children of Y, the income to be accumulated and distributed to A and B when they reached 30. The taxpayer contended that with respect to A and B (X and Y having died) four separate trusts were created, two separate trusts of the corpus (one for A and one for B), and two separate trusts of the accumulated income (one for A and one for B). The trust deed did not provide for the division of the corpus into separate shares, but spoke of the beneficiaries' interest in "the trust." The Tax Court held that only one trust was created. \(^6\)

In most instances multiple trusts as opposed to a single trust with multiple beneficiaries would satisfy the testamentary plan equally well. Where this is the intention, the will should direct that the corpus be divided into separate shares and that each share be held in separate trust for the beneficiary. Separate accounts should be kept for the trusts and separate tax returns filed. It is not necessary to have a

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57. 296 U. S. 481 (1936).
58. See also Kohitz Family Trust, 5 T. C. 554 (1945). In this case the trustee was directed to "divide the trust estate into three equal shares" setting aside one share for each of three children. The share set aside for each child was to be held in trust for such child. The trust also provided for holding the corpus *in solido* for administration purposes. The Tax Court held that three separate trusts were created. The decisive factor was the intent of the creator of the trusts that there be three trusts, and his direction to divide the estate in three equal shares and hold each share in trust.
59. 8 T. C. 1269 (1947).
60. Similar results were reached in William T. Belcher Trust No. 1, P-H 1947 TC Mem. Dec. Serv. ¶ 47,237 (1947); Edward M. and Fred E. Hiecke Trust, 6 T. C. 30 (1946); James S. Reid Trust, 6 T. C. 438 (1946).
physical segregation of the corpus, although obviously segregation is preferable tax-wise to keeping one fund.

Frequently, the testator desires that control over the entire income of the estate be retained in one person. Thus, if the testator has a wife and two minor children, he may desire the wife to have full control over the income. Even in such a case, the creation of multiple trusts has advantages. The control in the wife may be retained by having the wife as the trustee of three separate trusts, one for her own benefit and one for the benefit of each of the children. As to the income from the children’s trusts, the wife, as trustee, could have discretion: (1) to pay out or apply the income for the children’s benefit; and (2) to pay the balance to herself.

The tax benefit to be derived from the suggested plan is demonstrated by the Tax Court decision in *Virginia White.* In this case the husband left to the petitioner, his wife, a life interest in one-half of his estate. His will contained precatory language that the wife should support, maintain and educate their two children out of this income. The other one-half of the estate was left in trust, the income to be accumulated for the children’s benefit. In 1940 the wife used a substantial amount of the income from her trust for support of the children and contended that she was taxable on the income of her half of the estate, reduced by the amount used for support of the children. She argued that the income she received on her half of the estate was impressed with a trust for the children. The Tax Court denied her contention and taxed her income from half the estate without reduction for the amounts expended for the children. The court held that the precatory language did not mean that the income was impressed with a trust for the children.

If the testator in this case had divided the one-half of the estate left in trust for the wife into three separate trusts, one for the wife and one for each of the children, and had directed that the wife apply the income from the children’s trusts for their support, maintenance and education, any balance of the income to go to the wife, the same distribution of income would have been achieved from the viewpoint of the three heirs, but the tax result might have been different. Instead of the wife being

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61. If a beneficiary has the unrestricted right in the tax year to demand all the income, then the beneficiary is taxed under § 22(a) whether or not the income is actually distributed to him. U. S. Treas. Reg. 111, § 29.22(a)-22 (1943). See also Bunting v. Commissioner, 164 F. 2d 443 (C. C. A. 6th 1947); Mallinckrodt v. Nunan, 146 F. 2d 1 (C. C. A. 8th 1945); Stix v. Commissioner, 152 F. 2d 562 (C. C. A. 2d 1945); Busch v. Commissioner, 148 F. 2d 798 (C. C. A. 8th 1945). *But cf.* Hallowell v. Commissioner, 160 F. 2d 536 (C. C. A. 3d 1947); Samuel B. Knight, 6 T. C. 90 (1946).

62. 5 T. C. 1082 (1945).
taxable on all the income, the children might have shared the tax burden
to the extent that the income was used for their support, with reduced
surtax liability on the family's income.\textsuperscript{63}

\textit{Accumulation Trusts}

The \textit{Garrard E. Kelly} case indicates the extreme to which the number
of taxpayers may be carried. In that case the taxpayer contended that
where the trust provided for the accumulation of income during the
lifetime of two minor beneficiaries, four trusts were created, one trust
of corpus for each of the beneficiaries and one trust of accumulated in-
come for each of the beneficiaries. The contention of the taxpayer was
denied in the \textit{Kelly} case because the language used did not substantiate
the construction urged of four separate trusts. However, it is possible
to draft a will providing for the creation of a separate trust for accu-
mulated income, with a resulting increase in the number of taxpayers.\textsuperscript{64}

Suppose the testamentary plan is to leave the estate for the benefit of
two minor children and during their minority to apply the income for
their support and maintenance, accumulating the balance. Suppose that
during a given tax year the trust has $20,000 of ordinary income and
$10,000 of capital gain. If only one taxpayer were created, the $20,000
of income would be taxed at $6,900 (with a top bracket of 53.5 per
cent). The $10,000 of capital gain would be subject to the maximum
25 per cent capital gain tax, or $2,500. If the will were drawn to pro-
vide for separate trusts of corpus for each of the children and a separate
trust of income accumulated for each of them, then the two accumu-
lated income trusts would each have incomes of $10,000, and each of
the corpus trusts would have capital gain income of $5,000. The accu-

\textsuperscript{63} \textit{Compare} Agnes K. May, 8 T. C. 860 (1947), \textit{with} Stix \textit{v. Commissioner}, 152 F. 2d 562 (C. C. A. 2d 1945). In the \textit{May} case the petitioner's parents had set up a trust with
the petitioner as trustee, giving her all the income of the trust except amounts necessary
for the education of the petitioner's children. The petitioner, as trustee, was to be the
sole judge of the amounts necessary for such education. The remainder went to petitioner's
issue. During the taxable years, petitioner expended sums on the education of her son,
which sums were separately reported in a tax return filed by the son. The Commissioner
contended that by reason of the control in the petitioner as trustee, she was taxable on
all the income of the trust. The Tax Court held that, under the terms of the trust, the
petitioner was under an obligation to use part of the income for the education of her
children and that on the income so used, the petitioner was not taxable. In the \textit{Stix} case,
the court taxed the primary beneficiaries (who were also trustees) on income paid
to their children since the taxpayers failed to prove the amount of trust income which
they were under legal obligation pursuant to the trust to pay to the children.

\textsuperscript{64} George G. Allen, 40 B. T. A. 351 (1939); Lynchburg Trust & Savings Bank \textit{v.}
Commissioner, 68 F. 2d 356 (C. C. A. 4th 1934).
mulated income trusts would each pay tax of $2,500. The corpus trusts would each pay tax of $485. Thus, the total tax liability would be $5,970, as compared to the total tax liability, if only one trust were created, of $9,400.

If, during the taxable year, the accumulated income trusts applied $5,000 toward the support of each of the children, the tax advantage would be even greater. In this case each of the two accumulated income trusts and each of the two beneficiaries would report income of $5,000 and pay a tax of $1,045, or a total tax of $4,180. The corpus trusts would each pay a tax of $485, so that the total tax liability on the entire income would be only $5,150, as compared to $9,400 if there were only one trust and no distribution of income.

Thus, the tax advantage can be derived by putting accumulated income in separate trust. This can be accomplished only by clearly indicating the intention to create separate trusts of corpus and accumulated income through the use of appropriate language. To gain maximum flexibility, the will should provide a trust of corpus and direct distribution of income to a second trust, and authorize accumulation or distribution of such income in the discretion of the trustee. In practice such provision should be implemented by the keeping of separate accounts by the trustee.

Discretionary Trusts

Where permissible under state law, wills providing for discretionary distribution by trustees achieve a favorable tax result. Such provision permits analysis by the fiduciary of the relative income tax brackets of the fiduciary and the beneficiaries and the distribution of income and retention of the balance by the fiduciary to achieve the lowest overall surtax bracket. Similar provision might be made to cover distributions by the executor during the period of administration, so as to give him the same flexibility in determining whether to distribute or retain the income of the estate during administration in order to achieve the lowest overall surtax bracket.

Allocation of Expenses

The second important principle of estate income tax planning is the distribution of taxable income to, or retention of taxable income by, the taxpayer with the largest amount of income tax deductions. This prin-

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65. In some states accumulation is limited to minorities. See, e.g., N. Y. PERS. PROP. LAW § 16.
66. Ibid.
67. Such a provision might avoid the necessity of obtaining court approval before making distributions. Cf. Estate of Isadore Zellerbach, 9 T. C. 89 (1947).
ciple may be implemented by a will provision granting the fiduciary power to allocate expenses or losses either to income or corpus, in order to enable the fiduciary to utilize the income tax deductions to the best possible advantage. Provisions granting such discretionary powers have been held effective to set off capital losses against income distributable to a beneficiary, thereby utilizing the deduction for the loss which would otherwise have been lost. In another case such a provision was held effective to permit the charging of an expense against the income of a beneficiary.

In the absence of such discretionary power the usual rules of state law apply to determine whether expenses and losses are to be charged against income or corpus. Tax deductions which are charges against income reduce the distributable income which is taxed to the beneficiary, without increasing the income tax of the fiduciary. In Marjorie V. L. Hudson the petitioner was the life beneficiary of a Pennsylvania testamentary trust. Included in the trust corpus was realty which the trustees acquired upon default in 1932 and operated through 1945. In the tax years in question (1937, 1938 and 1940), the excess expenses of operating the property over the rental income from the property were charged by the trustees against the other income of the trust. The Commissioner contended that the excess expenses were corpus charges and that the beneficiary should be taxed on the income of the trust without reduction by the excess expenses from operating the realty. If this contention had been sustained, the beneficiary would have paid tax on more than the net income of the trust and the deduction for the excess expenses of operating the realty would have been lost for tax purposes unless there was other trust income which was not distributable. The Tax Court made a careful analysis of Pennsylvania law, and concluded that, as the Pennsylvania law stood in the tax years, the trustee’s action in charging the expenses to income was not clearly wrong.

Amounts chargeable against corpus which are tax deductions do not reduce the distributable income of the beneficiaries and are lost as deductions except where the fiduciary has other income. This was the

70. 8 T. C. 950 (1947).
71. Expenses properly charged to income reduce taxable income of the beneficiary. Forrest G. Pearson, 4 T. C. 218 (1944), aff’d, 154 F. 2d 255 (C. C. A. 3d 1946); Minnie Behl, 7 T. C. 1473 (1946); Bessie B. Hopkinson, 42 B. T. A. 580 (1940), aff’d, 126 F. 2d 406 (C. C. A. 2d 1942).
case in Charles S. McVeigh, involving facts similar to those in the Hudson case, with one difference. In the McVeigh case the will provided that excess expenses from the operation of a parcel of realty should be charged to corpus. The taxpayer contended that the excess expenses were chargeable to income and that the amount distributed to him to make up the excess realty expenses came from corpus and was not taxable. The court held that the excess expenses were chargeable to corpus under the terms of the will. Thus the beneficiary was taxed on more than the net income of the trust and the excess realty expense deduction was lost. If in the McVeigh case the trustee had had the power to allocate expenses against corpus or income in his discretion, tax saving might have been effected by allocating the excess realty expense to income, with the same results as in the Hudson case.

Where the fiduciary has income taxable to him, then a charge against corpus is not lost as an income tax deduction. Thus, in James H. Knox Trust trustees' commissions were paid out of corpus. The trust had income held for accumulation and capital gains. The Commissioner contended that the trustees' commissions payable out of corpus were not an income tax deduction, but the court permitted the deduction under Section 23(a)(2), and this off-set the otherwise taxable income of the trust.

The element of income tax planning involved is the giving of discretionary power to the fiduciary to allocate deductions and losses where they will do the most good tax-wise. Thus, a fiduciary with such power may apply capital losses, or excess expenses of real estate, or other deductions, against the beneficiary's income or against the fiduciary's so as to obtain maximum tax advantage.

Obviously there are limits to the usefulness of this device. Such allocation of expenses and losses changes the substantive rights of the parties involved. If capital losses are charged against income, the life beneficiary receives less income. Discretionary allocation has particular

72. 3 T. C. 1246 (1944).
73. See also Gertrude Libbey Anthony, 9 T. C. 956 (1947); Mary deF. Harrison Geary, 9 T. C. 8 (1947); Irma L. Harris, 5 T. C. 493 (1945); I. T. 3830, 1946-2 CUM. BULL. 47; Augusta Bliss Reese, 30 B. T. A. 1 (1934).
74. 4 T. C. 238 (1944).
75. Charges against income which are not tax deductions reduce the distributable income taxable to the beneficiary, but result in taxing the fiduciary on an equal amount. Mary Helen Cadwalader, 27 B. T. A. 1078 (1933); cf. Estate of Mortimer B. Fuller, 9 T. C. 1069 (1947). Charges against corpus which are not tax deductions do not reduce the distributable income taxable to the beneficiary, and cannot result in tax benefit to the fiduciary. Anna F. Ardenghi, 37 B. T. A. 345 (1938), aff'd, 100 F. 2d 406 (C. C. A. 2d 1938).
value where the beneficiary entitled to the income will ultimately get the corpus. If the testamentary plan is to keep the estate in trust until the beneficiary reaches 30 and then to distribute the corpus to the beneficiary, the tax advantages from charging expenses and losses against income otherwise distributable to the beneficiary may outweigh the immediate disadvantage to the beneficiary of receiving less income.70

**Dollar Bequests**

Where the testator plans to leave a large portion of his estate outright to a legatee, consideration should be given to the question whether such bequest should be in the form of a percentage of the residue of the estate or in the form of a fixed dollar amount. While an estate ordinarily does not realize income by a distribution to legatees of assets in kind,77 an estate does realize income by payment of a bequest of a fixed dollar amount with securities which have appreciated in value. Thus, in *Kennan v. Commissioner*78 the beneficiary was entitled to $5,000,000 to be paid either in cash or, at the discretion of the fiduciary, in securities. The fiduciary satisfied the bequest with securities which had appreciated in value, and the court held that the fiduciary had realized income despite the distribution in kind. In this case, a bequest of a percentage of the residue might have been more advantageous taxwise. The desirability of a percentage bequest from the income tax viewpoint must be weighed with the desire of the testator as to whether the estate or the beneficiary should take the risk of depreciation in the value of the estate after the date of death.

**Distribution in Kind or Cash**

Even where the bequest is of a portion of the residue, it would be advantageous to include a provision in the will granting the fiduciary discretion to satisfy the bequest by distributions in kind or in cash. This would enable the fiduciary to determine at the time of distribution whether gains or losses have occurred with respect to the estate's assets and the most economical way to handle the assets from the income

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70. Discretionary allocation provisions must also be read in the light of the local law, which may limit the trustee's scope of action. *Cf.*, *e.g.*, Caroline Gove Doty, 3 T. C. 1013 (1944), *aff'd*, 148 F. 2d 503 (C. C. A. 1st 1945), where a dividend was held taxable to the beneficiary despite its allocation to corpus by the trustee, on the ground that under local law such dividend was distributable despite the trustee's discretionary power.


tax point of view. Thus, if an estate has substantial income in the year of distribution, sale of depreciated assets by the fiduciary may be indicated to offset the income by the loss to the extent permissible. On the other hand, if the fiduciary has no income and some of the beneficiaries have substantial income, distribution of depreciated assets to the beneficiaries and sale of the assets by them in order to realize the tax loss might be indicated. Similarly, if the estate has realized losses, appreciated assets should be sold by the estate in order to minimize the tax on the gain. If the estate has no losses, but the beneficiaries have losses, then distribution of the assets in kind and their sale by the beneficiaries may be the most economical method from the tax viewpoint.

**Realty**

Where realty owned by the testator is sold after his death, the proper taxpayer to report gain or loss on the sale depends upon the terms of the will and local law. Where realty is left outright to the heirs and under local law descends to the heirs at date of death, gain or loss on a sale by the heirs is reported on their tax returns whether the sale is made during or after the period of administration. If the will directs a sale of the realty and transfer of the proceeds to the heirs and under local law the heirs have no interest in the realty but only in the proceeds, gain or loss on sale is reportable by the estate.

Where the realty is left to the heirs subject to a power of sale in the executors, whether gain or loss is taxed to the estate or to the heirs depends on whether the executor has powers of management over the realty in addition to the power of sale. If he has only the power of sale, gain or loss is reportable by the heirs.

Rental income and expense with respect to realty which descends to the heirs at date of death under the will and local law are reported by the heirs, but if it is not shown that the realty and rental income will not be needed to pay debts, legacies and expenses of the estate, one case holds that rental income and expense are reported by the estate.

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83. Estate of B. Brasley Cohen, 8 T. C. 784 (1947). In this case, the will provided
If it is desired that rental income and expense and gain or loss on the sale of realty be reported by the heirs for tax purposes, this might be done under the *Weber* case\(^8\) by devising the realty to the heirs subject only to a naked power of sale in the executor. But the maximum tax flexibility in handling realty can be achieved by devising realty to the heirs, subject to powers of sale and management in the executor pending transfer of possession to the heirs or sale by the executor, coupled with a clause giving the executor discretion to charge expenses either to income or corpus.

Under such provisions, rental income and expense would be reported by the fiduciary prior to transfer of possession to the heirs. If rental income exceeds the expense, the tax burden could be borne either by the executor or by the heir (through distributions of the income) whichever were cheaper tax-wise. If the expenses exceed the rental income, the executor could charge the excess against income or corpus; tax benefit would result from the charge against corpus only if the executor retained sufficient other income to off-set the deduction.\(^8\)

Similarly, if sale is contemplated and tax analysis indicates that the fiduciary should report the gain or loss, then the fiduciary should sell. If better tax results would be achieved by having the heir report the gain or loss, then the fiduciary should transfer possession so that sale could be made by the heir.

**Charitable Deduction**

As pointed out above, a trust or estate is entitled, under Section 162 (a) of the Internal Revenue Code, to a charitable deduction for all income which, pursuant to the will or deed, is paid to or permanently set aside for charitable purposes. The deduction for charitable contributions allowed an estate or trust differs from the charitable deduction allowed individuals and corporations in two important aspects:

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84. 111 F. 2d 766 (C. C. A. 2d 1940).

85. See *supra*, pp. 22-24 and notes 71, 73 and 75 *supra*. 

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First, there is no limitation on the amount which may be paid to or permanently set aside for charities and allowed as an income tax deduction to an estate or trust, whereas, in the case of individuals and corporations, the deduction is limited to a percentage of gross income.

Second, the charitable deduction of an estate or trust is broader than in the case of individuals and corporations. In the latter cases, the deduction is allowed only for payments to specified types of organizations. In the case of estates and trusts, the deduction is allowed for amounts paid to or set aside for any of the organizations to which an individual or corporation may contribute and obtain a tax deduction, and in addition a deduction is allowed for any income which is used (or held for use) exclusively for religious, charitable, scientific, literary or educational purposes or for the prevention of cruelty to children or animals or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit, even though such use is by the trust or estate itself without payment to a charitable organization.

The difference between the amount of charitable deduction allowed an estate or trust and that allowed an individual or corporation is demonstrated in John E. Andrus Trust No. 1. In this case 45 per cent of the income of the trust was set aside for charitable purposes. The income so set aside included capital gains. The trustees claimed a charitable deduction for the full amount of the income set aside, or $37,000, without reducing the capital gains to the amount of the long term capital gain income included in gross income under Section 117. The Commissioner contended that the charitable deduction was limited to the amount of taxable income set aside for charities, after reducing the capital gain income by the applicable percentages under Section 117, or $17,800. The trustees argued that under Section 162(a) the trust was entitled to a deduction for income which, pursuant to the terms of the trust, was paid to or set aside for charities “without limitation,” and that the quoted language required that the amount of the income paid to or set aside for charities be allowed as a deduction before reducing the capital gain income by the percentage requirements. The Tax Court sustained the trustees, and as the trust had other income subject to tax, the allowance of a charitable deduction of $37,100 enabled $19,300 of other taxable income to escape taxation (the deduction under the Commissioner's construction was $17,800).

The second circuit reversed the Tax Court and held that while the

full amount paid to or permanently set aside for charities is a tax deduction, the deduction is limited to the amount included in taxable gross income. Thus, although the trust actually paid to or permanently set aside $37,100 for charitable purposes, the deduction of the trust was limited to the $17,800 included in taxable gross income. The court relied on an analogy to the treatment of expenses incurred in connection with exempt income, which are not deductible to the extent attributable to the exempt income.87

The second difference is demonstrated in Commissioner v. Citizens & Southern Nat. Bank.88 In this case decedent left his entire estate (subject to two annuities and to other annual payments to be made to his former wife and his widow) to be used for "charity purposes and in the relief of pain and suffering and poverty." The will directed that a corporation be organized to take over the estate and that, after payment of the annuities (and the payments to decedent's two former spouses), one-fourth of the income be used for orphanages. The balance was to be used for charity, including disbursement of the funds "to individuals who are deserving and to other deserving institutions such as schools, whether the same be public or private, and in fact, any . . . deserving individual, association or institution that said Trustees may deem worthy and in need of the funds herein provided for without regard to race, color or creed."89

During the tax years in question, the estate had substantial income and claimed deduction under Section 162(a) for the excess income remaining after the payments to the individuals. The Commissioner denied the deduction on the ground that the income was not paid to or permanently set aside for the use of charitable foundations described in Section 23(o) (institutions to which contributions by individuals are deductible), since the corporation (to be formed under the will) had to pay out annuities and might use the funds for private individuals and private schools. The Tax Court allowed the deduction on the ground that under Section 162(a) deduction is not based on payment to an organization described in Section 23(o); it is sufficient if the funds are used (or held) for charitable purposes. The court pointed out that the charitable deduction under Section 162(a) is to be construed liberally and that the deduction was allowable even though under the will payments were permitted to needy individuals or private schools.90

87. Int. Rev. Code § 24(a)(5); see George N. Meissner, 8 T. C. 780 (1947).
88. 147 F. 2d 977 (C. C. A. 5th 1945), affirming 3 T. C. 40 (1944).
89. Id. at 42.
90. Other decisions broadly construing the charitable deduction for estates and trusts are: Old Colony Trust Co. v. Commissioner, 301 U. S. 379 (1937); Estate of Edward T. Bed-
Whether income is paid to or permanently set aside for charities is a question of fact. The possibility that funds set aside for charity may be used for individuals is not sufficient to deny the deduction, if it can be established that the funds will not in fact be diverted to the individuals. 91 To avoid any problem where income is not paid to charities during the tax year, but is held for future distribution to charities, it is suggested that a separate trust be created by the will, all of the income and corpus of which is to go to charities, and that any funds held for distribution to charities be paid into this trust. Suppose that a will creates a trust and provides that as much income as necessary be paid by the trustees for the support of the beneficiary, and that upon the beneficiary's death all the principal and unused income be paid to charities. A charitable deduction for the excess income in this case might be denied because of the possible use of income for the individual beneficiary. 92 But it would seem that the deduction would be allowed if the will provided that the excess income be paid into a separate trust to be held for charities, since such income would then be permanently set aside for charities and would not be subject to use in any other manner.

A similar provision is desirable where corpus is held for charity subject to possible invasion for the benefit of the life tenant. If the trust has capital gains, the government could take the position that the capital gains are not permanently set aside for charity in view of the possibility of invasion and are therefore subject to tax. 93 A direction in the will to pay the capital gains into a separate trust to be held for charitable purposes would appear to justify deduction of the capital gains as income permanently set aside for charities.

V. INCOME TAX CONSIDERATIONS WHILE THE ESTATE IS IN ADMINISTRATION

Estate Tax Return

The preparation of the federal estate tax return presents two income tax problems: Should the property be valued at the date of death or at the optional valuation date? Should administration expenses and other deductions be claimed as income tax deductions or as estate tax deductions?


Under Section 113(a)(5) of the Internal Revenue Code, the basis of property acquired by bequest, devise or inheritance is the value of the property on the date of acquisition. The date of acquisition is the date of death unless the executors elect to value the estate for federal estate tax purposes at the optional valuation date, one year after death, under Section 811(j). In the latter case, the property is treated as having been acquired at the optional valuation date and its value on that date is the income tax basis of the property.

In the usual situation, the estate consists of many assets, some of which have appreciated in value and some of which have depreciated in value in the year following the death. No categorical rule for the election of either the date of death value or the optional value can be stated. The executor must make an over-all analysis, listing the assets which are to be sold, comparing the income tax cost on such sale (using both date of death and optional valuations) with the estate tax cost if the date of death or optional value date is used, determining the tax benefit from income tax losses which could be realized by the estate or heirs and then electing the estate tax valuation date which results in the lowest over-all total of estate and income taxes.

Whether the deductions allowed under Section 812(b) as estate tax deductions, should be taken as deductions under Section 812(b) or Section 23 (as income tax deductions) depends upon the relative estate tax and income tax brackets of the estate. If the estate will be in a higher income than estate tax bracket, it should forego the deduction under Section 812(b) and take the deduction under Section 23. Where no federal estate tax return is filed (net estate under $60,000) then the expenses and other deductions should be claimed on the income tax returns.94

Period of Administration

During the period of administration, the heirs are taxable only on income properly paid or credited to them, the estate being taxable on the balance.95 This rule permits flexibility, since the executor can determine how much of the income should be distributed and how much retained in order to achieve the lowest over-all surtax rate. For this reason, it is usually desirable to prolong the period of administration. The Treasury Regulation provides that the period of administration is

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94. In a special ruling reported in 5 P-H 1947 Fed. Tax Serv. 76,136 (1947), it was held that where no estate tax return was filed because of the insufficiency of the estate, administration expenses could be deducted on the income tax returns, if the estate filed a waiver foregoing the right to claim the expenses as an estate tax deduction at any time. See also special ruling reported in 5 P-H 1948 Fed. Tax Serv. 76,153 (1948).

95. See part III supra.
not dependent upon local rules of law, but is the time required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. Where the time required for administration of the estate has ended, even though the assets are still held by the executor, the income of the estate will be taxed to the heirs under Section 162(b). That is, after the period of administration, except in the case of an accumulation trust or a trust providing for discretionary distribution or accumulation, the income is taxed to the beneficiaries if distributable, whether or not actually distributed. In *William C. Chick* the testator died in 1929 leaving his assets to residuary trusts, one for the benefit of each of his two children. By 1937 all the debts and legacies of the estate had been paid, but the residuary trusts had not been set up, nor had any of the income of these trusts been paid or credited to the two beneficiaries, one of whom was also the executor. The Tax Court held that in 1940 the estate was out of administration even though the administration had not been terminated in the local state court; the income of the estate was taxable to the two beneficiaries even though it had not been distributed.

That the courts will not unduly limit the period of administration appears from *Caro du Bignon Alston*. In this case the testator died on February 4, 1938. The petitioner was the executor and also a residuary legatee. By January, 1941, all the debts of the estate had been paid. In the fall of 1942, the executor accounted and distributed the assets to the beneficiaries. The Commissioner contended that during 1941 the estate was out of administration and that the income was taxable to the beneficiaries and not to the estate. The Tax Court held that the reasonable time required for the administration included the accounting and distribution, which were not unduly prolonged, and that the estate was in administration during the year 1941.

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96. U. S. Treas. Reg. 111, § 29.162-1 (1943). In *Frederich v. Commissioner*, 145 F. 2d 796 (C. A. 5th 1944), the court held that by reason of the local Florida law, an estate was in administration from 1934 through 1943 in spite of the fact that all of the debts of the estate had been paid by 1937. In this case the decedent's interest in a partnership was continued by the administrator, and the continuation of such interest was approved by the Florida courts. The fifth circuit held that since the estate was properly continued in administration under the Florida law, the heirs could not be taxed on income of the estate not actually distributed. The Tax Court has refused to follow the *Frederich* decision. See *William C. Chick*, 7 T. C. 1414, 1422 (1946), *aff'd*, 5 P-H 1948 Fed. Tax Serv. ¶ 72,384 (C. C. A. 1st 1948).


98. 8 T. C. 525 (1947). See also Marie B. Hirsch, 9 T. C. 896 (1947).
Residuary Trusts

Where the will provides for the creation of trusts, it is advisable to set the trusts up at an early date in order to create more taxpayers. Payment of income by the estate to the trusts would shift the tax on such income to the trusts,\(^9\) or to the beneficiaries if the income were distributable by the trusts. Where the income of the trust can be partially accumulated, then additional tax advantage is derived by having the trust distribute only part of the income so that the tax burden is spread three ways among the estate, the trust and the beneficiary, thereby reducing the over-all surtax bracket. In addition to the advantage of splitting the tax on the ordinary income among the three taxpayers, under present law it is possible that the tax on the capital gain income may also be split. Prior to 1942, where income was distributed as corpus (as in the case of final distribution to a residuary legatee after the estate realized capital gain), the estate was not entitled to a deduction for the income so distributed. Such amounts were taxable income to the estate and not taxable to the legatee.\(^{10}\) Under the law since 1942, an estate is entitled to a deduction for all income distributed, even if it is distributed as corpus,\(^{11}\) except for payments of legacies payable in one sum.\(^{12}\)

The foregoing may be illustrated by the following example. Suppose that in the tax year the estate has ordinary income of $20,000 and capital gain income of $20,000. If no income were distributed, the estate would pay $6,900 on the $20,000 of ordinary income and be in the 53.5 per cent bracket; it would pay capital gains tax at 25 per cent, or a total tax of $11,900. If the estate distributed $10,000 of the income to a beneficiary, then the beneficiary would pay a tax of $2,500, the estate would pay a tax of $2,500 on its ordinary income and a capital gains tax of $3,600. If a residuary trust were created, and if the estate distributed $10,000 of ordinary income and $10,000 of capital gain to the residuary trust, and the trust distributed the $10,000 of ordinary income to the beneficiary, it is believed that the estate would pay a tax

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\(^12\) G. C. M. 24702, supra note 101; Old Colony Trust Co., 38 B. T. A. 828 (1938).
of $2,500 on the ordinary income and $1,800 on the capital gain; the beneficiary would pay $2,500 on the $10,000 of ordinary income; and the trust would pay $1,050 on the $10,000 of capital gain. If this method of reporting were sustained, the total tax liability would be $7,850, as compared with a total tax liability of $11,900 where the estate reported all of the income, and $8,600 where a residuary trust was not set up but partial distribution was made to a beneficiary. If the trust were authorized by the will and local law to accumulate part of the ordinary income, and did so, the over-all tax would be even lower. Numerous combinations resulting in tax savings are possible, especially if there are several trusts to work with.

Fiscal Year

Additional flexibility is afforded by putting the estate on a fiscal year basis. In the case of an estate in administration, where the tax year of the estate and of the beneficiary differ, the beneficiary is taxed on income in the year in which it is paid or credited to him. This rule enables the fiduciary to distribute the income of one taxable year of the estate in two taxable years of the beneficiary. Suppose the decedent dies June 30, 1947, and the estate has $50,000 of ordinary income and $50,000 of capital gain income by December 31, 1947. The estate distributes $25,000 of ordinary income to the beneficiary on December 31, 1947. The balance of $25,000 of ordinary income is distributed to the beneficiary on April 15, 1948. If the estate reports on a calendar year basis, then its tax return for 1947 shows $25,000 of net income (after deducting the amount distributed to the beneficiary under Section 162(c)) and $50,000 of capital gain. The estate pays a tax of $9,650 on the ordinary income and $12,500 on the capital gain. The beneficiary includes the $25,000 in income for 1947 and, assuming he has no other income, pays a tax of $9,650. Under Section 162(d)(2) and (4), the distribution in 1948 would result in no tax to the beneficiary (assuming the estate has no other income in 1948). Thus, the total tax liability would be $31,800.

If the estate were on a fiscal year ending June 30, 1948, the return for that period for the estate would show $50,000 of capital gain income (after deducting the $50,000 distributed to the beneficiary in 1947 and 1948 under Section 162(c)), and the estate would pay a tax of $9,650. The beneficiary would report $25,000 in 1947 and pay a tax of $9,650, and would report $25,000 in 1948 and again pay $9,650. Thus, the total tax liability on the same income would be $28,950, a saving of $2,850.

in taxes. It is possible that further flexibility may be obtained by setting up testamentary trusts early in the administration and placing them on a different fiscal year from the estate. Unlike distributions from estates (which are taxed to the beneficiary in the year received), distributions from a trust, the income of which is distributable, are taxed to the beneficiary in the taxable year of the beneficiary in which the fiscal year of the trust ends. This rule may permit the beneficiary to report over three taxable years income received by the estate in one taxable year.

The foregoing may be illustrated by the following example: The decedent dies on March 31, 1947. The estate is put on a fiscal year ending March 31st. For the fiscal year ending March 31, 1948, the estate has ordinary income of $50,000. Of this, $15,000 is distributed to the beneficiary (who reports on a calendar year basis) in the calendar year 1947. An additional $15,000 is distributed to the beneficiary by the estate on January 31, 1948, and is reported in the beneficiary’s 1948 return. On February 1, 1948, the testamentary trust is established and the estate distributes $20,000 to the trust. The trust elects to report on a fiscal year basis ending January 31st. The income of the trust which is distributed to the beneficiary is reported in the beneficiary’s calendar year 1949, the year in which the fiscal year of the trust ends. This is so even though the trust income is distributed by the trust to the beneficiary during 1948.

Earlmarking Income

Where the distribution of the income of a taxable year is made after the close of the taxable year without being earmarked, it is treated as having been made from the most recently accumulated income. In this way, income tax planning can be partially nullified by failure to earmark. Suppose that on May 15, 1948, the fiduciary of an estate having a taxable year ending March 31, 1948, distributes $50,000 of income to beneficiaries. Assume the estate has $10,000 of income between April 1, 1948, and May 15, 1948. Unless the income were earmarked, only $40,000 of the income for the fiscal year ending March 31, 1948, would be treated as deductible by the fiduciary and taxable

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105. There is no decision on this point. In order to minimize tax risks, it would be desirable for the estate to distribute corpus as well as income to the residuary trusts, and for the residuary trusts to be actually set in operation. If the residuary trusts only received income which they were immediately required to distribute, the Government might take the position that the setting up of the residuary trusts was a sham, and should be ignored for tax purposes. Cf. Gregory v. Helvering, 293 U. S. 465 (1935).
to the beneficiary for that taxable year. To avoid the complications arising from this presumption, the income of each period should be earmarked when distributed. To facilitate earmarking, the fiduciary should consider keeping the income of each taxable year in a separate bank account.

Income to be Distributed

As above pointed out, unless the income of a fiduciary is distributed within the the first sixty-five days after the close of the taxable year, such income is taxed to the fiduciary. Accordingly, within the first sixty-five days after the close of the taxable year, the fiduciary should analyze the income and deductions of the various taxpayers and then distribute income so as to achieve the lowest over-all tax bracket. The safest course would be the preparation of tentative income tax returns for each of the beneficiaries and for the estate within the sixty-five days following the close of the estate's taxable year. Adjustments to achieve the lowest over-all surtax could then be made through distributions by the estate of the taxable income for the year within the sixty-five days.

The amount of income which should be distributed by the fiduciary to the beneficiary in any taxable year depends upon an analysis of the surtax brackets of the beneficiary and the fiduciary, taking into account the income tax deductions available to each and the nature of the income (whether Section 126 income, ordinary income or capital gain income).

The treatment of income tax deductions available to the fiduciary and beneficiary has been discussed.\textsuperscript{107} The effect of the nature of the income on the determination of the amount of the distribution may be illustrated by the following example: Suppose that an estate has the right to receive income in respect of a decedent which, when received, will be subject to tax under Section 126. Suppose that the capitalized value of the income had previously been included in the estate tax return so that a deduction of a part of the estate tax will be available for income tax purposes under Section 126(c). If there are two beneficiaries, \(A\) and \(B\), and \(A\) is in a higher surtax bracket than \(B\) (without consideration of the fiduciary income), distribution of the right to receive the income might be made to \(A\) since, by reason of the deduction under Section 126(c) and \(A\)'s higher surtax bracket, there will be greater tax benefit than if the right were transferred to \(B\) and fully taxable income were distributed to \(A\). A similar analysis can be made with respect to such capital gain income of the trust as may be distributed,

\textsuperscript{107} Pp. 22-25 \textit{supra}. 
since capital gain income of the fiduciary distributed to the beneficiary is probably taxable as capital gain to the beneficiary. The amount to be distributed is determined, the amount must either be paid or credited to the beneficiary. The requirement of payment or credit is not satisfied by a mere bookkeeping entry, nor by the fact that the beneficiaries reported the income on their individual returns. To insure taxation of the income during the period of administration to the beneficiaries, either payment should be made or the following conditions should exist: (1) appropriate entry should be made in the books crediting the beneficiary's account; (2) the beneficiary should be notified that the funds are available to him; (3) funds should actually be available for withdrawal by the beneficiary; and (4) the beneficiary should report the income on his individual tax return.


109. Frank v. Commissioner, 5 P-H 1948 Fed Tax Serv. ¶ 72,361 (C. C. A. 3d 1948). The rule that during the period of administration, the beneficiary is taxed only on income paid or credited to him applies even where provision is made that the income is to be paid to the beneficiary from the date of death. The courts have held that such provision does not require the executor to pay out the income during the period of administration. First Nat. Bank of Memphis, 7 T. C. 1428 (1946); Estate of Peter A. Bruner, 3 T. C. 1051 (1944).

110. Commissioner v. Stearns, 65 F. 2d 371 (C. C. A. 2d 1933); Estate of Peter A. Bruner, supra note 109.

111. Estate of B. Brasley Cohen, 8 T. C. 784 (1947).

112. See Estate of Andrew J. Igoe, 6 T. C. 639 (1946).