1977

Tax Elections in Post Mortem Administration

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"TAX ELECTIONS IN POST MORTEM ADMINISTRATION"

by

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Thank you very much, Emeric. This has been a very depressing morning for you all. It started off with our client looking forward to the holiday season and wondering what he could do to save taxes toward year-end. We don't know how it happened to him, but he is next involved in tax fraud and now the man's dead. Well, how did he die? Maybe we're responsible for that in part. Perhaps the client died because he had an operation and not knowing whether he was going to survive, he called his lawyer or his tax advisor and received some tax advice that killed him. He was probably told, "You ought to pay your doctor's bills immediately, while you're on the hospital bed. That way you'll reduce your gross estate and you can also deduct the medical expense against your income tax on your last 1040. Furthermore," he was probably told, "you should probably liquidate a good portion of your appreciated assets, incur your capital gain liability while you're alive and your capital gain liability will be a claim against your estate, and you can get a deduction for the taxes you pay as you relieve your basis problem." And if that didn't kill him, your probably tell him to take out his checkbook and write $3,000 checks to as many of his beneficiaries as he can think of, distribute them immediately, and thereby get $3,000 per donee annual exclusions that are not subject to gift tax and also will not be brought back into the gross estate under Section 2035. If that doesn't kill him, I don't know what will. On the other hand, if you don't tell him those things, perhaps you're not performing your duty to him. In any event, he's dead, by whatever process, and now the question is "As tax advisor to his estate and to the beneficiaries who have survived him, what are some of the decisions that the executor and the beneficiary need to make in order to conserve the assets of the estate during the period of administration and after the termination of the estate?"

I've organized my outline as principally a listing of elections and will discuss some of them in more detail than others. It is essentially a checklist of tax significant decisions that can be made during the administration of an estate.[1] Most of the decisions are "executor" decisions. However there are several that may be called "beneficiary" decisions. Some of these are more complicated than others and those that are not particularly complicated will simply be noted without much discussion.

The first option is whether to file a joint 1040 and doesn't require extended discussion. I would remind you that an executor, if he has qualified, the surviving spouse otherwise, is under a duty to file 1040

[1] The checklist is set forth in the Appendix.

returns for the decedent and that might involve two taxable periods. If the decedent dies in March of 1978 not having filed his 1977 return, there are two returns as to which decisions must be made with respect to a joint filing, if there's a surviving spouse. Returns are due for the full calendar year that just ended and also for the first three months of the next calendar year. For each of these periods a joint return can be filed if the executor consents. Obviously, the executor would be inclined to consent if this decision were in the best interests of the estate and the surviving spouse; and if there are lower income taxes as a result that normally dictates the choice.

One thing requires caution in this regard. If the effect of filing a joint return is to generate a right to refund, there are procedures where the refund can be paid directly to the surviving spouse. That may not be desirable. If the refund is paid to the surviving spouse, then to the extent that the refund is attributable to overpayment of taxes by the decedent an asset of the estate has gone to the surviving spouse. If the surviving spouse is a residuary legatee, we have a distribution to a residuary legatee; and if in the taxable year of the estate, for fiduciary income tax purposes, there is income in the estate, the distribution of the asset will constitute a distribution of distributable net income, and the surviving spouse as she receives her income tax refund will also be receiving ordinary income in the process. Be mindful of that possibility; generally you will want to make a very careful choice as to whether or not the fiduciary income is to be taxed to the executor or distributed and taxed to the beneficiary. Strangely enough, a refund claim for income taxes can result in a distribution of the distributable net income to the spouse.

The next major choice to be made involves the treatment of medical expenses. There are two ways to view medical expenses, and I mean by medical expenses those that were paid by the executor within one year of death but which were accrued prior to death with respect to treatment that the decedent received. Those medical expenses can be viewed alternatively as charges against income that can be claimed as a deduction on the decedent's 1040 under section 213(d) or can be viewed as a claims against the estate and deductible on the 706 return, but cannot be viewed both as a charges against income and as a claims against the estate. So there is a decision as to where to take the deduction for medical expenses that were paid by the executor within one year following death. It's not an easy decision.

If the deduction is taken on the 1040 return, this has the effect of reducing income tax liability, and the decedent's income tax liability is a claim against the estate. It therefore reduces claims against the estate, enhances the size of the net estate, and thereby enlarges the size of the marital deduction. Be mindful of the interplay; anything that reduces income tax liability tends to increase the size of the gross estate and increase the marital deduction.

On the other hand, if you elect to take the medical expense as a claim against the estate on the 706 return, you have deliberately chosen a course of action that may increase the decedent's accrued income tax liability reportable on the last 1040. That increase in income tax liability is itself a claim against the estate which generates a deduction in computation of the gross estate. The medical expense deduction claimed on the 706, of course also reduces the estate and further reduces the ceiling on the marital deduction. Accordingly one must be mindful of the interplay of claims against the estate generated by income tax liability accrued prior to death and the effect on the marital deduction in making the appropriate decision.

It should also be noted that it is not necessarily the decedent's last income tax return as to which the medical expense election relates. Going back to the decedent who died in March of 1978, the medical expenses may have been accrued in November and December of 1977. His last return will be for the three month period in 1978, not calendar year 1977. The deduction could be taken on the 1977 calendar year return, the year of accrual, which is not the decedent's last 1040 filing period.

An area where many of us are already familiar with the executor's options involves the treatment of administrative expenses, selling costs and casualty losses on the 706 and 1041 returns. Again, selling expenses, administration cost, and casualty losses can be viewed alternatively as reductions in the taxable estate on the 706 return or as charges against income deductible on the estate 1041 fiduciary income tax return, but not both. Like the medical expense deduction, the administrative costs, selling expense and casualty loss items can be allocated between the respective returns. The administrative expenses can be allocated in part to the 1041 fiduciary return and in part to the 706 return and likewise medical expenses paid after death can be allocated in part to the 1040 return and in part to the 706 return. It's possible to spread so long as the effect is not a double deduction.

In regard to selling expenses, I need to alert you to a 1976 Tax Reform Act change that is most significant. Under prior law it was well established that a selling expense could be both a reduction in the amount realized in defining gains reportable on the 1041 and a deductible administrative expense that could be claimed on the 706. Thus the same item enjoyed what amounted to double deductibility. The Tax Reform Act amended Section 642 to prohibit a double deduction for selling expenses. If on the 1041 you reduce gain by selling expenses, then you may not take selling expenses as an expense of administration on the 706.

How does the executor choose between deductibility for income tax purposes and deductibility for estate tax purposes. The choice is made on the income tax return, not the estate tax return. To elect to take medical expenses paid after death as a 1040 deduction, you file a claim of those expenses with a written waiver in duplicate of the right to claim the expenses on the 706 return and associate the waiver with the 1040 or submit it before the period for assessing deficiencies has lapsed.

Similarly with respect to the 1041 return, if you elect to claim administration expenses, selling costs, or casualty losses as deductions on the 1041 return, you simply associate with the 1041 return at time of filing, or later but before the period for assessing a deficiency has lapsed, a statement in duplicate under which you waive the right to claim the item on the 706 return. Pragmatically, it is possible without violating the law to claim the item on both returns. Claim it on the income tax and the estate tax return and wait until the results of audit to determine the return for which to make the binding election, and then file the necessary statement in duplicate if the choice is an income tax deduction.

Where to take the administrative expense, selling expense or casualty loss deduction again requires a consideration of marginal tax rates. The 1041 return might have the taxpayer in a 40% bracket; the 706 return might have the taxpayer in a 30% bracket. This might dictate the result; however if a marital deduction is involved, trial calculations to assess the impact of the marital deduction may be necessary to a careful choice.

One other very important thing to keep in mind is that it is very easy in talking about post mortem estate planning to assume that the client is faced with both 706 choices and a 1041 choices. In the overwhelming number of cases, there will only be a 1041 problem. The estimates are that as a result of the Tax Reform Act of 1976 only two to three per cent of taxpayers dying after 1981, when the unified credit is fully phased in, will have estate tax problems. Obviously if there is no estate tax liability, claim the deduction on the 1041 return.

If we do have a wealthy decedent and a choice to make as to deductibility on the 1041 or 706, there is one point that should be stressed. To the extent that administrative expenses are allowed on the 706 return, they're not allowable on the 1041 and an opportunity to generate what is called an "excess loss" on the final 1041 return will be lost. I'll be talking about "excess losses" later. I did want to refer to the fact that the choice of where to take administrative expense deductions does bear on the capability of generating an "excess loss" that can be helpful to the beneficiaries on their respective 1040's after the estate is terminated.

The next choice for discussion is a relatively easy one to make if we know what the options are, and that's the choice of whether or not to accrue Series E Bond interest on the form 1040 or 1041 return or not at all. As many of you are aware, under Section 454 of the Internal Revenue Code, one of the features of Series E Bonds is that the taxpayer may elect to accrue the interest even though he has been previously handling his investment in government bonds on a cash realized basis.

The Executor on behalf of the decedent could elect to accrue all of the previously accrued but unreported Series E Bond interest during the taxpayer holding period and reflect that on the last 1040 return. If the decedent dies in January having little income for the month of January and being on a calendar year reporting basis, it could be advantageous to accrue Series E Bond interest on the decedent's last 1040 return. In the alternative, the Series E Bond interest could be accrued and reported on the 1041 return.

If the effective income tax rate paid by the executor is likely to be less than the income tax rate to be paid by the beneficiary, accrual on the 1041 return might be warranted. If, however, the Series E Bond interest is accrued on the last 1040, any income tax liability by reason of that accrual becomes a claim against the estate and deductible in computing the size of the gross estate. Also, to the extent that Series E Bond interest is accrued and reported on the 1041 return the accrual attributable to the period prior to death generates an item of income in respect to the decedent realized during the administration of the estate and thereby generates a deduction on the 1041 return for estate taxes attributable to the inclusion in the gross estate of an item of income in respect to the decedent pursuant to section 691.

The next election, whether to choose the alternate valuation date, is usually very simple. Almost invariably the choice will be dictated by the desire to reduce estate taxes to the lowest level.

There are some collateral consequences, however, which can suggest in some rare cases the election of the valuation date that will give higher estate tax values. Some of those involved the impact of valuation on other elections that are available. Certain percentage requirements between the value of closely held business interests and the size of the gross estate are required in order to qualify for automatic extensions of time to pay the tax under sections 6166 and 6166A and to qualify for Section 303 redemption privileges. It is possible in some cases that the choice of valuation date can result in a disqualification of an opportunity that may have otherwise existed.

One other thing to keep in mind, and I'll come to this in more detail momentarily, is that under Section 1040 when assets are distributed in kind in satisfaction of pecuniary legacies, the amount of gain is the difference between estate tax value, not carryover basis, and value at time of distribution. That's the amount of gain to be recognized on the 1041 return. If the estate tax value is higher, then the amount of gain to be recognized when an asset is distributed in satisfaction of pecuniary legacies will be lower, and this can be extremely important for example in a case where an estate tax return is required but there is no estate tax liability by reason of a combination of deductions and expenses and the unified credit. Accordingly there are some circumstances in which one would in fact elect the higher valuation date.

The next topic involves the selection of personal and household effects as non-carryover basis property and we need to begin the discussion with a cautionary statement. The regulations under Section 1023 are not out in permanent form. There are a number of interpretative problems that need to be resolved and one of them is what are household and personal effects within the meaning of Section 1023(b) (3).

The new basis rules except from carryover basis treatment and thereby give estate tax value as basis to household and personal effects having an aggregate value of not more than $10,000 as selected and designated by the executor within a prescribed time frame. It appears that the reason for this rule was one of administrative convenience to ease compliance problems for the taxpayer. The executor is generally required to know, under the new basis rules, decedent's purchase price. He's not likely to know the purchase price of the silver collection, the various items that compose the dishware, the cooking utensils, etc, and so as a rule of convenience, one may simply ignore $10,000 of value in household and personal effects. As to these one doesn't research what the original basis was; instead give them a basis equal to estate tax value.

However, the rule of convenience is also a rule of complexity, because if among the household and personal effects there are appreciated assets as well as depreciated assets, then there is a planning opportunity and a tax savings opportunity in selecting appreciated household and personal effects for non-carryover basis treatment. How to handle this is not necessarily an easy decision. Let us assume, and again we have only very rudimentary committee langauge to even suggest that the assumption might be a correct one, that among the assets of the decedent is an antique car having a value of $10,000 and a basis of $3,000 and a stamp collection having a value of $10,000 with a basis of $6,000. Our normal choice would be to select the antique car for noncarryover basis treatment because we would by selecting the antique car get a higher amount of unrealized appreciation off the tax roles through a tax free step up in basis. However, if we are more likely to sell the stamp collection than to sell the antique car, then we have to be mindful of the principle that "taxes postponed is money saved" and it might be preferable in order to postpone the payment of taxes that would otherwise come due immediately to select the stamp collection for non-carryover basis treatment so that when that collection is sold there is no gain to be realized. Thus, we'll not always be governed by which asset has the greatest amount of unrealized appreciation reflected in it, we'll also have to take into account the likelihood of the asset being sold either during the administration of the estate or by a beneficiary after distribution.

Whether to elect special use valuations for farm land and other qualified real estate is an election that is given to us by the Tax Reform Act of 1976 and it is a very complicated subject matter. In the context of the time we have available today, I'm not going to explore all of the ramifications of Section 2032(A) other than to indicate broad features. The election is basically a choice to value certain qualified assets as "use" value rather than at fair market value, thereby reducing the estate taxes in the process (anything that reduces the value of assets in the estate tends to reduce estate taxes). That choice, if the estate qualifies, is a choice that the executor alone cannot make. Each person who has an interest in the real estate that qualifies for the election must consent to it. And there are good reasons why that person must consent. First, the making of the election will cause a lien to arise with respect to the real estate and the person is going to have an encumbered title by reason of the election and secondly, there will be potential liability for any taxes that might become due by reason of any throwback that would occur if the farmland is put to a disqualified use or disposition within a certain time frame. A discussion of the requirements necessary for property to qualify for the election is beyond the scope of this presentation. However, I do wish to point out certain problems and pitfalls that can attend a Section 2032(A) election. First, be mindful of the effect that that election will have on the size of the marital deduction. Be mindful, too, that unless the Technical Corrections Act passes there will be no real knowledge as to the tax exposure that is being deferred. Many persons will not want to choose to defer a tax exposure unless they know what that exposure is, and this arises from the following problem. If special use valuation is elected, then actual fair market value is not determined by audit, and if there is a disqualifying disposition or disqualifying use made of the farmland and a recapture tax becomes due the recapture tax will be measured by reference to fair market values that have not yet been determined. As a result the deferred tax exposure is unclear and the amount of the lien on the real estate securing that tax exposure would be unclear. The Technical Corrections Act, which has passed the House of Representatives, does purport to deal with this problem by providing for a Service determination of fair market value with respect to the qualified farmland thereby enabling a measure of the tax exposure being deferred. Also with regard to the presence of land in the estate that qualifies for the use value election one must evaluate the impact of any clauses that call for the distribution of assets at estate tax values, because the farmland might have a much greater value than the estate tax value. If it's to be distributed at estate tax value there may be lack of equity among the heirs. If there is a recapture tax due by reason of a disqualified disposition with respect to the farmland it is also unclear as to whether the additional estate tax due operates to cause an increase in basis of carryover basis assets as to the estate tax attributable to unrealized appreciation reflected in those assets.

The next major choice to consider is whether to sell assets during the period of administration. This is a choice that is aggravated by the Tax Reform Act treatment of the carryover basis rules. I anticipate this afternoon that Don Ricketts, in giving you a more detailed discussion of fiduciary tax income problems, will alert you to some of the changes in the basis rules which might be forthcoming and give you his feelings as to whether or not the basis rules are likely to endure. I think it would be helpful at this point for the purposes of clarity to state what the new basis rules are in broad outline form.

Carryover basis is basically defined as the decedent's adjusted basis determined the moment prior to death with four possible upward adjustments. The first of the adjustments is available as to property held by the decedent prior to December 31, 1976. This is the "fresh start" adjustment. To decedent's adjusted basis determined the moment prior to death, you may add an adjustment that has the effect of "grandfather clausing" unrealized appreciation attributable to the period prior to December 31, 1976. You must use for purposes of determining how much to "grandfather clause", market value as of December 31, 1976, if the asset was a traded security. On the other hand, if the property is not a traded security, the amount of "grandfather clause" appreciation for the period prior to December 31, 1976 is determined on the assumption that the total appreciation in the asset occuring over a decedent's total holding period from date of acquisition to date of death, occurred on a rateable daily basis in equal amounts daily, and on that assumption you determine how much of the unrealized appreciation was attributable to the period prior to December 31, 1976 and add that allocated unrealized appreciation to the decedent's basis previously determined to come up with the fresh start adjustment. After that, there are three further possible adjustments. One adjustment is allowed for death taxes attributable to inclusion in the gross estate of unrealized appreciation, using carry-over basis as the measure of that unrealized appreciation, to avoid problems of double taxation. There is also another adjustment that will be frequently available in smaller estates. That adjustment is designed to let assets in the aggregate have a basis equal to fair market value, but not in excess of $60,000. Accordingly, with carryover basis assets having a carryover basis of $40,000 and a fair market value of $55,000 one may, under this $60,000 minimum basis rule increase the basis of the underlying asset to $55,000. The final adjustment that is allowed is the adjustment for succession taxes paid not by the estate but by the heir or distributee of the particular asset in satisfaction of state succession requirements, and that adjustment is made by the person who pays those taxes, the beneficiary of the estate.

Under the new basis rules, we have a major problem. We could previously assume, under the old law, that all assets got a step up in basis estate tax value and that as a consequence, in most cases there would be very little gain to be realized if assets were sold during the period of administration of the estate. Occasionally there would be major fluctuations in value during the short period that the estate was administered but usually there was no major capital gains problem. It is a major problem now. And, we will be looking at a number of the choices available to the executor in regard to the problem presented. The first choice is whether to sell assets during the period of administration. However, sometimes there will be no choice. The decedent, in his wisdom, may have left his surviving spouse $500,000 and directed that it be paid in cash and she may insist on cash and it may be necessary to liquidate a portion of the portfolio to raise the cash and the carry over rules can generate gain in the process. So let's assume for purposes of discussion that he has a choice of whether to sell the assets during the period of administration. If the executor has the choice, then he would make the choice of whether to sell or distribute the assets primarily with regard to the marginal income tax bracket of the estate and of the potential beneficiary as to whom the asset might be distributed. There is an opportunity to make conscious choices as to where to realize the gain where it's likely the asset would be sold by the beneficiary if the executor did not sell it. It is possible that if this is the reasoning of the executor and he is choosing to sell for convenience of the beneficiary that the selling expenses would not be regarded as a deductible expense of administration under 706. The Revenue Service has taken the position—not always successfully—that when assets are sold for the convenience of beneficiaries this is not a deductible expense.

Having determined whether to sell the asset or distribute it in kind there is another range of choices to be examined; whether it is to be distributed in kind to residuary legatees or to pecuniary legatees. With respect to distribution of assets in satisfaction of pecuniary legacy, a new code section is of considerable significance. Code Section 1040 is not an exception to the basis rules, rather it is a non-recognition provision and like most non-recognition provisions it merely calls for a deferral of gain. If an asset is transferred to a pecuniary legatee in satisfaction of a pecuniary legacy and the asset is an appreciated asset, then the gain to be reported on the 1041 return is not the difference between carryover basis and value at time of distribution, but is instead the difference between estate tax value and value at time of distribution. Thus only the gain essentially attributable to the period of administration of the estate is going to be picked up if a pecuniary legacy is satisfied with a distribution in kind. This means, however, that the pecuniary legatee who might have insisted on a cash receipt is now receiving something that is less valuable than cash, because to the extent that gain was not—using carryover basis as the measure—picked up on the 1041 return, the asset is a tainted asset. The unrecognized gain still remains in the asset in the hands of the beneficiary and when the beneficiary sells it, he will not realize fair market value but would have to pay tax on the previously unrecognized gain.

Another major choice which is potentially an extremely important one, is whether to pass distributable net income to residuary legatees through distributions of appreciated assets. In order to discuss this point, we need to lay down one very firm and cardinal rule of fiduciary income taxation. That rule is that distributions are out of distributable net income to the extent of distributable net income. To the extent that distributable net income is distributed the fiduciary takes a 1041 distributions deduction and the recipient of the distribution picks up any taxable income reflected in distributable net income. There are certain exceptions to that rule that distributions are out of DNI (distributable net income) to the extent of DNI. One of the exceptions relates to pecuniary legacies. Generally under Section 663 pecuniary legacies are not regarded as distributions that carry with distributable net income. But a distribution to a residuary legatee is invariably regarded as out of DNI to the extent of DNI. So let us postulate the case of an estate with $50,000 of income. It's distributable net income is $50,000 or higher. It also has $50,000 in cash that could be distributed to the residuary legatee and IBM stock having a fair market value of $50,000 but a carryover basis of $20,000. If the $50,000 in cash is distributed to the residuary legatee the fiduciary gets a distributions deduction of $50,000 and the beneficiary has $50,000 of taxable income. On the other hand, if the IBM stock, having a carryover basis of $20,000 and a fair market value of $50,000 is distributed to the residuary legatee, we have the same result. The fiduciary get a $50,000 distributions deduction and because the distribution is out of DNI to the extent of DNI the distributee, that is the residuary legatee, again has $50,000 of income. But there is one major advantage to the stock distribution. What is the basis to the distributee with respect to the IBM stock? Under Section 661 where a distribution of property in kind carries with it DNI there is an upward adjustment to basis so that to the extent taxable income is recognized on the distribution, basis is increased by the income recognized, and in the circumstances indicated the IBM stock distributed would have a basis of $50,000. $30,000 of gain has left the tax base. The significance of this is as follows: the wise choice of appreciated assets carrying distributions of DNI to residuary legatees has in the example used, accomplished a repeal of the carryover basis rules.

The next choice to consider is whether to make pro-rata or disproportionate distributions to residuary legatees, and great caution is in order. Let us suppose that we have two brothers who are each residuary legatees of 50% of the estate and that in the year that distribution is contemplated the estate had $20,000 of income. One brother has a greater need for his share of the estate than the other, so the executor distributed to one brother $50,000 and credits his share of the residue with that distribution. The executor chooses to wait until a later year to make a distribution of the other brother's share of the residue. What has happened? We have had disproportionate distributions within the year among residuary legatees. If we come back to the cardinal rule that distributions are out of DNI to the extent of DNI, the brother in need who received the early distribution received all of the income of the estate for the year in which the distribution occurred and although he *thinks* he's receiving corpus which is free of income tax as a legacy under Section 101, he has really received a distribution of income under the fiduciary accounting rules that Subchapter J employs. So when we make distribution to residuary legatees, the amount distributed in the particular year of the distribution should be proportionate to the claim of the residuary legatees, otherwise we will be misallocating the income that the legatees ultimately should be paying income tax on.

Whether to distribute carryover basis assets with regard to the effect on the distributee of the element of unrealized appreciation is the next choice to consider. What we are really doing as an executor when we distribute carryover basis assets, is distributing potential income tax liability with respect to the element of unrealized appreciation. A choice needs to be made as to whether or not we will make distributions with regard to the marginal income tax bracket to the distributees, or whether we will just forget the distributee's income tax posture and do the fair thing without regard to income tax consequences. It is something that should be carefully weighed, assuming the will or local law allows the choice.

The choice of the initial tax year for which to report fiduciary income can be very important. It's axiomatic that, to the extent we can tax the same amount of income over additional taxable periods, there will be less income tax to pay. By choosing an initial short tax year, for the first tax year to be reported on the 1041 return, we have an opportunity to spread income over an additional taxable period thereby reducing income tax liabilities.

Another important decision is whether to administer with a view to generation of excess losses in the year of termination. An excess loss occurs where in the year of termination of an estate expenses of administration and other allowable deductions exceed estate income reported on the final 1041 return. Under Section 642(h) the rule is that if an excess loss is generated, then those who bear the cost of the loss may claim it as an itemized deduction on their 1040 individual income tax returns. Those persons normally are the residuary legatees. Let's postulate the following example. $15,000 of administrative expenses could be paid in the next to the last year of administration of the estate and it's reasonably possible for the executor to close that administration just about whenever he wants to. Assuming a calendar year fiscal period, if he pays them in December, they become deductible against other estate income and merely reduce the bottom line on the fiduciary income tax return. On the other hand, if he pays them in January of the next fiscal period, and then terminates the administration of the estate, he'll have $15,000 of administration expenses, no income and an excess loss deduction of $15,000 that could be claimed by the residuary legatee on the 1040 return. So when we choose when to pay administration expenses we need to ask the question: to whom would the deduction be most valuable? To the fiduciary on the 1041 return or to the residuary legatee on his 1040, using the excess deduction carryover as an itemized deduction on that 1040. Frequently we'll conclude that administration expenses should be paid in a year in which there is little or no estate income, the last year in order to generate that deduction.

The next decision, whether to waive executor's commissions, is a choice that is frequently available when a residuary legatee is the executor. The waiver of executor's commissions if done cleanly means that the executor does not realize ordinary income. If one earns an executor's commission and receives it, it is ordinary income. If one waives it effectively, thereby increasing the size of the gross estate, and increasing the size of the residue, one gets the amount back as part of the residue and income tax-free. To secure the advantage of the item being received in a form that's not taxable income, however, an increase in estate tax is a risk since "waived" fees are not deductible on the 706. Wherever the residuary legatee is the executor the choice should be carefully weighed.

The next choice is an easy one—whether to elect to pay income taxes in installments. The taxes due on a 1041 return do not need to be paid on the due date of the return. One may elect to pay ¼ of the taxes on the due date of the 1041 return and the remaining balance pro rated in three-month installments over the next three installment periods following.

The next grouping of choices relate to opportunities to extend the time for filing and paying estate taxes. I'm going to provide a listing of code provisions at this point, being mindful of the hour, and describe what they state generally so that you might resort to them in appropriate cases. Under Section 6081 the Internal Revenue Service in its discretion, for good and sufficient cause can extend the time for filing an estate tax return by 6 months. Under 6161(a) the Revenue Service for reasonable cause (it used to be undue hardship, but now "reasonable cause") may extend the time for paying tax over a ten year period in installments. One good question, I think, that is going to have to be resolved, is whether or not trying to avoid the realization of gain under the new basis rules is sufficient cause to defer the payment of estate tax. If assets have to be sold to pay the estate tax, and the sale of the asset by reason of carryover basis would generate taxable income to be reported on the 1041 return, is the avoidance of that income tax liability or a reduction in it by spreading it out over additional periods, reasonable cause for requesting an extension of time to pay estate tax? I would hope that the regulations would deal with that question.

The former provision allowing an automatic ten year extention of time to pay estate taxes if the required percentage relationship between the value of a closely held business and the gross estate or the taxable estate was met is continued, the code section is now Sec. 6166 A. Section 6166 is a new provision that authorizes an extention of time of up to 15 years for paying the estate taxes in installments, and under this election, during the first five years to the extent that the amount of deferred taxes is within prescribed limitations there are no installments of principal on the tax due, only installments of interest and again within prescribed limitations, the interest rate can be as low as 4%.

The next decision to consider is whether, because of the impact of carryover basis rules, to file protective refund claims as to gains reported on form 1041. This is a minor point, and it reflects some of the complexities associated with the new basis rules. When we indicated the four adjustments that could be made in defining carryover basis, one of the adjustments was for death taxes attributable to unrealized appreciation reflected in the gross estate. Unfortunately, one cannot know with accuracy what those death taxes are until they have been finally determined pursuant to audit. Frequently, we will have sold an asset during the period of administration of the estate with an estimate of estate taxes attributable to unrealized appreciation as to that asset, and defined gain accordingly. If, pursuant to a 706 audit additional estate taxes are owing, then the determination of gain has, by reason of an inappropriate basis adjustment, become erroneous. Additional estate taxes mean that the true gain is less so there may be a need or an opportunity for seeking a refund. However, it may be that the period of limitations may have run before final estate tax liability is ascertained, and if that's the situation, it might be desirable, if the amounts involved are significant enough, to consider filing a protective refund claim in connection with gain reported on the 1041 return before the limitations period expires.

Whether to redeem section 303 stock I think is self-explanatory. Several points need to be made, though. First, it is much more difficult to qualify for section 303 redemption because of changes in the qualifying percentage tests. Secondly, to the extent that stock in a closely held business is used to fund a marital deduction or is otherwise not subject to estate tax, it does not qualify for a section 303 redemption. Thirdly, because of the new basis rules, section 303 redemptions will generate much more income tax liability than in the past.

With respect to beneficiary elections, there are three which deserve mention. As to the first, let's assume that a beneficiary under a qualified pension and profit sharing plan, has the option of taking a lump sum distribution, or, an annuity or distribution payable in installments that would be regarded as non-lump sum within the meaning of section 2039 as amended. Which choice is the best to make? If the beneficiary, let's call her the surviving spouse, elects the lump sum distribution, that means by reason of amendments to section 2039, that the gross estate is increased by the value of the annuity benefit or the qualified plan benefit. That has the effect of increasing the taxes due on the estate and it also has the effect of increasing the marital deduction but it has the disquieting effect from the standpoint of the surviving spouse, of reducing what other amounts she is going to receive in funding the marital deduction. In having elected a lump sum payment, that sum is now an amount that passes to her from the decedent and tends to fund the marital deduction under a formula clause and as a result other amounts going to her will be less. On the other hand, by making the lump sum election she is at the same time, qualifying for the special 10 year income averaging rule, which can be very advantageous. I'm not suggesting how the decision should be made, but obviously it's going to require a careful understanding of the impact of the size of the wife's estate when she later dies, a consideration of who's going to bear the burden of the increased estate taxes that will be attributable to the wife's electing a lump sum distribution as well as an analysis of the relative income tax advantages of the ten year averaging that's available.

The final two elections are basically elections as to whether or not the recipients choose to receive what has been given to them. Whether to repudiate the will and take the statutory share is an election that a spouse might make for purposes of qualifying amounts received from the estate for the marital deduction when they would not otherwise qualify. Also a choice to disclaim a legacy can, depending upon the operation of the state law, operate to increase the amounts going to the surviving spouse and thus help enlarge a marital deduction that would not otherwise have been so great. Also, the disclaimer is an opportunity to pass the wealth to the person who receives the property disclaimed, who may be the child of the disclaimant, without gift tax or estate tax liability to the disclaiming person and it may be an advantageous election from that standpoint.

I'd like to conclude by saying that much of what I've tried to get across requires some understanding of the principles of fiduciary income tax[2], a much neglected field of study and an area that seems to have been significantly neglected by the Revenue Service from the standpoint of audit attention. I think we can all realistically assume, as a result of the new basis rules that if the Revenue Service is going to be responsible in protecting the revenue, 1041 returns will receive much greater scrutiny in the future. Thank you very much.

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[2] For a more detailed discussion of elections in post-mortem administration, see Conway and Hale, T. M. 301, *After-Death Tax Planning—Tax Options* and Conway and Hale, 302 T. M., *After-Death Tax Planning—Payments and Distributions.* Both are part of the Tax Management Portfolio series published by the Bureau of National Affairs.

APPENDIX

TAX ELECTIONS IN POST-MORTEM ADMINISTRATION

PRINCIPAL EXECUTOR ELECTIONS

1. Whether to file a joint form 1040.
2. Whether to deduct medical expenses on form 1040 or 706 or allocate.
3. Whether to deduct administrative expenses, selling costs and casualty losses on form 706 or 1041 or to allocate.
4. Whether to accrue Series "E" Bond interest on form 1040 or 1041 or not at all.
5. Whether to choose the alternate valuation date.
6. Selection of personal and household effects as non-carryover basis property.
7. Whether to elect special use valuation for farm land and other qualified real estate.
8. Whether to sell assets during the period of administration.
9. Whether to satisfy precuniary legacies with distributions in kind.
10. Whether to pass distributable net income to residuary legatees with distributions of appreciated assets.
11. Whether to make pro-rata or disproportionate distributions to residuary legatees.
12. Whether to distribute carryover basis assets with regard to the effect on the distributee of the element of unrealized appreciation.
13. Whether to use a non-calendar year as the fiscal period for the estate.
14. Whether to administer with a view to generation of excess losses in the year of termination.
15. Whether to waive executor's commission.
16. Whether to elect to pay estate income taxes in installments.
17. Whether to seek extensions of time for filing and paying estate taxes.
18. Whether, because of the impact of carryover basic rules to file protective refund claims as to gain reported on form 1041.
19. Whether to redeem section 303 stock.

BENEFICIARY ELECTIONS

1. Whether to receive "qualified" plan distributions in lump sum.
2. Whether to repudiate the will and take statutory share.
3. Whether to disclaim.