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INCOME TAX SAVINGS THROUGH PROPER TIMING AND SELECTION OF ESTATE INCOME DISTRIBUTIONS

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Few areas in tax law offer as many unfettered opportunities for income tax savings as are available during the administration of an estate. This freedom of choice exists particularly in the matter of the timing and selection of the type of estate distributions to be made.

Paradoxically, this freedom of action arises from certain statutory limitations. Because the statutory lines are drawn so clearly, the "open field" is clear. To understand this, let us examine the applicable provisions of the Internal Revenue Code and the Regulations. In addition, on the assumption that most of the readers are Ohioans, reference will be made to some sections of the Revised Code pertaining to the administration of estates.

STATUTORY AREA OF MANEUVERABILITY

How An Estate is Taxed

In general, income of an estate is taxed in the same manner as that of an individual.[1] But an estate is allowed two additional deductions:

(1) "For any amount of current taxable income which is required to be distributed currently under the terms of the will or local law, or which is properly paid or credited during the taxable year."[2]

(2) "For any amount of gross income, without limitation, which under the will is paid or permanently set aside during the taxable year for charitable purposes."[3]

Accordingly, an estate pays tax on its income properly retained. In turn, the beneficiary reports the amount of the estate's current taxable income required to be distributed or properly paid or credited to him during the estate's taxable year.[4] The latter amount includes any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of the estate's income for the taxable year.[5] For example, if the will provides that $1,200.00 be paid annually

1. INT. REV. CODE OF 1954, §§ 641(a), (b). (Hereinafter cited as §).
2. §§ 661(a)(1), (2); Treas. Reg. § 1.661(a)-2. (Hereinafter cited as Reg.).
3. § 642(c).
4. § 662(a).
5. § 661(a)(1).

to the sole beneficiary and the estate has $1,000.00 of taxable net income, the beneficiary must report $1,000.00 as taxable income even though the entire $1,200.00 may be and actually is paid from corpus.[6]

The Conduit Theory and Distributable Net Income

Coupled with the foregoing basic rules are several unique Code provisions which embody what is commonly referred to as the "conduit" theory. Interwoven with them is the statutory term "distributable net income."[7] Generally, distributable net income means the amount of taxable and non-taxable income of the estate, determined in an accounting sense, which is available for distribution to beneficiaries. The conduit theory is based on the principle that the distributable net income of the estate, which is distributed currently or paid or credited properly to a beneficiary, retains its same character in the beneficiary's hands.[8] For example, an estate's tax-exempt interest and long-term capital gain distributed in the year received are treated as such by the distributee. The amount distributed, or properly paid or credited to a beneficiary, is deemed to consist of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate, unless the terms of the will direct otherwise.

In order to determine the net amount of each class of income included in distributable net income, the expenses and deductions of the estate must be allocated in accordance with the Regulations.[9] The Regulations provide that all deductions attributable directly to any class of income (except dividends excluded under section 116)[10] must be allocated to that class. For example, costs of repairs, maintenance and collection of rents, taxes on and depreciation of rental property are allocated to rental income. Similarly, if an estate carries on a business, all expenses and deductions related to it are allocated to business income. In general, deductions not attributable to a specific class of income and the excess of deductions attributable to a specific class of income may be allocated to any item of income.

Effect of Estate's Taxable Year

An estate may choose a fiscal year or calendar year. If the taxable year of a beneficiary is different from that of the estate, the beneficiary reports his share of the estate's distributable net income for his taxable

6. Reg. § 1.661(a)-2(b).
7. For definition see § 643(a).
8. §§ 661(b), 662(b).
9. Reg. § 1.652(b)-3.
10. § 116.

year within which the estate's taxable year ends.[11] More will be said later as to how the estate's choice of a fiscal year may effect tax savings or lighten the fiduciary's administrative burden.[12]

BASIC TAX SAVING FACTORS

Subject to the foregoing statutory limitations, the extent to which any income tax savings may be effected is dependent chiefly upon the following four factors:

(1) The provisions of the will or the requirements of local law;

(2) The amount and character of the estate's income;

(3) The amount and character of the beneficiary's or beneficiaries' other income and deductions; and

(4) The time when the estate's income is reportable.

PRE-DEATH PLANNING

It is difficult to suggest will clauses of general application in the income tax-saving field. Not many situations permit pre-death calculations of a prospective estate's income which would forecast savings with any degree of accuracy, as is possible with respect to estate tax. Nevertheless, there are opportunities — most frequently in cases where the amount of saving could be substantial.

Suppose a client owns a large amount of tax-exempt municipal bonds and has two sons, *A* with high income and *B* with average income. He wishes to treat both sons alike. An effective direction in his will to provide a saving for *A* would be:

"During the administration of my estate, I direct that such net income thereof as my executor deems properly distributable be paid equally to my sons, *A* and *B*. To the extent available, I direct my executor to pay *A's* share thereof from any non-taxable income."[13]

Care must be taken, however, in using a similar *trust* clause in which the trustee is given discretion to allocate different classes of income to different beneficiaries. The Commissioner does not recognize this as a specific allocation.[14] Conversely, if a charitable organization is to be one of the beneficiaries, provision in the will might be made directing specifically that its share of the estate's net income be paid first from taxable income, thus enabling the taxpaying beneficiaries to enjoy the benefit of

11. § 662(c).

12. See discussion p. 165.

13. Reg. § 1.661(b)-1.

14. Reg. § 1.651(b)-2(b)(2). *But see* Craven, *Taxation of Estate and Trust Income*, 96 TRUSTS & ESTATES 112, 114 (1957).

any exempt income. Correspondingly, the maximum charitable deduction is obtained.[15]

Another saving device is the "sprinkling trust," in which the trustee is given the discretion to sprinkle the income among a group of beneficiaries and a direction to pay all or a set share of dividends from domestic corporations (subject to the dividends received exclusion and credit) or of royalties from mineral leases (subject to the depletion allowance), to a named individual in a high bracket.[16]

But all or much of such carefully laid plans may be nullified if circumstances arising during an estate's administration require a change in or a liquidation of investments.

POST-DEATH PLANNING

As soon as the decedent's personal representative has been appointed (even before, if it appears, for example, that there will be some delay in probating his will), the attorney must begin the assembly of the necessary tax-saving information, as previously outlined.

If the personal representative is a trust company, ordinarily its personnel will lighten the task of the attorney — at least as to the amount and character of the estate's prospective income. But if such is not the case, the attorney is obliged to take the initative. Merely ascertaining the assets of the decedent's estate is not sufficient.

Suppose the decedent has been employed by a corporation in an executive capacity. Inquiry may disclose that its Board of Directors is considering voting decedent a sizeable bonus in recognition of his past services. The estate's attorney may be in a position to suggest how such bonus will be paid — in a lump sum (when?) or installments (over what period?). But to make a worthwhile suggestion, the attorney first must be in a position to answer three questions as to the estate's other income: How much? What kind? When will it be received?

Along with ascertaining the inventory of the probable assets and the answers to these three questions, the executor and attorney should review the situation in the light of the requirements of the decedent's will. In fact, if the estate's gross income is $5,000.00 or more, the Regulations require that the fiduciary attach to the estate's first income tax return a statement of opinion, with references to the governing clauses of the will, as to the extent to which the income of the estate is taxable to the estate or to the beneficiaries.[17] A proper analysis of the will should provide reasonably accurate answers to these important questions:

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15. Reg. §§ 1.643(a)-5, 1.643(a)-6, 1.643(a)-7.

16. Mannheimer & Friedman, *Income Tax Aspects of Various Will and Trust Arrangements*, NYU 10TH INST. ON FED. TAX 909, 914 (1951); Price, *Defining Tax Consequences to Beneficiaries by the Use of Will Clauses*, NYU 16TH INST. ON FED. TAX 1049, 1057 (1958).

17. Reg. § 1.6012-3(a)(2).

(1) To what extent and to whom is the estate's income *required* to be distributed?

(2) *When* must such income be distributed?

(3) *What kind* of income must be distributed?

An early search for the answers to these questions may bring forth tax-saving opportunities which otherwise might be lost by the time the filing of the first return is due.

Finally, in order to complete the factual picture, the executor and attorney should ascertain the amount and character of the beneficiary's or beneficiaries' other income and deductions. Without this information, no estate income tax-saving planning can be effective. For example, if the principal income beneficiaries already have net taxable income of amounts subject to a tax bracket at least equal to that applicable to the estate, deferral of distribution for as long as possible may be the obvious answer. In such a situation and, as explained later,[18] for other reasons, the choice for the estate of a fiscal year may be proper.

Having assembled the pertinent data, the real work begins. Except in instances where the answer is clear that distribution of income should be postponed as long as permissible, there is no escape from the tedious task of making a series of computations to determine which available alternative will produce the greatest tax saving. The larger and more complicated estate, with multiple beneficiaries, will necessitate a more extensive series of computations, but at the same time it will provide more opportunities for the resourceful executor and attorney. Of course, there is no assurance that such computations will produce great tax-saving plans. But frequently they do. Furthermore, they may avoid embarrassing questions later, such as: "Why didn't you tell me that the income of John's estate could have been taxed to his estate for the first several years, instead of being added to the income from my own investments?"

An important part of such computations is a consideration of when distribution in kind may be made of other than specific bequests. Any distribution not qualifying as a specific bequest will be treated as a distribution of income of the estate for the year of distribution to the extent of the estate's entire income for such year. This is so even though the estate has collected little or no income in such year up to the date of the distribution.

For example, take the simple case where the husband left all of his property to his widow without mentioning specifically any item. The executor decides for one or more reasons that the tax on the first year's income of the estate should be paid by the estate. Decedent owned an

18. See discussion p. 165.

automobile appraised at $2,000.00. During the estate's first taxable year the time for securing new license plates arrives and the widow wants the certificate of title transferred to her. To avoid the common trap of the widow being taxed on the estate's current income to the extent of its value, the widow should be advised to select the automobile as part of her property exempt from administration.[19]

Although it may be argued by the Commissioner that property exempt from administration is not the same "as an allowance or award under local law for the support of the decedent's widow,"[20] it is submitted that there is no logical basis for any such distinction. Under Ohio law, both allowances are charges on the corpus of the estate.

CHOICE OF TAXABLE YEAR

Finally, calculations should include a choice of a taxable year based upon a calendar or one or more fiscal years. In this connection, it will be helpful to estimate how long the administration will take. The time recognized by the Regulations for administration of an estate is indeed fair and reasonable.[21] Generally, the choice of a fiscal year will provide the greatest amount of flexibility in deciding when to accumulate or distribute income. Moreover, even if it appears that no income is to be distributed, using a fiscal year may offer the best opportunity of evenly spreading the income over the longest possible period.

Use of a fiscal year ending shortly after the decedent's death may be a very effective way of isolating from other administration income the tax applicable to a post-mortem bonus payable by an employer. Also, because most individuals are on a calendar tax year, a January 31st fiscal year for the estate will enable a beneficiary to postpone paying tax on his distributive income.[22] For example, if a calendar-year beneficiary received on June 27, 1960, $5,000.00 of taxable income from an estate which has adopted a January 31st fiscal year, he would not be obliged to report it until 1961.

Although this discussion is directed to how income tax may be saved during the administration of an estate, a final word of caution seems appropriate. One must be careful not to become so imbued with tax-saving ideas or intrigued by the results of mathematical calculations as to subject the fiduciary to the possibility of personal liability. An apparent substantial income tax saving may boomerang on the fiduciary, if to accomplish it a non pro-rata distribution of income has been made among beneficiaries of the same class, the effect of which is to favor one

19. OHIO REV. CODE § 2115.13.
20. Reg. § 1.661(a)-2(e).
21. Reg. § 1.641(b)-3(a).
22. § 662(a).