Taxation of Rental Income and Profits on Sale of Real Property during the Period of Estate Administration

David G. Kay

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
David G. Kay, Taxation of Rental Income and Profits on Sale of Real Property during the Period of Estate Administration, 12 W. Res. L. Rev. 176 (1961)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol12/iss2/9

This Symposium is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
SUMMARY

The necessity of correctly determining the year of termination of the administration of a decedent's estate has assumed greater importance since enactment of section 642(h) of the Internal Revenue Code of 1954. The test for determining the duration of administration is a factual one, controlled by federal tax law rather than local law, although precedent exists in support of the supremacy of local law where administration is continued under an affirmative court order. Section 642(h), adopted to prevent waste of deductions in the year of termination of estates, has proved to be a useful tool for positive income tax planning. By its use, the executor is enabled to apply estate administration expense, not only against income taxable to the executor, but against the beneficiaries' income. During the year of termination, the estate's ordinary income and capital gains are taxed to the beneficiaries. Each beneficiary, however, is taxed in accordance with the ratio of his distribution to total distributions made. Interim partial distributions may distort the result in the final year, and care is required to adopt correct procedures for both interim and final distributions to avoid unintended results.

V

TAXATION OF RENTAL INCOME AND PROFITS ON SALE OF REAL PROPERTY DURING THE PERIOD OF ESTATE ADMINISTRATION

David G. Kay

Taxing the tree that bears the fruit — the owner of the income-producing property — is a fundamental principle of federal income tax law.1 The concept must be refined a bit, however, in considering income taxation of rents and proceeds from the sale of real property in the course of estate administration. During that period the incidence of tax is upon the person having possession and control of the income-producing property without regard to whether he is the legal owner of the property. For example, in Estate of Brasley Cohen2 rental income was held taxable to the estate because the property was subject to the possession and control of the administrator, notwithstanding the fact that, under California law, title to real estate is vested in heirs and devisees immediately upon the

2. 8 T.C. 784 (1947).
death of the decedent. Revenue Ruling 57-133, interpreting Oregon law, similarly makes a distinction between title on the one hand and possession and control on the other in ruling that rental income is taxable to the estate even though the devisees are owners of title during the period of administration and are entitled to the income from real property beginning with the date of the testator's death.

It is clear in Ohio that possession, control, and title to real property pass in one package directly to heirs and devisees upon the decedent's death. Accordingly, rental income and, in the event of sale, gain or loss during the period of administration is reportable for income tax purposes by the heirs and devisees. The Board of Tax Appeals in George L. Craig and Guarantee Trust Company of New York reached this tax result on the basis of similar local law in the states of Pennsylvania and New York.

**SALE OF REAL PROPERTY WHERE PERSONALTY IS INSUFFICIENT**

What are the tax consequences in Ohio if a personal representative of a decedent's estate sells real property under statutory authority to pay estate debts, costs of administration and allowances, the personalty in his hands being insufficient for that purpose? In Overturf v. Dugan, it was held that income received by heirs and devisees prior to the sale of real property is beyond recall for the purpose of satisfying these charges. It would, therefore, remain taxable to the heirs and devisees. As to the proceeds of sale in excess of those used to satisfy the charges against the estate, they are distributable under Ohio law to the heirs and devisees who would have been entitled to the real estate had it not been sold.

If the property is sold at a price either higher or lower than its basis, there being a surplus available for distribution, it becomes necessary to relate the gain or loss on sale to the estate and to the heirs and devisees as taxpayers, each having an interest in the property sold. Revenue Ruling 59-375 considers precisely this problem in terms of North Carolina law which parallels the law of Ohio. The ruling holds that, where real estate is sold at a price in excess of its basis, only that part of the gain from the sale which is proportionate to the portion of proceeds payable to the administrator, under the state law for the discharge of the debts of
the estate, is required to be included in the gross income of the estate. The remainder of the gain is taxable to the heirs. In reaching this conclusion, the ruling stresses that the administrator of the estate had an interest in the real property only to the extent that the property was sold for the purpose of providing funds for the administration of the estate. Presumably, if the property were sold at a loss, a like apportionment of the loss as between the estate and the heirs and devisees would follow.

**Effect of a Will Contest**

When a will is contested, it is uncertain whether there is a shift of the incidence of income taxation from the heirs and devisees to the personal representative of the decedent's estate. There is good argument in both directions. Section 2113.21 of the Ohio Revised Code states in part:

"When a will is contested, the executor, the administrator de bonis non, with the will annexed . . . may, during the contest, do the following: (A) control all the real estate which is included in the will but not specifically devised . . . ." (Emphasis added.)

In arguing that the statute does not alter tax results, it may be said (1) that the statute is discretionary; (2) that it is procedural and effects no change in property rights; and (3) that an executor or administrator when he acts under the statute does so in a ministerial capacity as agent for the ultimate beneficiary, pending the outcome of the contest. On the other hand, it might be urged that when the personal representative invokes the statute, he, by definition, takes control of the undevised real property and such control is sufficient to cause rental income and proceeds on sale during the contest to be taxed to the estate.\(^1\) It should be noted that specifically devised real estate does not come within the purview of this statute, and without more, it remains subject to the rules of income taxation which apply where the will is not in contest.

**Powers of Sale**

The fact that the personal representative of an estate has either an express or implied power of sale with regard to real property will not change the rule that rental income and profit on sale of real property during the period of administration is taxable to heirs and devisees. To alter the application of the tax, it is necessary to give the personal representative not only a power of sale but an interest in the property as well.

\(^1\) See Sol. Mem. 2673, III-2 CUM. BULL. 177 (1924). It was ruled that under Maryland law, similar to the law of Ohio, devisees for income tax purposes must report the income derived from the realty devised to them for all taxable periods subsequent to the testator's death, except in cases where a trustee or conservator is duly appointed to take possession of the realty pending the outcome of judicial proceedings or action. In such case, the income from the realty would be properly taxable, pending the contest, to the fiduciary.
The distinction found in the authorities appears to be that if land is devised to executors to be sold, or if it is devised to be sold for the payment of debts, in either case the power is coupled with an interest. But it appears that when no estate is devised but there is a mere direction in a will to executors to sell land, or an authority given merely to sell, the rule is different and the executor is given but a naked power. A power given by a will to an executor to sell when he shall think best has been held to be a mere naked power, but where this same power to sell at the discretion of the executor is given coupled with a direction that he shall hold the proceeds and distribute them to certain legatees as they come of age, it was held that the executor had more than a mere naked power to sell. And so, where, in a will, the testator confers as full and complete power as possessed by himself, upon his executors after his decease, to dispose of all of the estate, real, personal, and mixed, in the way and manner which they think best calculated to carry into effect all the purposes specified, except that no part of the estate shall be sold at public sale, the power conferred is coupled with an interest.\footnote{\textsuperscript{11}}

Giving an executor both a power and an interest will work an equitable conversion of real estate into personalty, and the income prior to sale, and gain or loss on sale, is taxable to the estate as if the same were personalty from the time of the testator's death.

\section*{Uncompleted Contracts of the Decedent to Buy Real Estate}

By statute the representative of a decedent's estate is authorized to complete contracts to buy or sell real property made by the decedent during his lifetime.\footnote{\textsuperscript{12}} Where the uncompleted contract is one to buy real property, the contract is treated for administrative purposes, under the doctrine of equitable conversion, as if it were real property from the date of its execution.\footnote{\textsuperscript{13}} Accordingly, income realized from the time of purchase, and gain or loss upon subsequent sale, is reportable by the heirs and devisees.\footnote{\textsuperscript{14}}

Where, on the other hand, the uncompleted contract relates to the decedent's selling of real property, the contract will be treated for administrative purposes as personalty, and the purchase money and other rights in the contract pass to the personal representative of the estate as an asset of the estate.\footnote{\textsuperscript{15}} The income received prior to sale, and gain or loss upon sale, would, therefore, be taxable to the estate.

The rule is different, however, when the decedent's real property is not the subject of an unequivocal contract to sell, but rather, a mere

\begin{footnotes}
\item \textsuperscript{11} 22 OHIO JUR. 2d \textit{Ex'r and Adm'r} § 183 (1956).
\item \textsuperscript{12} OHIO REV. CODE §§ 2113.48, 50.
\item \textsuperscript{13} Gray v. Hawkins, 8 Ohio St. 449 (1858).
\item \textsuperscript{14} See Radin v. Commissioner, 33 F.2d 39 (3d Cir. 1929), involving similar law of New Jersey.
\item \textsuperscript{15} Gray v. Hawkins, 8 Ohio St. 449 (1858).
\end{footnotes}
option to purchase in the hands of a lessee or other interested party. The existence of an option as contrasted with a contract to sell does not work an immediate equitable conversion of the decedent’s real property into personalty. Smith v. Loewenstein dealt with a lessee of a perpetual lease who had the privilege of purchasing the land at any time and duly exercised the option to purchase after the death of the lessor. The court held that the conversion of realty into personalty occurred at the time of exercising the option and could not be related back to the time of the execution of the lease, and that the purchase money, if not required to pay debts or legacies of the lessor, passed to the heirs of the lessor rather than the personal representative. The heirs and devisees, entitled to the rents until the option is exercised and to the purchase price upon the sale of the land, are, therefore, the logical taxpayers.

PROBLEM AREAS IN ADMINISTRATION

There are a number of problem areas in the taxation of rental income which stem from the fact that during the period of administration there is no one to lay claim to possession and control of the income-producing property. Who, for example, pays the tax on rental income (1) where a testamentary trust is provided under the will, but the trustees have not been appointed and the trust has not been established at the end of a tax year, or (2) where, in the application of a marital deduction formula, the proportion of ownership of real property as between several beneficiaries or several trusts is uncertain at the end of that year, or (3) where real estate is distributed through the residue and the proportion of ownership among beneficiaries is uncertain at the end of a tax year? There is no consensus among attorneys dealing with these problems as to when and to whom rental income is taxable; practice varies.

MANAGEMENT OF REAL ESTATE BY EXECUTOR OR ADMINISTRATOR

Section 2113.311 of the Ohio Revised Code was enacted in 1959 to clothe an executor or administrator with authority to take over the management and rental of real estate where, after a reasonable time following his appointment, no one else in authority has taken over these duties. Under the statute, a personal representative is authorized inter alia to rent the property, collect the rents, and from the rents collected, pay taxes, make repairs, and insure the property. He is directed to pay over to the heirs and devisees, if known, their share of the net rents at least as often as annually.

It has been suggested that this statute, when invoked, will cause rental income to be taxable to the estate because the executor or admin-
istrator has effective possession and control of the income-producing property. Does the personal representative have a taxable interest of his own or does he act in such case merely as an agent for heirs and devisees? The wording of this statute, particularly when compared with the language of section 2113.21 of the Ohio Revised Code relating to an executor's authority during a will contest, appears to indicate an agent-principal relationship. If this is the case, rental income will continue to be taxed to heirs and devisees as principals.