Case Western Reserve Law Review

Volume 12 | Issue 2

1961

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or more beneficiaries. Similarly, to make a distribution prior to the expiration of the will contest period or a distribution which leaves insufficient assets in the estate to satisfy all creditors' claims, including state and federal taxes, would be folly. Even if such premature distributions are made, the fiduciary would be well advised first to secure the protection afforded by sections 2113.53 and 2113.54, Ohio Revised Code.

Most of what has been suggested presupposes an agreeable atmosphere. Should there be any doubt about it, the planning by the fiduciary and counsel should be carried on jointly with the beneficiaries.

### SUMMARY

Effective planning of estate income distributions to provide the best possible opportunities for income tax saving necessitates:

(1) Familiarity with sections, 641, 642, 643, 661, 662 and 663, Internal Revenue Code, and the applicable Regulations;

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

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

(4) Drafting or administering the will in the light of the foregoing; and

(5) Quite often, making a series of alternative computations.

## IV

## PROBLEMS INCIDENT TO THE TERMINATION OF ESTATES

J. H. Butala, Jr.

The termination of the administration of a decedent's estate presents both problems and opportunities to the executor.[1] Since income of the estate received in the year of termination is accorded different tax treatment from that given to income received in an interim year, it is important to make a correct determination of the actual year of termination. If adoption of a fiscal tax year is contemplated by the executor, he must know the extent to which he may control the year of termination to avoid a "bunching" of more than twelve months' income in the bene-

1. The term "executor" as used here and throughout is intended to include any personal representative of a decedent's estate. See INT. REV. CODE OF 1954, § 2203. (Hereinafter cited as §).

ficiaries' returns. A proper determination of the year of termination has become particularly important since the enactment of the present section 642(h)[2] of the Code under which "excess deductions" incurred in the year of termination are made available as deductions to beneficiaries succeeding to the property of the estate.

## WHEN DOES THE ADMINISTRATION TERMINATE?

When does an estate terminate for tax purposes? According to the Regulations,[3] and these are amply supported by court decisions,[4] local law does not control. In the interests of a uniform system of taxation, the test to be applied to determine termination is a factual one. The period of administration may last only for that period of time reasonably required to perform the ordinary duties of administration. The Regulations mention as duties of administration only the collection of assets and the payment of debts, taxes, legacies and bequests.[5] This test, however, is a broad one and is not applied literally. An executor may not be warranted in keeping an estate open until the last payment is collected upon a mortgage or an installment obligation, nor may he prolong administration until the last asset is reduced to cash to facilitate distribution.[6] Litigation involving the devolution of property or disputed claims is, of course, a valid reason for continuing the administration. Tax litigation, although it involves a relatively small amount in relation to the size of the estate, apparently will support continued existence of the estate as a separate tax entity.[7] Illness of either the fiduciary[8] or the beneficiary,[9] except when of a temporary nature, has not met with the courts' favor as a reason for continued administration. If the fiduciary and the beneficiary are the same, the estate will be subjected to closer scrutiny by the Internal Revenue Service.[10]

2. § 642(h).

3. Treas. Reg. § 1.641(b)-3(a). (Hereinafter cited as Reg.).

4. The following cases all hold that federal tax law controls over local law, but they also distinguish their fact situations from the one in Frederich v. Commissioner, 145 F.2d 796 (5th Cir. 1944), wherein the court allowed the estate to continue on the basis of an affirmative order of continuance, issued by the local probate court. There were no affirmative local court orders by courts having jurisdiction in Estate of Josephine Stewart, 16 T.C. 1 (1951), *aff'd,* 196 F.2d 397, 398 (5th Cir. 1952); Estate of Alma Williams, 16 T.C. 893, 901 (1951); Estate of W. G. Farrier, 15 T.C. 277, 280 (1950); Estate of William C. Chick, 7 T. C. 1414, 1421 (1946), *aff'd,* 166 F.2d 337, 341 (1st Cir.), *cert. denied,* 334 U.S. 845 (1948).

5. Reg. § 1.641(b)-3(a).

6. Estate of Alma Williams, 16 T.C. 893 (1951).

7. Estate of R. W. Harwood, 46 B.T.A. 750 (1942).

8. Estate of William C. Chick, 7 T.C. 1414, 1423 (1946), *aff'd,* 166 F.2d 337 (1st Cir.), *cert. denied,* 334 U.S. 845 (1948).

9. Estate of Alma Williams, 16 T.C. 893, 904 (1951).

10. See Estate of Josephine Stewart, 16 T.C. 1, 11 (1951), *aff'd,* 196 F.2d 397, (5th Cir. 1952); Estate of Alma Williams, 16 T.C. 893, 902 (1951).

*Business Enterprise*

Litigation concerning the duration of administration has frequently centered upon the continuation of a decedent's business enterprise. Although the character of the estate's assets has a bearing upon the length of administration, the existence of a business enterprise as an estate asset does not license the executor to engage in protracted operation of the business. In the court's view, he has no duty as executor to build up a failing business before effecting distribution or to delay distribution until a sale is made.[11] The decedent may not fix the duration of the settlement of the estate by providing in his last will and testament that the business shall be continued for a designated period of time.[12] However, if the operation of the business is continued by reason of an affirmative court order, there may be greater hope of successfully maintaining the separate tax entity of the estate. In *Frederich v. Commissioner*,[13] the decedent died in 1934, a member of a two-man partnership. The surviving partner, his brother, eventually qualified as administrator in 1938 and continued the partnership until 1943 by virtue of a local court order issued under a permissive Florida statute. The administration was continued with the concurrence and probable delight of the heirs since the brother increased the value of the estate from $20,000 to $134,000. The Fifth Circuit Court was faced with an apparent direct clash between the federal "reasonable time for performing ordinary duties" test and an order of the local judiciary. Reluctant to override the latter, the court held that the estate was, for tax purposes, in the process of administration until 1943. In *Chick v. Commissioner*,[14] the First Circuit Court upheld the dominance of federal tax law, but, in deference to *Frederich*, carefully qualified its language to distinguish situations involving affirmative actions by state courts. The *Frederich* case, however, falls considerably short of being a reliable precedent for maintaining the separate tax entity beyond the period allowed by federal law. Its reasoning is not persuasive, it is burdened by a dissent,[15] and the Regulations have since been amplified to avoid a recurrence of the literalness of interpretation applied in *Frederich*.[16] There appears to be no compelling reason why the executor may not be regarded as clothed with all the authority of a fiduciary for local law purposes, and at the same time be subjected to limitations imposed by federal tax law in his role as trustee or agent for the beneficiaries. The existence of a local court's affirmative order

11. Estate of W. G. Farrier, 15 T.C. 277, 283 (1950).
12. Estate of Josephine Stewart, 16 T.C. 1, 15 (1951), *aff'd*, 196 F.2d 397 (5th Cir. 1952).
13. 145 F.2d 796 (5th Cir. 1944).
14. 166 F.2d 337, 341 (1st Cir. 1948).
15. 145 F.2d 796, 800 (5th Cir. 1944).
16. Reg. § 1.641(b)-3(a).

merely provides a more graphic illustration of the variance between state and federal tax law. Implicit in the decisions basing time of termination upon federal law is the reasoning that if the acts of the executor could have been accomplished with substantially equal facility by the trustee or beneficiaries, the administration is terminated. It is not safe to rely on any narrower concept.

### *Reserve Funds*

The present Regulations have been broadened to provide, for the first time, that a reasonable reserve set aside in good faith may be retained to meet claims, and the estate may nevertheless be regarded as terminated.[17] This is welcome language to the executor who wishes to fix conclusively the year of termination for the purpose of shifting "excess deductions" to the beneficiaries, since it should minimize the possibility of attack upon a technical basis. Such language, however, may in due course provide the Service with an additonal weapon to force the tax termination of estates whose administration has been continued on the premise that claims against the estate have not been settled.

## TREATMENT OF INCOME DURING YEAR OF TERMINATION

Normally, in the year of termination of the administration, all of the estate's assets are distributed to the beneficiaries. The executor will thus receive a distribution deduction, usually much greater than the income of the estate, since the distinction between corpus and income distributions has been abolished, and the estate's income, including capital gains, will be taxed to the beneficiaries.[18] Although a hairline distinction as to whether capital gains are paid as such or as general corpus distributions is still possible, it is now relatively settled that capital gains are, in the year of termination, includible in distributable net income which measures the amount taxable to the beneficiaries.[19] If the beneficiaries of the final distribution are individuals, each will be taxed on that portion of the estate's income as is determined by the ratio of the total property, income and corpus, received by such beneficiary to the total property distributed.[20]

When the distribution is entirely to a trust, the trustee is the sole recipient and is taxed on all of the income of the estate for its last year. If the trust is one which, by its terms, is required to distribute income cur-

17. *Ibid.*

18. §§ 661, 662. It is assumed throughout that the last will and testament contains no provision requiring the current distribution of income during the period of settlement of the estate.

19. See Fillman, *Selections From Subchapter J*, 10 TAX L. REV. 453, 467 (1955). The Code adopts the rule of Carlisle v. Commissioner, 165 F.2d 645 (6th Cir. 1948).

20. Reg. § 1.662(a)-3(c).

rently, the ordinary income received by the trustee from the executor is, as a matter of property law, generally distributed to the trust beneficiaries. The trustee in turn receives a distribution deduction and the ordinary income is taxed to the trust beneficiaries.[21] Under normal circumstances, capital gains will remain with the trustee. Since they are not paid or required to be paid to the beneficiaries, they are not included in the trustee's determination of his distributable net income and are not taxed to the trust beneficiaries.[22] Therefore, the net result of the usual distribution from an estate to a trust is the taxation of ordinary income to the trust beneficiaries and the taxation of the capital gains to the trustee.

If the administration of an estate has been terminated, not by a distribution of its assets, but by a determination that its formal administration has been unduly prolonged, the income of the estate will similarly be taxed to the beneficiaries of the estate. This result can be accomplished on the basis of either of two theories. First, the income, including capital gains, may be regarded as being currently distributable after the termination date has been fixed.[23] Second, a constructive distribution may be regarded as having occurred. The latter theory has apparently been adopted by the Regulations.[24] The theory employed is immaterial except where the possibility exists that the distribution itself gives rise to a capital gain. This may occur, for example, where a formula clause marital deduction gift of the "dollar-amount" or "fixed-sum" type has been provided for by the testator. The Service has ruled that satisfaction of such a bequest by distribution of appreciated property may create a capital gain.[25]

## EXCESS DEDUCTIONS AND LOSS CARRYOVERS UPON TERMINATION

Prior to the adoption of the Internal Revenue Code of 1954, deductions or losses which exceeded the estate's income in the year of its termination were wasted. This led Congress to enact the present section 642(h).[26] In summary, this section provides that (1) net operating loss

21. §§ 651, 652.

22. The beneficiaries can be taxed with no more than the distributable net income of the trust. The definition of distributable net income excludes capital gains allocated to corpus unless paid, credited, or required to be distributed. § 643(a)(3).

23. This is the theory adopted as to trusts with respect to which the termination date has been reached, *i.e.*, the death of the life beneficiary, but which retain their tax entity status during the winding up period. Reg. § 1.641(b)-3(c). See Somers, *Some Income Tax Problems Incident to the Termination of a Trust*, 14 TAX L. REV. 85 (1958).

24. Reg. § 1.641 (b)-3(d): "If a trust or the administration or settlement of an estate is considered terminated under this section for federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust."

25. Rev. Rul. 60-87, 1960 INT. REV. BULL. NO. 10, at 18.

26. § 642(h).

carryovers, (2) capital loss carryovers, and (3) current year's deductions in excess of current year's gross income, shall be allowed as deductions to the beneficiaries succeeding to the property of the estate upon termination of the estate. The personal exemption and charitable deduction are excepted from operation of the rule.[27]

Where the estate has, in the last year of its administration, a mixture of various types of income and expense, the Regulations[28] indicate that the various "excess deductions" and carryovers are to be sorted out as follows:

(1) Business income is first set off against business expense to arrive at any net operating loss. If no other income exists in the estate, the net operating loss is carried over to the beneficiaries. If other income, but no other expense, is present, the net operating loss may be applied against the estate's other income, and any excess carried over to the beneficiaries.

(2) If both business income and expenses are present as well as other income and deductions, the net operating loss is determined as above, and an "excess deduction" is computed by applying other expenses against other income. Both a net operating loss carryover and an "excess deduction" may be available to the beneficiaries.

(3) If capital losses are present, they are applied only against capital gains, and any excess is carried over to the beneficiaries.

The determination of the resulting deductions or carryovers involves a series of setoffs: business expense against business income, capital losses against capital gains, and other expenses against other income. The excess of one type of deduction over its counterpart of income is applied against other types of income of the estate only to the extent permissible under rules generally applicable.[29] However, if a net operating loss carryover lapses in the last taxable year of the estate, any excess of the loss over the estate's income for that year is converted into an "excess deduction" and is passed on to the beneficiaries.[30]

Further operating rules are spelled out by the Regulations.[31] The net operating loss carryover and capital loss carryover retain their character in the hands of the beneficiaries. The "excess deduction" is not allowed in computing adjusted gross income of the beneficiaries, but only in computing their taxable income. The net operating loss can be carried forward by the beneficiaries, but not back. In determining the allowable period of the net operating loss carryover or capital loss carry-

27. Reg. § 1.642(h)-2(a).
28. Reg. § 1.642(h)-5.
29. Reg. § 1.642(h)-2.
30. Reg. § 1.642(h)-2(b).
31. Reg. §§ 1.642(h)-1, 1.642(h)-2.

over, the last taxable year of the estate and the beneficiaries' taxable years, with or within which the estate's last taxable year ends, constitute two separate years.

Where capital gains constitute the only income of an estate in its year of termination and the estate also has deductible expense, an "excess deduction" is generated although capital gain income exceeds the amount of the expense. In Revenue Ruling 59-392,[32] the Service was asked to consider the tax treatment of a testamentary trust which in its year of termination had 100x dollars of long-term capital gains and 20x dollars of deductible expense. It was ruled, rather liberally, that the beneficiaries report in their returns 80x dollars of long-term capital gain and are entitled to an "excess deduction" of 10x dollars. In arriving at its conclusion, the Service determined that 80x dollars (the excess of gross long-term gain over expense) was beneficiaries' income and 20x dollars was trustee's income. The trustee was entitled to a section 1202 deduction (fifty per cent long-term capital gain deduction) of 10x dollars and the latter qualified as an "excess deduction."

### *Allocating Administration Expense*

The Service has also taken a liberal position with respect to allocation of administration expense to tax-free income.[33] On the theory that there is no true double deduction, it has been ruled that any portion of administration expenses shifted from federal estate tax to income tax deductions and allocated to tax-free income may be reclaimed as a federal estate tax deduction. This rule is equally applicable to tax-free income in the year of termination. Therefore, if the executor has determined to shift expenses to income tax deductions in concluding his audit of the federal estate tax return, he should estimate the required allocation and claim a portion of the expenses, generally fees, as a federal estate tax deduction in an amount sufficient to cover the amount expected to be allocated to tax-free income. Such procedure will avoid the necessity of filing a claim for refund and reopening the federal estate tax.

### *Beneficiaries*

The Regulations in somewhat general language have defined the phrase "beneficiaries succeeding to the property of the estate or trust" as those beneficiaries who bear the burden of the loss or deduction.[34] They may be heirs or next of kin under intestate succession or residuary beneficiaries (including a residuary trust) under the last will and testament.

32. 1959-2 CUM. BULL. 163.
33. Rev. Rul. 59-32, 1959-1 CUM. BULL. 245.
34. Reg. § 1.642(h)-3.

Non-residuary beneficiaries are not within the scope of the phrase, except to the extent that their legatees or devisees are not paid by reason of the insufficiency of the estate. Income beneficiaries are excluded. Normally, there is no great difficulty in determining which beneficiaries succeed to the property and the extent to which they bear the burden of the loss or deduction. Again, however, the formula clause marital deduction gift presents complications.[35] The Service has pointed out that the executor may, as a matter of property law, enhance the value of the marital gift in such cases by shifting administration expenses from federal estate tax to income tax deductions.[36] If this in fact occurs, it would appear that the widow has not borne any burden of the expenses shifted to income tax deductions. Presumably, however, the executor may elect to shift the expenses, establish the marital gift in the smaller amount, be content with a reduced marital deduction, and still obtain an income tax advantage.[37] The determination of the participation in the "excess deductions" in this situation raises many questions, with no present assurances of the answers. For example:

(1) If the formula clause gift is of the "dollar amount" type, is it, for this purpose, to be considered a specific bequest or devise which excludes the spouse or her trustee from the category of "beneficiaries succeeding to the property?"[38] This interpretation would appear to be unduly restrictive. Unlike other specific bequests or devises which are fixed in amount solely by the terms of the last will and testament, the formula clause gift is directly determined by the amount of administration expenses. Therefore, its recipient should be entitled to participate in the "excess" deductions.

(2) If the formula clause bequest or devise is not a specific gift, either by definition or because it is of the "fractional share" type, to what extent does it bear the burden of the deduction? Frequently, the spouse has received other qualifying property and her interest in the residuary estate is somewhat less than fifty per cent. Does the actual percentage of her share of the residuary estate determine her participation in the "excess deduction," or is this always fifty per cent? Argument in favor of the latter result is available inasmuch as the formula clause gift is decreased, either in actuality or by percentage, by one-half of administration expenses.

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35. See discussion p. 155.

36. Rev. Rul. 55-643, 1955-2 CUM. BULL. 386.

37. See the discussion of this problem in Fleming, *From Peter to Paul*, 96 TRUSTS & ESTATES 1089 (1957).

38. The "dollar amount" type formula clause marital deduction gift is considered to be a fixed sum, the discharge of which may give rise to a capital gain, Rev. Rul. 60-87, 1960 INT. REV. BULL. NO. 10, at 18. Conceivably, it may similarly be considered a bequest of a fixed sum for the purpose under discussion.

## PLANNING FOR EXCESS DEDUCTION SAVINGS

The section 642(h) "excess deduction," far from being merely a defensive measure to avoid waste of deductions in uncontrolled situations, can be used as a positive tool in income tax planning and savings. The federal estate tax rate, particularly where a marital deduction is involved, is frequently lower than the income tax rate of the estate and the personal rates of the beneficiaries succeeding to the property of the estate.[39] In such cases, the executor would normally elect to claim administration expenses as income tax deductions. He may achieve his greatest saving by deferring payment of a substantial portion of the expenses (the bulk of which are usually represented by fees) until the year of termination. In short, he should consider the deliberate creation of an "excess deduction" to be passed on to the beneficiaries. At least two factors may dictate this action: (1) very high income tax rates may be involved inasmuch as the beneficiary, after termination of the estate, will be receiving both the former estate's income and the beneficiaries' "outside" income; (2) where spouses are involved, the surviving spouse may no longer be able to file a joint return and, therefore, reach substantial income tax rates. However, where a trust succeeds to the property, the "excess deduction" should not exceed the amount of taxable income of the trust. Unless the trust terminates in the same year as the estate, the deduction can only be used to reduce the income otherwise taxable to the trust beneficiaries. Any excess is lost.[40] In estates which are less than $60,000 in amount and no federal estate tax return is required, administrative expenses should as a matter of course, be claimed as income tax deductions. Appreciable tax savings may result, despite the fact that the estate may have little or no income, if expenses are paid in the year of termination and made available to the beneficiaries to be applied toward their salaries or other income.

The benefits achieved through "excess deductions" may unintentionally be reduced if substantial capital gain income is generated in the year

39. For purposes of determining whether administration expenses should be claimed as death tax deductions or income tax deductions, the effective death tax rates may be stated generally as follows: (a) If more than the maximum marital deduction is available, the effective rate is one-half of the net federal estate tax rate; (b) If less than the allowable marital deduction is available, and the marital gift is a fractional share of the residue, the effective rate is the net federal estate tax rate. The marital deduction is determined by taking into account the administration expenses regardless of the fact that they have not been claimed as federal estate tax deductions; Rev. Rul. 55-225, 1955-1 CUM. BULL. 460; (c) If a formula clause marital deduction gift governs, the effective rate is one-half of the net federal estate tax rate, if the enhanced value of the marital gift is paid and claimed as a marital deduction. If the marital gift is established in the smaller amount, the effective rate is the net federal estate tax rate; (d) In any case in which the inheritance tax credit allowed under § 2011 of the 1954 Code governs the total amount of local inheritance taxes payable, the gross federal estate tax rate must be substituted for the net federal estate tax rate.

40. Reg. § 1.642(h)-5(e).

of termination.[41] In fact, capital gains are more frequent in termination years because of sales required to raise cash for closing expenses. This result may, in appropriate cases, be circumvented by providing for cash needs in the year immediately prior to the expected termination year.

## CORPUS DISTRIBUTIONS

As a general scheme of taxation, the Internal Revenue Code of 1954 has provided that the taxable income of an estate is apportioned among the beneficiaries of the estate upon the basis of total distributions, whether of income or corpus, received by each.[42] Thus, unless the executor has been careful to preserve equality of any partial distributions made to the various beneficiaries during interim years, he may create considerable distortion with respect to the taxability of income earned in the final year.

Where the final distribution is to a trust which distributes income currently, distortion may similarly result, either unintentionally or perhaps deliberately, by distributions of income in the year of termination directly from the estate to the beneficiary. For example, assume that in the year of termination the estate has corpus of $190,000 and income of $10,000. The income is distributed directly to the life beneficiary and the corpus to the trust. Since the trustee is deemed to be a beneficiary for the purpose of Subchapter J, and there is no distinction between corpus and income distributions, presumably the distributions result in the taxation of 1/20th of the income to the life beneficiary ($10,000/$200,000) and 19/20ths of the income to the trustee ($190,000/$200,000).[43] This result is perhaps clearer where the executor is authorized, but not compelled, by the terms of the last will and testament to make distributions of income directly to the beneficiary. If, in form, the last will and testament merely provides for distribution of all assets to the trustee, it may be argued that the executor's distribution is in effect a constructive receipt and simultaneous distribution of the income by the trustee. If the result indicated actually occurs, it would appear that the trustee is confronted with the problem of obtaining contribution from the income beneficiaries for the tax paid on their behalf.[44] The result is easily avoided by having payments made only by the trustee, but its possibility demonstrates the necessity of examining the income tax effect of even the most routine estate transactions.

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41. The deductions may be applied against capital gains rather than ordinary income. See Rev. Rul. 59-392, 1959-2 CUM. BULL. 163.

42. Reg. § 1.662(a)-3(c).

43. See the discussions in Falsey, *Distributions by Estate to Residuary Trust*, 9 TAX L. REV. 281 (1954), and Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trust, Estates, and Beneficiaries*, 54 COLUM. L. REV. 1237, 1256, (1954).

44. See Estate of Rice, 8 Pa. D. & C.2d 379 (Orphans' Ct. 1956).