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BECAUSE of the nearly universal applicability of federal income taxation to decedent's estates, a working knowledge of the income tax rules that pertain to estates is vitally important to the lawyer responsible for the administration of an estate. The purpose of this article is to review the general principles which govern the income taxation of an estate and to emphasize certain specific tax opportunities and pitfalls which may arise during the course of administration.

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The discussion will focus on four areas of estate income taxation: (1) income splitting among multiple taxpayers — the phenomenon which provides many of the tax saving opportunities in the income taxation of estates; (2) the basic pattern of the income taxation of estates; (3) the estate income tax return; and (4) a review of certain existing opportunities and pitfalls in the area of estate taxation.[1]

I. INCOME SPLITTING AMONG MULTIPLE TAXPAYERS

From an income tax point of view, death terminates the existence of one taxpayer, but simultaneously creates a new one — the estate. The decedent's taxable income includes only income which he has received prior to his death. Income received by his estate is taxable to his estate. The taxpayer's death splits income in the year of death between the decedent and his estate.

There is another dimension to income splitting. If a decedent's property passes immediately to his heir, the income from that property would be taxable to the heir. Since it would be added to the heir's other income, the inherited property income would be taxed

[1] It will be assumed that both the decedent and the estate are on the cash basis of accounting, this being the most commonly encountered situation; it is possible, of course, that either the decedent or the estate or both will be on the accrual basis.

to the heir at rates commencing with his highest bracket. By contrast, if the income remains in the estate, it is taxed at rates commencing with the estate's lowest bracket. Here, income can be split between the estate and the heir depending on the relative tax bracket of each. Thus, death creates a new taxpayer, the estate, and often affords an opportunity to split income among multiple taxpayers.

II. MULTIPLE TAXPAYERS

A. The Decedent

While death ends the decedent's status as a taxpayer, a return must be filed in his name covering the portion of the year during which he was alive. Three general rules are commonly applicable to a decedent's final return. First, the final return for the decedent is made on form 1040 by his administrator, executor, or legal representative.[2] Second, the final return includes only that income which was actually or constructively received by the decedent prior to his death. Third, there is no obligation to file a declaration of estimate or to continue making payments on a declaration of estimate filed by the decedent. However, the surviving spouse must continue to make estimated payments on her own income and, indeed, if a joint estimate has been filed, the surviving spouse is liable for payment of installments of the joint estimated tax unless she files an amended declaration giving her separate estimated tax for the year.[3] Fourth, deductions are allowed only for amounts actually paid before death.[4] Fifth, if the decedent left a surviving spouse, there can be filed for the year of death either separate returns or a joint return which would include the decedent's income until his death. The decision to file jointly or separately should be made only after a comparison of the total taxes due under each method. If a joint return is filed, the executor and surviving spouse should agree on what portion of the tax is to be contributed by each.[5]

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[2] This return is due on April 15 of the year following the year in which death occurs.

[3] Treas. Reg. § 1.6015(b)-1(c) (1957) [hereinafter cited as Reg. §].

[4] An exception to this rule is provided for decedent's medical expenses. Thus, under INT. REV. CODE OF 1954, § 213(d) [hereinafter cited as CODE §], such expenses, if paid within one year after death, are treated as paid when incurred. This deduction can be taken either on the income tax return or on the estate tax return, but not in both places. CODE § 213(d); Reg. § 1.213-1(d) (1960).

[5] Some guidance is afforded by Rev. Rul. 290, 1965-1 CUM. BULL. 445, which states that in determining the amount of an estate tax deduction to be taken for decedent's final income tax obligation, the estate can deduct that proportion of the joint tax that the tax for which decedent would have been liable on a separate return bears to the total taxes that decedent and spouse would have paid for the period prior to death had separate returns been filed for that period.

B. *The Spouse*

Prior to death, the decedent and his spouse were probably filing a joint return which is itself a kind of automatic income splitting device. After death, the benefits of joint return filing will no longer be available, with certain exceptions.[6] However, the spouse's income and that of the estate can be reported separately during the period of administration, since the spouse and the estate constitute separate taxpayers.

C. *The Estate*

In the year of death, income is split between the decedent's final return and the estate. During the entire period of administration, income can be split between the estate and the beneficiaries. Thus, the estate's income can be allocated entirely to the estate, or to the beneficiaries, or be divided between estate and beneficiaries in whatever manner is most advantageous from a tax standpoint. Two very important aspects of this splitting are that the allocation can be controlled and that the opportunity continues for as long as the estate remains open.[7]

D. *The Beneficiary*

The beneficiary, absent the interposition of the estate, will be taxed on the income from the decedent's assets. The presence of the estate makes it possible to split the income at the point that is most advantageous for the whole family unit. As a general rule, estate income is taxed to the estate unless there is a residuary distribution.[8] When there is such a distribution, then the taxable income is shifted to the beneficiary.[9] There may be more than one beneficiary and each is a separate taxpayer. If the decedent's will provides for distribution to a trust, the trust is treated as a separate taxpayer, although, depending upon the terms of the trust, the income may be automatically taxable to the trust beneficiary. For the present discussion, it is sufficient to realize that trusts can be used as additional taxpayers, separate and apart from the estate and the beneficiaries.

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[6] A joint return can be filed for the year of death. In addition, *joint return rates* are available to the surviving spouse for two years after death if she maintains a household for a dependent child and does not remarry.

[7] It is axiomatic, of course, that the administration cannot be prolonged indefinitely. See Reg. § 1.641(b)-3 (1956), as amended, T.D. 6353, 1959-1 CUM. BULL. 163, as amended, T.D. 6462, 1960-1 CUM. BULL. 49.

[8] CODE §§ 661, 663.

[9] CODE §§ 662, 663.

III. The Basic Pattern of Income Taxation of Estates

The reduction of income tax by channeling taxable income away from upper bracket taxpayers and towards those in lower brackets is made possible by the basic pattern of income taxation of estates. Two key concepts are involved in this pattern: the separate taxable entity concept and the conduit concept.

A. Estate as a Separate Taxable Entity

Under the separate taxable entity concept, the estate is considered to be a separate taxpayer. As a taxpayer, the estate's income is taxable to it beginning at the lowest bracket. The estate has its own 600 dollar exemption, and is entitled to appropriate deductions. The estate remains a separate taxpayer until it is closed, except where residuary distributions are made by it, in which case the conduit theory may be brought into play.

B. Estate as a Conduit

Under the conduit concept, where the estate makes a residuary distribution, whether of income or of principal, the taxability of estate income shifts from estate to distributee.[10] Thus, the estate changes from a separate taxable entity to a conduit. The income flows through the estate to the distributee. The flowing income retains, in the hands of the distributee, the same character that it had in the hands of the estate.[11] Thus, capital gains to the estate become capital gains to the distributee, dividends to the estate become dividends to the distributee, and interest to the estate becomes interest to the distributee.

C. Application of the Basic Concepts

The application of these concepts is relatively simple. If no distribution is made by an estate during its taxable year, all income is taxed to the estate. If, on the other hand, the estate makes a residuary distribution, then, while the estate reports its income, it also takes an offsetting deduction to the extent of the distribution. The distributee then must report the income so distributed in his own return.

A simple example will illustrate the application of these prin-

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[10] CODE §§ 661-63.

[11] CODE §§ 661(b), 662(b).

ciples. It will be assumed that a decedent dies on June 30, 1965, that his estate earns 5,000 dollars of income for the period from June 30 to December 31, 1965, and that the estate files its return on a calendar year basis. If the estate makes no distribution in 1965 and deducts only its 600 dollar exemption, the estate's income tax on that 5,000 dollars of income will be 778 dollars. If, on the other hand, the estate were to distribute the 5,000 dollars in 1965 to a distributee who has 10,000 dollars of other taxable income for 1965, then the 5,000 dollars would not be taxed in the estate, but would be subject to an income tax of up to 1,750 dollars in the hands of the distributee. The retention of the 5,000 dollars of income for taxation in the estate will save about 1,000 dollars of tax.

Of even greater significance is the fact that similar savings can be realized during each year that the estate remains open. Continuing the example, assume that the estate remains open for two more calendar years, 1966 and 1967, during each of which it realizes 10,000 dollars of income, and that no residuary distributions are made until January 1, 1968. In addition, assume that during each of these years the distributee had 10,000 dollars of his own taxable income. The following tabular comparison illustrates the potential tax savings:

Period	Estate Income	Tax to Estate if no Distribution	Tax to Distributee on Income if Distribution	Possible Tax Saving
7/1/65 to 12/31/65	$ 5,000	$ 788	$1,750	$ 972
1/1/66 to 12/31/66	10,000	2,022	3,880	1,858
1/1/67 to 12/31/67	10,000	2,022	3,880	1,858
Total Estate Income	$25,000			
Total Possible Income Tax Savings Over Period of Administration				$4,688

IV. THE ESTATE'S FEDERAL INCOME TAX RETURN

Having reviewed the general conceptual patterns, the estate's income tax return should now be examined. In reviewing the tax return itself, three areas will be considered: (1) the estate's income; (2) deductions other than the distribution deduction; and (3) the distribution deduction.

A. *The Estate's Income Tax Return: Gross Income*

In general, Internal Revenue Code section 641(b) provides that the taxable income of an estate is to be computed in the same manner as that of an individual.[12] The responsibility for reporting income extends to all income received by the estate during the period of administration.[13]

(1) Income in Respect of a Decedent.—An aspect of estate income taxation which is responsible for much confusion is "income in respect of a decedent." The taxability of such income is governed by section 691 of the Code.[14] The regulations define income in respect of a decedent as amounts to which the decedent was entitled as gross income, but which were not properly includable in computing his taxable income for his final year.[15] Such income includes accrued income of a decedent on the cash basis and income to which a decedent had a contingent claim at death.[16] However, the language of the regulations is very general and it is necessary to examine the authorities for further definition.

Income in respect of a decedent has been held to include the value of services rendered by the decedent which were capable of approximate valuation. Thus, in *Helvering v. Estate of Enright*,[17] a partner's share in the profits of a law partnership including un-

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12 CODE § 641(b) specifies that the return shall be made and the tax paid by the fiduciary.

13 Reg. § 1.641(a)-2 (1956). So far as the duration of the period of administration is concerned, the regulations also specify that the period of administration is the period *actually required* by the fiduciary to perform the ordinary duties of administration, regardless of whether such period is longer or shorter than the period specified by local law for settlement of an estate. Reg. § 1.641(b)-3(a) (1956).

14 Perhaps some of the confusion which enshrouds this topic can be dispelled with a short review of the development of the concepts of taxation in this field. Prior to 1934, the courts had held that income accrued by a cash basis decedent prior to his death was not taxable in the decedent's final return because it had not actually been paid to him. Nor was such income taxable in his estate, because it came into the estate as capital and not as income. Nichols v. United States, 64 Ct. Cl. 241 (1927), *cert. denied*, 277 U.S. 584 (1928). Thus such income completely escaped income taxation. To close this gap there was enacted § 42 of the Revenue Code of 1934, ch. 277, § 42, 48 Stat. 680, which provided that *all* income accrued at death was taxable in the final return of the decedent. This resulted in severe taxpayer hardship since there was a bunching of income in the decedent's final year, with the result that income accrued at death was subjected to higher rates of tax than would be applicable if the income were spread out over the period it was received. See Helvering v. Estate of Enright, 312 U.S. 636 (1941). To alleviate the hardship, Congress in 1942 enacted § 126(a) of the Internal Revenue Code of 1939, ch. 619, § 126(a), 56 Stat. 798. Under § 126(a) income in respect of a decedent was taxed as received to the person who acquired the right to receive it, so that the income was taxed as received, and was not bunched in the decedent's final year. CODE § 691(a) corresponds to § 126(a).

15 Reg. § 1.691(a)-1(b) (1957), as amended, T.D. 6808, 1965-1 CUM. BULL. 12.

16 Reg. § 1.691(a)-1(b) (1957), as amended, T.D. 6808, 1965-1 CUM. BULL. 12. See also Richardson v. United States, 177 F. Supp. 394 (E.D. Mich. 1959), *aff'd*, 294 F.2d 593 (6th Cir. 1961), *cert. denied*, 369 U.S. 802 (1962); Estate of Sarah L. Narischkine, 14 T.C. 1128 (1950), *aff'd*, 189 F.2d 257 (2d Cir. 1951).

17 312 U.S. 636 (1941).

collected accounts and his share of the value of unfinished work were held to be includable as accruable items in the final return. Indeed, income earned after death has been held to constitute income in respect of a decedent where, under a partnership agreement negotiated by the decedent, his widow was entitled to a portion of partnership earnings for ten years after death.[18] Thus, income in respect of a decedent includes not only income which has already accrued at the date of death, but also includes income which results from the pre-death efforts of the decedent.[19] The distinction between income resulting from the efforts of the decedent and income generated by his assets can be a fine one. In Revenue Ruling 57-544,[20] the Commissioner stated that royalty payments under a publishing contract, where there was a sale by the author of all his rights, were income in respect of a decedent. In a later ruling,[21] the Commissioner announced that royalty payments under a nonexclusive licensing agreement were ordinary income — but not income in respect of a decedent. The distinction, presumably, was based upon the fact that in the first instance there was a sale with payments deferred, while in the second instance the property generating the post-death income itself passed at death and was not merely a deferred right to income.

Salary accrued, but not paid at death, is income in respect of a decedent.[22] A problem may arise when an employer makes gratuitous payments after death. If such a payment is a gift, it is probably not income in respect of a decedent. However, it has been held that noncontractual payments made by an employer to the employee's estate were income in respect of a decedent and not gifts, on the grounds that they related to past services of the decedent.[23]

Under the partnership sections of the present Internal Revenue Code,[24] the partnership's taxable year generally does not close with respect to the deceased partner until the end of the regular partner-

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18 United States v. Ellis, 264 F.2d 325 (2d Cir. 1959).

19 See Frances E. Latendresse, 26 T.C. 318 (1956), *aff'd*, 243 F.2d 577 (7th Cir.) *cert. denied*, 355 U.S. 830 (1957), holdiing insurance renewal commissions to be income in respect of a decedent.

20 Rev. Rul. 544, 1957-2 CUM. BULL. 361.

21 Rev. Rul. 227, 1960-1 CUM. BULL. 262.

22 Reg. § 1.691(a)-2(b) (1957).

23 Bausch's Estate, 14 T.C. 1433 (1950), *aff'd*, 186 F.2d 313 (2d Cir. 1951); Estate of O'Daniel, 10 T.C. 631, *aff'd*, 173 F.2d 966 (2d Cir. 1949).

24 See generally CODE §§ 692-771.

ship year.[25] At the end of the year the estate is taxed on the decedent's share of the entire year's distributable earnings. Thus, even though the decedent withdrew part of the current year's earnings prior to death, the decedent's final return will not include any partnership income. The partnership income for the entire year will be includable in the return of the estate which covers the date on which the partnership year ends. To the extent that such partnership income is attributable to the decedent for the period ending with his death, this part of the distributable share of partnership income is income in respect of a decedent.[26]

Subchapter S of the Internal Revenue Code[27] provides that certain corporations can elect special tax treatment which permits corporate income to be taxed directly to the shareholders. Section 1373 provides that any undistributed taxable income at the end of the corporation's year shall be taxed as dividends to the shareholders on the last day of the corporation's year. Where a decedent shareholder in a Subchapter S corporation dies shortly before the end of the corporation's taxable year, with no dividends having been declared prior to his death, and with the estate succeeding the decedent as a shareholder in the corporation,[28] the estate is the shareholder on the last day of the year, and all of the corporation's undistributed income is taxable to it. Since this income accrued over the entire year while the decedent was a shareholder, the question arises as to whether the income is to be treated as income in respect of a decedent, so that the deduction allowed for estate tax attributable to such income is available to the estate.[29] The Com-

[25] CODE § 706; Reg. § 1.706-1(c)(3) (1956). Note that CODE § 736 and the regulations thereunder set forth special rules for treatment of payments made in complete liquidation of the entire interest of a deceased partner. In essence, these rules are concerned with what part of a liquidating payment is income and what part is return of capital. Space does not permit detailed treatment, but since a liquidating payment would seem to relate to decedent's efforts, it would seem that all of such a payment is income in respect of a decedent and would, under the rules of CODE § 691, retain to the recipient the same income or capital character it would have had to the deceased partner.

[26] Estate of Freund, 35 T.C. 629, *aff'd*, 303 F.2d 30 (2d Cir. 1962).

[27] CODE §§ 1371-77.

[28] Assuming that the proper election and consent formalities have been observed.

[29] A different problem is raised with respect to Subchapter S undistributed earnings for years prior to the year of death. The decedent has already paid a tax on such income. Were he still living the income could be distributed to him free of further tax. However, under Reg. § 1.1375-4(e) (1959), the right to nondividend treatment of previously undistributed but taxed income is personal to the shareholder to whom that undistributed income had previously been taxed; accordingly the previously taxed income when paid out to the estate will be taxable as a dividend to the estate to the extent that the corporation has current year, or past years', accumulated earnings and profits.

missioner has ruled that since there was no dividend declared at death, and since only shareholders in existence on the last day of the corporation's year are required to include undistributed income, the corporation's undistributed taxable income for the entire year is income to the estate but no part of it constitutes income in respect of a decedent, and that therefore no deduction is allowable under section 691(c).[30]

Another question of concern is who must report income in respect of a decedent. There are three general rules in this area. First, income in respect of a decedent is reported by the recipient, which may or may not be the estate.[31] Second, income in the hands of the recipient keeps the same character it would have had for the decedent. What would have been capital gain to the decedent is capital gain to the recipient, and what would have been ordinary income to the decedent is ordinary income to the recipient.[32] Third, a transfer by the recipient *may* accelerate the time of taxability. Thus, if decedent had a contractual right to have his employer make payments to his widow for five years and if after his death the widow sells such right, in the year of sale there will be taxable to her either the fair market value of the right at the time of sale or the consideration for the transfer, whichever is greater.[33]

An unusual aspect of income in respect of a decedent is the fact that the receipt of such income may also generate a deduction for the recipient.[34] The deduction is given to remedy the inequity of double taxation. The rationale for subjecting such income to income tax is that the income would have been taxed to the decedent had he lived. However, had he received the income before death and paid a tax on it, the income included in his estate for estate tax purposes would have been reduced by the income tax previously paid on it. Since income in respect of a decedent is subjected to estate tax *before* it is reduced by income tax, some nonexistent property (that part of the income which goes to the tax collector) would be subject to the estate tax. Section 691(c) ameliorates the inequity

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[30] Rev. Rul. 64-308, 1964 INT. REV. BULL. NO. 48, at 12. The logic of the ruling might be questioned in view of the very broad language of the cases relating income in respect of a decedent to the decedent's activities during his lifetime.

[31] CODE §§ 691(a)(1)(A)-(C).

[32] CODE § 691(a)(3).

[33] CODE § 691(a)(2).

[34] CODE § 691(c).

by giving to the recipient of income in respect of a decedent a deduction for the estate tax attributable to such income. The Code and regulations contain detailed rules for the computation of the deduction.[35]

(2) Dividends as Income.—The determination of whether dividends constitute income to estates is made according to the same rules applied to individuals in similar situations. Ordinarily, of course, all dividends are income. A common problem is whether a dividend paid close to the time of death is income to the decedent or to the estate. In the case of the usual cash dividend, there are three significant dates: the date of declaration, the record date, and the date of payment. There are three general rules governing this area: (1) If death follows the payment date, the dividend is included in the decedent's final return; (2) If death occurs before payment but after the record date, the dividend is income in respect of a decedent[36] when received by the estate and reported by the estate; and (3) If death occurs before the record date, the dividend is income to the estate. Dividends declared prior to death but payable to shareholders of record after death are not income in respect of a decedent[37] because, while the amount of the dividend was fixed, the ascertainment of the identity of the recipient was not known until after death.[38] In *Estate of Putnam v. Commissioner*,[39] the United States Supreme Court clearly implied that had the death involved in that case occurred after the record date, the dividend would have been income in respect of a decedent.

(3) Interest as Income.—In the case of interest, there is a similar problem of determining whether interest is income to the decedent or to the estate. In general, interest which could have been collected by the decedent as of the date of death should be treated as income in the decedent's final return.[40] If interest can be collected only periodically, then the decedent's final return should report only interest due on the last payment date prior to death;

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35 CODE § 691(c); Reg. § 1.691(c)-1 (1957).

36 Income in respect of a decedent includes those amounts to which the decedent was entitled as gross income but which were not properly includable in computing taxable income for his final year. Reg. § 1.691(a)-1(b) (1957). See text accompanying notes 14-35 *supra.*

37 See text accompanying notes 12-16 *supra.*

38 Estate of Putnam v. Commissioner, 324 U.S. 393 (1945).

39 *Ibid.*

40 Reg. §§ 1.451-2(a), (b) (1957), as amended, T.D. 6723, 1964-1 CUM. BULL. 73.

interest accruing from then to the date of death is income in respect of a decedent to the person who later receives the interest payments. Interest accruing after the date of death is income to the estate.[41]

(4) *Real Estate Rentals and Gains.*—Income from real estate often poses a more difficult problem as to who reports the income. When a person dies, the income from his personal property belongs to and is taxable to the estate.[42] However, in many states, including Ohio, title to real estate passes directly upon death to the heirs or devisees, who themselves become entitled to possession of the real estate and income from it.[43] The problem, then, is whether rents and profits are taxable to the estate or directly to the heirs or devisees.

Since the test of taxability seems to be whether the estate is entitled to possession of the real property and to the rents,[44] and since in Ohio the right to possession and to rents passes directly to the devisee, such income seems to be taxable to the devisee and not to the estate.[45] Ohio Revised Code section 2113.311, which permits an executor to collect rents as the agent of the devisee, would not seem to alter this result. Nor would the result be changed by the presence in the will of a mere power of sale,[46] although, if a sale becomes necessary to pay debts or legacies, the rule may be different as to any gain on the sale.[47] If the will contains a direction of sale, as distinguished from a mere power, the real estate should probably be treated as an asset of the estate with the income therefrom taxable to the estate.

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[41] For United States Savings Bonds there is a special rule. Interest represented by increment in value at the date of death (but previously unreported by the decedent) is income in respect of a decedent when the estate or person succeeding to the bond redeems or disposes of it. Increases in redemption price after death are ordinary income to the estate or other recipient. See Reg. § 1.691(a)-2(b) (1957); Rev. Rul. 104, 1964-1 CUM. BULL. 223.

[42] See 22 OHIO JUR. 2D *Executors and Administrators* § 84 (1956).

[43] Overturf v. Dugan, 29 Ohio St. 230 (1874); see generally 22 OHIO JUR. 2D *Executors and Administrators* § 144 (1956).

[44] Rev. Rul. 133, 1957-1 CUM. BULL. 200 states that income from real property is taxable to the estate if the real property is "subject to administration." How this test is applied is not entirely clear. However, the cases provide a more certain guideline: income is taxable to either the estate or the devisee depending upon which is entitled to possession and control of the real estate, and to the rents and profits thereof, during administration. See Estate of McBirney, B.T.A. Memo Docket No. 108982 (June 23, 1942).

[45] Guaranty Trust Co., 30 B.T.A. 314 (1934); George L. Craig, 7 B.T.A. 504 (1927).

[46] George L. Craig, *supra* note 45.

[47] Rev. Rul. 375, 1959-2 CUM. BULL. 161.

B. *The Estate's Income Tax Return: Deductions Other Than the Distribution Deduction*

The deductions and credits in the estate's income tax return are, except as otherwise provided, the same as those allowed to individuals.[48] There are, however, certain special rules. Each estate is allowed, in lieu of personal exemptions, a deduction of 600 dollars;[49] however, the optional standard deduction is not available to an estate.[50] Deductions for casualty losses, business losses, and losses in transactions entered into for profit are available to the estate.[51] The deduction most commonly utilized by an estate is that allowed for administration expenses, such as court costs, appraisers' fees, and executors' and attorneys' fees.[52] Interest paid by an estate may be deductible.[53]

The estate may also be entitled to a charitable deduction.[54] The rules on the charitable deduction differ considerably from those applicable to individuals. While there is no limit on the amount of the deduction, in order for an estate to qualify for the deduction, the payment to charity must be from income and must be paid or permanently set aside for a proper charitable purpose during the taxable year.[55]

One additional, but different, facet of the charitable deduction should be mentioned. Where residuary estates are left to charity,

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[48] CODE § 641(b).

[49] CODE § 642(b).

[50] CODE § 142(b)(4).

[51] CODE § 165. Note that Reg. § 1.165-7(c) (1960) and Reg. § 1.165-8(b) (1960) specify that for a casualty or theft loss income tax deduction, the option to take it as an estate tax deduction must be waived.

[52] Some attorneys' fees may *not* be deductible. See Estate of Henry Leaf, 33 P-H Tax Ct. Mem. 1639 (1964), holding a portion of attorneys' fees for defending a will contest to be nondeductible to the individual legatee who paid them.

[53] CODE § 163. Note that interest paid on overdue taxes may not be available as an estate tax deduction. Ballance v. United States, 347 F.2d 419 (7th Cir. 1965); Union Commerce Bank v. Commissioner, 339 F.2d 163 (6th Cir. 1964); however, such interest payments are apparently deductible for income tax purposes, and should therefore be taken on the income tax return rather than on the estate tax return. J. S. Hoffman, 36 B.T.A. 972 (1937), *acq.*, 1938-1 CUM. BULL. 15; Income Tax Unit Ruling 1317, I-1 CUM. BULL. 298 (1922).

[54] CODE § 642(c).

[55] An interesting interplay between the charitable deduction and the distribution deduction is pointed up in United States v. Bank of America Nat'l Trust & Sav. Ass'n, 326 F.2d 51 (9th Cir. 1963). In this case decedent's residuary estate was left in trust with the income payable to individuals and the corpus to pass to charities on their deaths. In the estate's first year, it distributed to the trust corpus in an amount in excess of estate income, thus receiving a distribution deduction to offset estate income. Since the property delivered to the trust was *corpus*, the court held that the trust was entitled to a charitable deduction. The result: no tax on the estate's income for that year.

estates have frequently claimed an income tax deduction for administration expenses, and on the estate tax return have taken a charitable deduction for the entire residuary estate *unreduced* by administration expenses. Both the Ninth[56] and Fifth[57] Circuits have now held that the amount of the estate tax charitable deduction must be reduced by administration expenses even though those expenses were taken as income tax deductions.

Another possible income tax deduction to which the estate may be entitled is that for depreciation and depletion.[58] If alternate date valuation is used, that valuation will be the basis for depreciation.[59] In general, the rule for an estate is that depreciation must be allocated between the estate and beneficiaries in the same proportion as income is allocated.[60]

A slightly different category of deductions are those "in respect of a decedent." Earlier it was noted that income accrued but not paid prior to death is, under section 691, taxable to the person who receives it.[61] A corollary to taxation of accrued, but unpaid, income is the allowance of a deduction for certain accrued, but unpaid, expenses.[62] Thus, the following deductions, if accrued prior to death, but paid after death, can be taken: (1) business expenses;[63] (2) interest;[64] (3) taxes;[65] (4) expenses incurred in the production of income;[66] and (5) depletion.[67] The deduction is available to the estate or person charged with the obligation. Perhaps the most significant aspect of the deduction in respect of a decedent is that it can be taken *both* for income tax under section 691(b) and for estate tax purposes under section 2053(a)(3). The section 642(g) rule against double deductions does not apply.

One significant limitation applies to *all* estate income tax deductions, except deductions in respect of a decedent and the distribu-

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56 Republic Nat'l Bank v. Commissioner, 334 F.2d 348 (9th Cir. 1964).

57 Alston v. United States, 348 F.2d 72 (5th Cir. 1965).

58 CODE §§ 167(h), 611(b), 642(e).

59 Rev. Rul. 223, 1963-2 CUM. BULL. 100.

60 Where actual income distributions are made to a beneficiary even though he is not entitled to mandatory income payments, he is entitled to a portion of the depreciation deduction. Estate of Nissen v. Commissioner, 345 F.2d 230 (4th Cir. 1965).

61 See note 22 *supra*.

62 CODE § 691(b).

63 CODE § 162.

64 CODE § 163.

65 CODE § 164.

66 CODE § 212.

67 CODE § 611.

tion deduction. Simply stated, a deduction may be taken either on the income tax return or on the estate tax return, but not in both places, although a particular deduction may be split between the two returns. If the estate elects an income tax deduction, then there must be filed with the income tax return a statement verifying that income tax deductions have not been allowed as estate tax deductions and waiving any right to have them so allowed. The timing of this statement is important because, once filed, the election cannot be changed. However, the fact that a deduction is taken on an estate or income tax return will not preclude a subsequent change so long as the estate tax deduction has not been finally allowed before the change. The statement does not have to be filed at the same time as the income tax return. It can be filed at any time before expiration of the statutory limitation period for the particular return. The moral is clear: the statement should not be filed until it is certain where the deduction is to be taken.

C. *The Estate's Income Tax Return: The Distribution Deduction*

The distribution deduction constitutes an important part of the mechanism for shifting taxable income from the estate to the distributee. If the estate makes a distribution, taxability of income generally is shifted from the estate to the distributee by giving the estate a deduction and requiring the distributee to report the income. The estate's deduction is equal to the amount of the distribution but cannot exceed "distributable net income" computed under section 643(a).[68] Generally, "distributable net income" is the same as the estate's taxable income.

A distribution of either income or principal will generally shift the tax burden. However, there are certain distributions which will not shift the burden: (1) payment of the widow's year's allowance and the distribution of property exempt from administration;[69] (2) the passing of an interest in Ohio real estate to heirs or devisees;[70] (3) satisfaction of a bequest of specific money or property, if paid or credited in not more than three installments;[71] and (4) a payment which qualifies for the section 642(c) charitable deduction.[72]

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[68] CODE § 661(a).

[69] Reg. § 1.661(a)-2(e) (1956).

[70] *Ibid.*

[71] CODE § 663(a)(1).

[72] CODE § 663(a)(2).

The accumulation distribution and five-year throwback rules do not apply to estates.[73] Thus, if an estate accumulates income in one year, and distributes to a beneficiary on the first day of the next year, there will be no shifting of that income from estate to beneficiary.

If, in an estate's final year, it has certain deductions in excess of income, the excess deductions are not carried over to the distributee and are available to him as deductions for the year in which the estate closes.[74]

V. OPPORTUNITIES AND PITFALLS IN ESTATE INCOME TAXATION

A. Inadvertent Shift of Income from Estate to Beneficiary

An estate's flexibility in income allocation affords an opportunity to shelter estate income from the impact of beneficiaries' high brackets by retaining income in the estate. However, there are pitfalls which may result in an inadvertent shift of income from estate to beneficiary: (1) Any distribution to satisfy a residuary legacy, whether of income or principal, will shift income to the distributee; (2) If the will provides for a residuary trust which requires payment of income to a beneficiary, a distribution to the trust will result in a "double shift"; estate income shifts to the trust, and trust income shifts to the beneficiary; and (3) An extension of the "double shift" principle is at least hinted at in a recent case which indicates that if a will directs the estate to commence trust benefits immediately at death (as distinguished from merely *authorizing* the commencement of such benefits), then income may be taxable to the beneficiaries *during* the estate administration even though the trust has not yet been established and the income has not been actually distributed.[75]

B. Estate's Determination of the Taxable Period

An opportunity for tax saving may arise from the estate's right to select its own taxable period. Selection of a fiscal year can split income at the inception of administration. However, there is a cor-

[73] Reg. § 1.665(a)-0 (1956).

[74] CODE § 642(h).

[75] McMillan Lane v. United States, 233 F. Supp. 856 (M.D. Ala. 1964), holding, where a will only *authorized* the executor to make trust payments during estate administration, that undistributed income was not taxable to the beneficiaries during the estate administration period. There is some indication in the opinion that the conclusion might have been otherwise had the will *directed* payment of income during the administration period.

ollary pitfall, since care must be used to avoid lumping income at the close of administration. Suppose a death occurs on January 1. The estate could close its first year on June 30, and report only one-half of a year's income in its first return. However, if the estate closes and distributes on the following June 30, the beneficiary will be taxed on the total of his own income, plus one year's estate income, plus six months' income from the assets formerly in the estate. There are several ways to avoid this danger. First, instead of distributing at the end of its fiscal year, the estate could wait and distribute on the first day of its next fiscal year. Then the estate, rather than the beneficiary, would report the full fiscal year's income.[76] Second, the estate could postpone paying administration expenses (such as executors' and attorneys' fees) until its final year. Those expenses could then be taken as an income tax deduction to offset income received during that final year.

C. *Periodic Distribution of Income*

Another tax saving opportunity arises from the estate's ability to sprinkle income by making periodic distributions during administration. If the estate has high income and the beneficiaries have low income, the estate can periodically shift income from its high brackets to the beneficiaries' lower brackets. Care must be exercised to insure that distributees are not given unequal tax burdens. To avoid this problem, if there are several residuary legatees, it would probably be best to make proportionate distributions to all at the same time.

D. *Use of Deductions*

A great deal of flexibility surrounds the use of deductions, but there are also many related pitfalls. One deduction opportunity involves the option to use deductions either for income tax purposes or for estate tax purposes, but not for both. However, as was previously mentioned,[77] if the required statement[78] is filed with the income tax return, the election cannot later be changed if it subsequently is determined that an estate tax deduction would have been more advantageous.

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[76] In any postponement of the closing of an estate regard must be had for the Commissioner's view that any period of administration which has been unreasonably prolonged will be considered terminated at the end of a "reasonable period" for performance of the executor's duties. Reg. § 1.641(b)-3 (1956), as amended, T.D. 6353, 1959-1 CUM. BULL. 163, and T.D. 6462, 1960-1 CUM. BULL. 49.

[77] See p. 669 *supra*.

[78] Reg. § 1.642(g)-1 (1956).

The manner in which the deduction is taken may affect substantive rights of beneficiaries. For instance, suppose a will leaves the maximum marital deduction to the widow and the residue to others. If deductions are taken on the income tax return, the estate tax deduction will be less, but the adjusted gross estate, and also the marital deduction bequest, will be greater — at the expense of the residuary legatees. Changes in substantive interests resulting from electing the most favorable overall tax treatment should be adjusted among the beneficiaries. There is a developing body of case law on how this adjustment should be accomplished.[79]

Another opportunity in the use of deductions lies in section 642(h) which permits excess expense and loss deductions in the year of termination to be carried over to the beneficiaries. There are, however, two primary pitfalls. First, if the administration has been unreasonably prolonged, the regulations specify that the administration will be deemed terminated after a "reasonable period."[80] The obvious difficulty of determining what is a reasonable period may render uncertain the determination of what is the final year. Second, if the distributee is a trust, the excess deduction may be lost. The carry-over deduction is allowed to the trust, and, to the extent that the deduction offsets trust income, it will benefit the beneficiary; but to the extent it exceeds trust income, the excess deduction will be lost.[81]

Still another opportunity in the use of deductions was demonstrated in an interesting case recently acquiesced in by the Commissioner.[82] In this case, almost all of decedent's assets were in an inter vivos trust, and her probate estate was small. Most of the work normally done by an executor was done by the trustee, and the trustee's fee for that work was deducted on both the estate tax return and the trust's income tax return. It was held that this double deduction was proper, although had the deduction been taken by an *estate* rather than a trust, a double deduction would not have been allowable under the rule of section 642(g).[83]

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[79] Estate of Bixby, 140 Cal. App. 2d 326, 295 P.2d 68 (1956); *In re* Levy's Estate, 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Surr. Ct. 1956); *In re* Warm's Estate, 140 N.Y.S.2d 169 (Surr. Ct. 1955).

[80] Reg. § 1.641(b)-3 (1956), as amended, T.D. 6353, 1959-1 CUM. BULL. 163, and T.D. 6462, 1960-1 CUM. BULL. 49.

[81] Reg. § 1.642(h)-5(e) (1956), as amended, T.D. 6828, 1965 INT. REV. BULL. No. 30, at 20.

[82] Commissioner v. Burrow, 333 F.2d 66 (10th Cir. 1964).

[83] *Id.* at 69.

E. *Unanticipated Income*

Two important pitfalls may involve the realization of unanticipated income. First, if a monetary legacy is satisfied by the distribution of assets which have appreciated in value over estate tax valuation, then the estate will realize a capital gain to the extent of such appreciation.[84] Second, an involuntary change in the accounting method without the availability of the relief provisions of section 481 could result in a tax nightmare.[85]

F. *Close Corporation Caveats*

If the estate owns stock in a Subchapter S corporation, in order to preserve the Subchapter S election, a timely consent must be filed by the estate.[86] Section 303 may afford an excellent opportunity to redeem stock in an amount necessary to pay death taxes without fear that the redemption proceeds will be treated as a dividend distribution.[87]

G. *Executor's Fees*

If a family member is to serve as executor, and if he does not wish to receive executor's fees, he will, nevertheless, be taxed on those fees unless he files a timely waiver. If a waiver is late, not only will it be ineffective, but indeed it may constitute the making of a taxable gift.[88]

VI. CONCLUSION

The flexibility of the federal income tax as it applies to estates affords many opportunities for tax savings. Unfortunately that very flexibility which creates opportunity also creates complexity and unanticipated hazards. Remaining abreast of the complexities in this area imposes a substantial burden on the estate practitioner. It is hoped that this article will ease that burden.

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84 Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Reg. § 1.661(a)-2(f) (1956).

85 Biewer v. Commissioner, 341 F.2d 394 (6th Cir. 1965) where the court denied access to § 481 relief to an estate after the Commissioner changed the estate accounting method from cash to accrual thus lumping into one year collections on accounts receivable from sales prior to death.

86 Reg. § 1.1372-3(b) (1959), as amended, T.D. 6615, 1962-2 CUM. BULL. 205, and T.D. 6707, 1964-1 CUM. BULL. 315.

87 CODE § 303.

88 Rev. Rul. 225, 1964-2 CUM. BULL. 15.