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## INCOME TAXATION OF ESTATES: AN OUTLINE

*The law of income taxation, to the degree still practiced by lawyers, is usually a speciality. Probate is probably the last bastion of the general practitioner. Seldom is there a similarity between the two arts in concept or approach. Yet what the probate lawyer does foreshadows the tax results. Enlightenment is the task of a textbook; what is produced here is a glimmer. This article outlines the rules applying with respect to the income taxation of decedents' estates. Hopefully the generalist will react with some regard for the tax rules.*

LAWRENCE J. LEE\*

### GENERAL RULES

The rate of income tax imposed upon estates is the same rate that is applied to individual taxpayers<sup>1</sup> while the tax base is the "taxable income of estates . . . ."<sup>2</sup> Taxable income, of course, is gross income less allowable deductions.<sup>3</sup> Gross income of an estate consists of all items of gross income received "by estates of deceased persons during the period of administration or settlement of the estate . . . ."<sup>4</sup> These items of gross income are determined by the same rules as applied to individual taxpayers.<sup>5</sup> Additionally, "the deductions and credits allowed to individuals apply also to estates . . . ."<sup>6</sup>

The executor, administrator, or other personal representative (hereinafter "executor")<sup>7</sup> is required to file the estate's income tax return<sup>8</sup>

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1. INT. REV. CODE OF 1954, § 641(a); Treas. Reg. § 1.641(a)-1 (1956). The rate of tax was changed by the Tax Reform Act of 1969, tit. VIII, § 803, 83 Stat. 678 (codified at INT. REV. CODE OF 1954, § 1(d)).

2. INT. REV. CODE OF 1954, § 641(a).

3. Cf. *id.* § 63.

4. Treas. Reg. § 1.641(a)-2(d) (1956). This includes certain items of income accrued prior to the decedent's death but collected subsequent thereto by his estate. See INT. REV. CODE OF 1954, § 691. Income in respect of a decedent is not discussed in this paper. See Brown, *Income In Respect of A Decedent*, 55 CORNELL L. REV. 211 (1970).

5. Treas. Reg. § 1.641(a)-1 (1956).

6. *Id.* § 1.641(b)-1 (1956).

7. UNIFORM PROBATE CODE § 1-201.

8. Treas. Reg. § 1.641(b)-2(a) (1961).

and is personally liable for the tax upon the estate's income earned prior to his discharge.<sup>9</sup> The tax liability, however, follows the assets and is payable by the heirs, devisees, legatees, and distributees to the extent of the shares received by each.<sup>10</sup>

The executor's liability for the tax applies with respect to the estate's taxable income during administration.<sup>11</sup> Administration for probate purposes commences with the granting of letters<sup>12</sup> and closes when the court terminates the proceedings.<sup>13</sup> As to income taxes, however, the period of administration<sup>14</sup>

is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates.<sup>15</sup>

Administration for tax purposes terminates when the first of the following occurs: (1) the executor, also trustee under the will, assumes his duties as trustee even though not discharged as executor;<sup>16</sup> (2) a reasonable period expires for the performance by the executor of all the duties of administration;<sup>17</sup> or (3) the assets are distributed, except for a reasonable reserve to pay unascertained or contingent liabilities and expenses.<sup>18</sup> When an estate is considered terminated for income tax purposes, "the gross income, deductions, and credits of the estate . . . are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate . . ." <sup>19</sup>

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9. *Id.*

10. *Id.* See UNIFORM PROBATE CODE § 1-201 and CAL. PROB. CODE § 161 (West 1956) which define categories of bequests. See also Treas. Reg. § 1.662(a)-4 (1956).

11. Treas. Reg. § 1.641(b)-2 (1961).

12. UNIFORM PROBATE CODE § 3-103.

13. *Id.* § 3-1001.

14. For the duties of an executor or administrator, see *id.* § 3-701.

15. Treas. Reg. § 1.641(b)-3(a) (1960).

16. *Id.* Presumably, however, if a testamentary trust is established upon, for example, preliminary distribution, the executor may still be functioning as such even though he also functions as trustee.

17. *Id.*

18. *Id.*

19. *Id.* § 1.641(b)-3(d) (1960). The question as to when an estate is terminated for income tax purposes is often litigated and is not discussed here. It should be remem-

## IMPOSITION OF TAXES

As indicated above, the estate is liable for income tax at the same rate applied to individual taxpayers.<sup>20</sup> The estate is also liable to pay the tax surcharge,<sup>21</sup> and, since December 31, 1969,<sup>22</sup> it is subject to the minimum tax for tax preferences.<sup>23</sup> The minimum tax is ten percent of the amount by which tax preference items<sup>24</sup> in excess of \$30,000 exceed the normal or regular income tax<sup>25</sup> less certain allowed credits.<sup>26</sup> Items of tax preference<sup>27</sup> include: (1) for years beginning before January 1, 1972,<sup>28</sup> excess investment interest<sup>29</sup> (excess of investment interest expense over net investment income);<sup>30</sup> (2) accelerated depreciation on real property<sup>31</sup> (the difference between the allowable accelerated method over the straight-line method);<sup>32</sup> (3) stock option "spread"<sup>33</sup> (the difference between the option price and the fair market value of the stock);<sup>34</sup> (4) percentage depletion;<sup>35</sup> (5) an amount equal to one-half of the excess of net long-term capital gains over net short-term

bered, however, that it works for, as well as against, a taxpayer: for example, the beneficiary with a loss year may wish to shift income ostensibly taxable to the estate into his individual income.

20. INT. REV. CODE OF 1954, § 1(d); Treas. Reg. § 1.641(a)-1 (1956).

21. INT. REV. CODE OF 1954, § 51(a)(1)(B).

22. Tax Reform Act of 1969, tit. III, § 301(c), 83 Stat. 586.

23. INT. REV. CODE OF 1954, § 56.

24. *See id.* § 57.

25. The reference is to Chapter 1, the normal tax and surtaxes, *i.e.*, the regular income tax, but INT. REV. CODE OF 1954, § 56(a)(2) excepts the accumulated earnings tax (§ 531) and the personal holding company tax (§ 541).

26. For the allowable credits, *see* INT. REV. CODE OF 1954, § 56(a)(2)(A)-(C). Special rules apply in the case of net operating losses. *See id.* § 56(b).

27. *See* INT. REV. CODE OF 1954, § 57.

28. *Id.* § 57(a).

29. *Id.* § 57(a)(1).

30. *Id.* §§ 57(b)(1), (2)(D); § 163(d).

31. *Id.* § 57(a)(2).

32. *Id.* § 167(j) lessens this problem somewhat because the use of accelerated methods were limited under the Tax Reform Act of 1969, tit. V, § 521(a), 83 Stat. 649 (codified at INT. REV. CODE OF 1954, § 1250).

33. INT. REV. CODE OF 1954, § 57(a)(6).

34. Section 57(a)(6) of the 1954 Code covers only qualified (§ 422) or restricted (§ 424) stock options. On the estate's position with respect to such options, *see* INT. REV. CODE OF 1954, § 421(c).

35. *Id.* § 57(a)(8), stated:

With respect to each property . . . the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

capital losses for the taxable year;<sup>36</sup> and (6) accelerated depreciation on personalty subject to a net lease,<sup>37</sup> the includable amount again being the difference between the accelerated and straight-line depreciation. Property is subject to a net lease if the deductions<sup>38</sup> with respect to the property for the year are less than fifteen percent of the rental income produced by such property,<sup>39</sup> or the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.<sup>40</sup>

The total of tax preference items is required to be allocated between the estate and the beneficiaries according to the income allocated to each (presumably the amount of income distributable or distributed to the beneficiaries)<sup>41</sup> and the \$30,000 "exemption"<sup>42</sup> allowed by Int. Rev. Code of 1954, § 56 is allocated among the estate and the beneficiaries according to the ratios established by allocating income.<sup>43</sup>

### GROSS INCOME

According to Treasury Regulation section 1.641(a)-2 (1956), the gross income of the estate is determined in the same manner as that of an individual and is the income received by the estate during administration.<sup>44</sup> Presumably, therefore, sections 61 through 83 of the 1954 Code, defining items specifically included in income, and sections 101 through 123 of the Code, defining items specifically ex-

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36. *Id.* § 57(a)(9)(A). Note there can be some doubling up, for example, if a stock option is exercised and the stock sold in the same year, both the "spread" and the capital gains are preference items.

37. *Id.* § 57(a)(3).

38. *Id.* § 57(c). The deductions referred to are those allowed under § 162.

39. *Id.* § 57(c)(1). It is not clear that the statute is referring to the lessor although presumably it is because on a "net, net" basis the lessee's expenses would exceed 15%. See S. REP. NO. 91-552, 91st Cong., 1st Sess. 114 (1969). Also, on a "net, net" basis, consider real property taxes. Under Treas. Reg. § 1.162-11 (a) (1960) payment of the taxes by the tenant is additional rent (deductible to the tenant as rent) to the landlord and the landlord takes the tax deduction. Does this mean the landlord has incurred the expense with respect to the lease?

Taxes are presumably deducted under INT. REV. CODE OF 1954, § 164 and not under § 162, and § 57(c) refers only to § 162 expenses.

40. INT. REV. CODE OF 1954, § 57(c)(2). Other preference items not commonly applying include: amortization of pollution control facilities (§ 57(a)(4)), amortization of railroad rolling stock (§ 57(a)(5)), and bad debt reserves of financial institutions (§ 57(a)(7)).

41. *Id.* § 58(c).

42. The minimum tax applies only to preferences in excess of \$30,000.

43. INT. REV. CODE OF 1954, § 58(c)(2). See S. REP. NO. 91-552, *supra* note 39, at 117.

44. Treas. Reg. § 1.641(b)-3(a) (1960).

cluded from gross income, control. Additionally, the estate may adopt its own accounting method for determining income without regard to that applied by the decedent or the beneficiaries.<sup>45</sup>

The following illustrate the operating rules involved:

1. The gain realized upon the sale of stock or stock rights owned by the estate are taxable to the estate.<sup>46</sup> If the securities are specifically bequeathed the sale is really on behalf of the specific legatees and the gain is taxable to them;<sup>47</sup> but is taxable to the estate if the specific bequests are subject to an intervening life estate.<sup>48</sup>

2. To the extent the decedent is found to have an interest in a business,<sup>49</sup> the income from its operation (whether by the estate or not) is taxable to the estate.<sup>50</sup>

3. One-half of the income arising from community property is taxable to the estate while the other half is taxable to the surviving spouse.<sup>51</sup>

4. Income distributed by another estate or trust to an estate is taxable to the recipient estate.<sup>52</sup>

5. The following "debt" rules apply: (a) realization in excess of the estate's tax basis in the debt, as is the usual rule, is ordinary income to the estate;<sup>53</sup> (b) distribution of a debt to the debtor in his status as beneficiary does not result in realization of income to the estate;<sup>54</sup> (c) transfer of securities in satisfaction of the estate's obligations or liquidation of the decedent's debts can result in gain or loss to the estate;<sup>55</sup> (d) distribution of securities (in kind) to the beneficiaries results in no gain or loss to the estate;<sup>56</sup> but (e) the distribution of ap-

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45. *Id.* § 1.662(c)-1 (1956).

46. *Manufacturers Hanover Trust Company v. United States*, 410 F.2d 767 (Ct. Cl. 1969); *Ford v. Commissioner*, 66 F.2d 1007 (3rd Cir. 1933); *William H. Hotchkiss*, 16 B.T.A. 1334 (1929).

47. Rev. Rul. 68-666, 1968-2 CUM. BULL. 283.

48. *In re Adolf's Will*, 200 Misc. 277, 103 N.Y.S.2d 542 (Sur. Ct. 1951).

49. *Estate of A. Bluestein*, 15 T.C. 770 (1950).

50. A.R.M. 151, I-1 CUM. BULL. 214 (1922); S.M. 1709, III-1 CUM. BULL. 218 (1924).

51. Rev. Rul. 55-726, 1955-2 CUM. BULL. 24.

52. *Ernest P. Waud, Executors*, 6 B.T.A. 871 (1927).

53. *Estate of Ernst Zobel*, 28 T.C. 885 (1957).

54. *Estate of Edwin Hodge*, 2 T.C. 643 (1943). *But cf.* *Whitfield v. Commissioner*, 311 F.2d 640 (5th Cir. 1962) (beneficiary forgives a debt the estate owes him).

55. I.T. 1562, II-1 CUM. BULL. 33 (1923).

56. S.M. 5719, V-1 CUM. BULL. 281 (1926).

preciated property in satisfaction of a pecuniary legacy can result in gain to the estate.<sup>57</sup>

6. The taxability of income arising on property ultimately taken by statutory right (dower, curtesy) depends on whether the surviving spouse takes the property directly from the decedent or through the estate; if the latter, the income is taxable to the estate until the property is distributed.<sup>58</sup> Once distributed, the income accruing thereafter is taxed to the beneficiary.<sup>59</sup>

7. The proper party to pay tax on the income arising upon specific property depends on whether, under state law, the beneficiary of such property takes it directly from the decedent<sup>60</sup> or whether it first passes through administration.<sup>61</sup> The key is whether the property is subject to administration even though technical legal title vests immediately upon death in the devisees.<sup>62</sup> Possession of the income item is not determinative as it is taxable to the party who, under state law, has the legal right to it.<sup>63</sup> The following is illustrative:

It is perfectly true that under Texas laws an administrator takes no title to the property, either real or personal; that all

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57. Rev. Rul. 66-207, 1966-2 CUM. BULL. 243. If the beneficiary's participation is stated as a percentage or fractional interest there is no "debt" (pecuniary bequest) being satisfied by the distribution. Rev. Rul. 55-117, 1955-1 CUM. BULL. 233. Thus, the distribution of securities in satisfaction of a pecuniary, formula marital deduction clause can result in gain or loss but not if the percentage or fraction formulas are used. Rev. Rul. 60-87, 1960-1 CUM. BULL. 286. Where, however, the estate is distributing its income and, instead of cash, distributes appreciated securities, the estate has a gain. Rev. Rul. 67-74, 1967-1 CUM. BULL. 194.

58. *Smith's Estate v. Commissioner*, 168 F.2d 431 (6th Cir. 1948); *George W. Crawford Estate*, 46 B.T.A. 436 (1942); G.C.M. 9086, X-1 CUM. BULL. 243 (1931).

59. S.M. 2526, III-2 CUM. BULL. 179 (1924).

60. *Abbott v. Welch*, 31 F. Supp. 369 (D. Mass. 1940); *Guaranty Trust Co. of New York, Executor*, 30 B.T.A. 314 (1934); S.M. 2673, III-2 CUM. BULL. 177 (1924); A.R.M. 151, I-1 CUM. BULL. 214 (1922).

61. *Wooley v. Malley*, 30 F.2d 73 (1st Cir. 1929); *Estate of B. Brasley Cohen*, 8 T.C. 784 (1947).

62. UNIFORM PROBATE CODE § 3-101 indicates that real and personal property devolves directly to the beneficiary subject, under § 3-709, to the personal representative taking possession of the assets for the estate's purposes, but "[t]he personal representative shall pay taxes on, and take all steps reasonably necessary for the management, protection and preservation of, the estate in his possession." If the Uniform Probate Code applies, presumably good tax planning (dividing income among as many taxpayers as possible) would warrant judicious selection and timing as to when the executor takes possession of the assets, if at all.

63. *Sanborn v. Commissioner*, 88 F.2d 134 (8th Cir. 1937), *cert. denied*, 301 U.S. 700 (1938); *Hibernia Nat'l Bank in New Orleans v. Donnelly*, 121 F. Supp. 179 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954).

of it descends to and vests in the legatees under a will, in the heirs, if there is none. It is equally true, however, that it does so subject to the payment of the debts of the intestate, and that it is provided that upon the issuance of letters testamentary or administration, the executor or administrator shall have the right to the possession of the estate as it existed at the death of the testator or intestate, and he shall recover possession and hold such estate in trust to be disposed of in accordance with law. It was in recognition of this period of husbandry and control by the administrator, which prudent administration requires, that the Revenue Acts provide that income received by estates during the period of administration or settlement shall be returned and paid by the administrator. They give the administrator the right, however, if a distribution of any of the income is in fact made, to deduct the amount distributed. The income in question here was received by the administrator during the course, and before the close, of the administration. . . . There was, in fact, neither segregation nor distribution of any of the stock or of any of the income from it. There is in law no warrant for the view that dividends on any part of stock passing to residuary legatees along with other property of the estate shall be considered as segregated for income tax purposes from the balance of the estate and the income from it merely because some of the residuary legatees have sold their interest in the estate to the corporation declaring the dividend.<sup>64</sup>

8. The income arising from jointly held property is taxable to the surviving joint tenant and not to the estate.<sup>65</sup>

9. The death of a partner does not terminate the partnership for income tax purposes.<sup>66</sup> The estate ("successor partner") picks up its share of the partnership income for each year it participates.<sup>67</sup> The estate's participation continues until the estate sells or liquidates its partnership interest.<sup>68</sup> If a buy-sell agreement provides that the decedent's interest is to be sold (*vis-à-vis* valued) at the date of death, the estate's participation ends at that date.<sup>69</sup> The decedent's final return includes only income earned to the date of his death<sup>70</sup> and, if it

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64. *Kuldell v. Commissioner*, 69 F.2d 739, 741 (5th Cir. 1934).

65. *Edwin M. Petersen*, 35 T.C. 962 (1961).

66. *Treas. Reg.* § 1.706-1(c)(1) (1956); § 1.708-1(b)(1)(i)(a) (1956).

67. *Id.* § 1.706-1(c)(2) (1956).

68. *Id.* § 1.706-1(c)(3) (1956).

69. *Id.* § 1.706-1(c)(3)(iv) (1956).

70. *Id.* § 1.706-1(c)(3)(ii) (1956).

is not received prior to death it is income with respect to a decedent.<sup>71</sup> The estate includes the balance of the year's and subsequent years' income.<sup>72</sup> The sale or liquidation of the decedent's participation are governed by the usual partnership rules<sup>73</sup> although when including partnership distributions the estate must separate payments of distributive shares of income and payments with respect to the decedent's capital interest.

### DEDUCTIONS

Usually "the deductions and credits allowed to individuals are also allowed to estates . . . ." <sup>74</sup> This involves sections 35 through 48, 141 through 154, 211 through 218 and, as applicable, 161 through 182 of the 1954 Code. These credits and deductions, however, are subject to the limitations provided in section 642.

#### *Deductions Related to Estates—General*

The controlling inquiry here is whether the expense was incurred in behalf of the estate or in behalf of a beneficiary or beneficiaries.

The following are examples of deductible expenses: fiduciary's bond premium;<sup>75</sup> interest paid on specific legacies whether paid him income or corpus;<sup>76</sup> real property taxes,<sup>77</sup> utilities, repairs, insurance, and rent paid by the estate with respect to a leasehold owned by the estate;<sup>78</sup> state income taxes attributable to income (whether or not exempt income under federal law);<sup>79</sup> and, maintenance expenses of a residence held by the estate.<sup>80</sup> Non-deductible items include: debts owed by the decedent (but interest accrued after administration commences on such

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71. *Id.* § 1.706-1(c) (3) (v) (1956).

72. *Id.* § 1.706(c) (3) (ii) (1956).

73. INT. REV. CODE OF 1954, §§ 731, 741, 751.

74. Treas. Reg. § 1.641(b)-1 (1956). Expenses paid in the administration of community property with respect to the surviving spouse's interest are not deductible by the estate but may be allowed to the surviving spouse. Rev. Rul. 55-524, 1955-2 CUM. BULL. 535.

75. Estate of Cornelia Adair, 43 B.T.A. 384 (1941).

76. I.T. 1720, II-2 CUM. BULL. 54 (1923).

77. Taxes are deductible under INT. REV. CODE OF 1954, § 164.

78. Estate of M.M. Stark, 45 B.T.A. 882 (1941). The deduction was allowed even though the estate reduced the value of the lease by the projected operating loss. In short, the estate obtained a *double deduction* of the expenses. To the same effect with respect to the operation of a ranch *see* Robert J. Kleberg, Executors, 31 B.T.A. 95 (1934).

79. Rev. Rul. 61-86, 1961-1 CUM. BULL. 41.

80. Estate of Wm. F. Markham, 12 P-H TAX CT. MEM. 43-874 (1943).

debts paid by the estate is deductible);<sup>81</sup> and legal expenses incurred in contesting a determination of estate taxes<sup>82</sup> (but expenses incurred in a will contest or by the executors in defending their accounting are deductible).<sup>83</sup>

Losses (usually capital in nature) arising from the sale of stock by the estate are deductible by the estate to the extent allowed by statute.<sup>84</sup> These losses are deductible by the legatees, not the estate, if under state law title to the property passed directly to them upon decedent's death.<sup>85</sup> Additionally, a beneficiary is presumably entitled to the dividend exclusion (Int. Rev. Code of 1954, § 116) regardless of what the estate does. An estate is also entitled to the exclusion but is required to prorate it for the amounts of dividends distributed and with respect to which a distributions deduction is claimed. For example, if the estate has \$1,000 dividend income and distributes \$500, it may claim the \$100 exclusion but may deduct only \$450 as a distributions deduction.<sup>86</sup>

Taxes are deductible by the party upon whom they are imposed. If upon the estate, then it takes the deduction;<sup>87</sup> and if upon the decedent, the estate does not claim the deduction (unless as an estate tax item). Such taxes are either deducted on the decedent's final return or they are lost.<sup>88</sup> A testamentary trust may be entitled to the deduction if it pays the tax even though the estate has sufficient assets with which to do so.<sup>89</sup> The estate may not claim as a deduction interest paid on inheritance taxes.<sup>90</sup> If the beneficiary has title to property,

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81. Estate of Jacob S. Hoffman, 36 B.T.A. 972 (1937). The debt is deductible in determining estate taxes. See INT. REV. CODE of 1954, § 2053.

82. James C. Ayer, Trustees, 26 B.T.A. 9 (1932), *appeal dismissed*, 63 F.2d 231 (2d Cir. 1933), *cert. denied*, 289 U.S. 752 (1933).

83. Commissioner v. Macy, 215 F.2d 875 (2d Cir. 1954). The expenses are deductible even if the executors are charged with fraud. Commissioner v. Heininger, 320 U.S. 467 (1943). See Tax Reform Act of 1969, tit. IX, § 902, 83 Stat. 710 (codified at INT. REV. CODE of 1954, § 162).

84. County Nat'l Bank & Trust Co. v. Helvering, 122 F.2d 29 (D.C. Cir. 1941); William H. Hotchkiss Estate, 16 B.T.A. 1334 (1929); Rev. Rul. 56-222, 1956-1 CUM. BULL. 155.

85. Arrott v. Heiner, 92 F.2d 773 (3rd Cir. 1937).

86. Treas. Reg. § 1.661(c)-1 (1969).

87. Rita S. Goldberg, 15 T.C. 696 (1950).

88. Herbert G. Perry, 32 B.T.A. 513 (1935).

89. Penrose v. United States, 18 F. Supp. 413 (E.D. Pa. 1937). *But cf.* Jones v. Hassett, 45 F. Supp. 195 (D. Mass. 1942).

90. Estate of Ella K. McClatchy, 12 T.C. 370 (1949), *aff'd per curiam*, 179 F.2d 678 (9th Cir. 1950).

although in the estate's hands, he is entitled to the real property tax deduction if he pays the tax.<sup>91</sup>

### *Section 642 Limitations*

Section 642 of the 1954 Code pertains to special estate rules with respect to credits and deductions. An estate is entitled to a credit for partially tax-exempt interest to the extent that the interest is not distributed to a beneficiary.<sup>92</sup> The same treatment applies to a foreign tax credit.<sup>93</sup> An estate is also entitled to a personal exemption of \$600.<sup>94</sup>

### *Charitable Bequests*

An estate is entitled to an unlimited charitable deduction against gross income for any amounts which, pursuant to the terms of the will<sup>95</sup> during the taxable year, are "paid or permanently set aside . . . or . . . to be used . . ." for charitable purposes.<sup>96</sup> If the will specifically pro-

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91. I.T. 3190, 1938-1 CUM. BULL. 143.

92. INT. REV. CODE OF 1954, § 642(a)(1); Treas. Reg. § 1.642(a)(1)-1 (1956). Of course, expenses incurred in connection with exempt income are not allowed as income tax deductions although such expenses are allowed for estate tax purposes. Rev. Rul. 63-27, 1963-1 CUM. BULL. 57.

93. INT. REV. CODE OF 1954, § 642(a)(2); Treas. Reg. § 1.642(a)(2)-1 (1964).

94. INT. REV. CODE OF 1954, § 642(b); Treas. Reg. 1.642(b)-1 (1956). Cf. The Tax Reform Act of 1969, tit. VIII, § 801, 83 Stat. 675, which increased the INT. REV. CODE of 1954, § 151 exemption for individuals in stages to \$750.

95. Presumably an executor can not make charitable gifts without authorization in the will, cf. UNIFORM PROBATE CODE § 3-709, and if he did the gift would first be treated as a distribution to the beneficiaries and in turn a gift by them. But cf. *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937); Rev. Rul. 68-667, 1968-2 CUM. BULL. 289.

96. INT. REV. CODE OF 1954, § 642(c); Treas. Reg. § 1.642(c)-1 (1956). A trust will no longer obtain a deduction for amounts "set-aside" for charity; a trust must actually pay the gift. H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 294-95 (1969) (conference report on The Tax Reform Act of 1969). The following rules govern the disposition of income, 6 W. PAGE, THE LAW OF WILLS § 59.15, at 424-27 (Bowe-Parker Rev. 1962):

A general legacy, other than a gift of testator's entire estate or a fraction or residue thereof does not carry income and profits before it is due, nor is a demonstrative legacy entitled to income from the property upon which it is charged or out of which it is to be paid. Such legacies are entitled, instead, to interest in accordance with the general rules of law relating to that subject. The income from property out of which a general or demonstrative legacy is given goes into the residue. Income from a general legacy arising after it is paid to the legatee passes as an incident to the legacy. After a testamentary trust fund has been set up, any decrease in its value should not be made up from undistributed assets.

A gift of all of testator's estate, or a fraction thereof, or the residue thereof, passes all income and increment not otherwise disposed of,

vides the source from which the gift is to be made, the will controls;<sup>97</sup> if not, the gift "is deemed to consist of the same proportion of each class of the items of income of the estate . . . as the total of each class bears to the total of all classes."<sup>98</sup> Where income is otherwise disposed of by the will or its disposition is otherwise directed by state law, however, a gift from the corpus is not an allowable income tax deduction.<sup>99</sup>

Under Treasury Regulation section 1.642(c)-2(1956), if the amount paid, set aside, or used "includes any items of estate . . . income [e.g. exempt interest] not entering into the gross income of the estate . . . the [charitable] deduction . . . is limited to the gross income so paid, permanently set aside, or used." In short, non-taxable income cannot be used as a basis for a charitable deduction. Unless the will directs otherwise, the charity's share of income includes its share of deductions attributable to that income, e.g., depreciation, and hence to that extent the depreciation deduction is wasted.<sup>100</sup>

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although such income is subject first to payment of expenses incurred in the interest of the estate, and may be appropriated to pay pecuniary bequests. As between life tenant and remainderman, expenses of leasing, etc., have been charged upon the principal. Income may be applied to interest upon debts of testator, which accrues after his death.

The income and profits of the estate as a whole are subject to deduction for the cost of administering, maintaining and preserving the general assets between the time of testator's death and distribution, which ordinarily results in diminution of the residue. If such expenditure increases the residue it may be charged against the corpus of the residue.

A life interest or a gift of income for a limited period does not pass an accretion due to the increase in value of the corpus. A beneficiary of a life interest in a specific devise or bequest is entitled to income accruing after the death of the testator and before termination of the life estate, although accretions in the form of increase in principal may accrue in whole or in part to the remainderman. Likewise, a life tenant's interest is chargeable with the cost of preservation of the property during the period of his enjoyment, unless the will indicates a contrary intent.

....

A specific devise of realty passes the income thereof from testator's death, including royalties for mining rights, after deducting taxes, assessments and other lawful charges which accrue after testator's death.

97. Treas. Reg. § 1.642(c)-2 (1956); § 1.662(b)-2 (1956), Examples (1) and (2); § 1.662(c)-4 (1956), Example. No guidance is provided in the regulations as to what happens where the will specifies a particular source and that source generates no income although the estate otherwise has income. Presumably a gift from corpus would not be deductible. See Rev. Rul. 68-667, 1968-2 CUM. BULL. 289.

98. Treas. Reg. § 1.642(c)-2 (1964).

99. Rev. Rul. 68-667, 1968-2 CUM. BULL. 289; cf. *W. K. Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3rd Cir. 1944); *Bank of America Nat'l Trust & Sav. Ass'n v. Commissioner*, 126 F.2d 48 (9th Cir. 1942).

100. Treas. Reg. § 1.642(e)-1 (1964). As an illustration, if the estate has \$10,000

The charitable bequest is permanently set aside if the will directs the gift and the deduction "does not . . . depend upon the action of the executors in crediting the income upon their books, but upon the permanent setting aside of the income by the will itself . . ."<sup>101</sup> If the principal (and attendant income) is earmarked for charity by the will, a deduction is allowed although creditors' claims leave open the actual amount to ultimately pass to charity.<sup>102</sup> A deduction is only allowed for actual income set aside; income taxable to the estate as income in respect to a decedent (Int. Rev. Code of 1954, § 691) but not actually received by the estate is not a basis for a deduction.<sup>103</sup> Similarly, a deficiency dividend (to escape the personal holding company tax), though "deemed paid" and included in the estate's income, cannot be claimed as a deduction where treated under state law as a part of the corpus of the estate (assets distributed upon liquidation of the corporation).<sup>104</sup> If an estate elects subchapter "S" treatment, it may not claim a deduction with respect to the corporation's income until the corporation actually pays out a dividend.<sup>105</sup> Where the estate borrows money to pay administrative expenses and thereby preserves the corpus to the charities, the estate can claim no deduction from income for amounts repaid on the loan.<sup>106</sup>

A charitable deduction is allowed with respect to income paid to charity where the charity takes part of the estate in a will contest settlement, as the income is deemed to follow the corpus.<sup>107</sup> As is the general rule, however, the income follows the title and if the asset (usually real property) descends directly to the legatee, so does the

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income, \$5,000 taxable and \$5,000 tax-exempt, and gives \$2,000 to charity, only \$1,000 is deductible as a charitable deduction. *See* Treas. Reg. § 1.662(b)-2 (1956).

101. *Bowers v. Slocum*, 20 F.2d 350, 352 (2d Cir. 1927); *cf.* *Commissioner v. Leon A. Beeghly Fund*, 310 F.2d 756 (6th Cir. 1962); *Elizabeth Guthrie Heywood, Executors*, 11 B.T.A. 29 (1928) holding that the estate is not entitled to the deduction in honoring charitable pledges made by decedent before he died where the will is silent on charitable gifts. The pledge, however, may be deductible for estate tax purposes.

102. *Rockland Oil Co.*, 22 T.C. 1307 (1954). *But cf.* *Willman v. Welch*, 99 F.2d 75 (1st Cir. 1938), indicating that no deduction is allowable where the estate is insufficient to pay pecuniary legacies in full and hence the charity would take nothing.

103. *Estate of H. E. Freund v. Commissioner*, 303 F.2d 30 (2d Cir. 1962). *But cf.* *Clymer's Estate v. Commissioner*, 221 F.2d 680 (3rd Cir. 1955), allowing the deduction where the funds (collections on partnership accounts receivable) were actually paid to the estate.

104. *Estate of Joseph R. Esposito*, 40 T.C. 459 (1963).

105. *Sid W. Richardson Foundation v. United States*, 306 F. Supp. 755 (N.D. Tex. 1969).

106. *Riggs Nat'l Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965).

107. Rev. Rul. 59-15, 1959-1 CUM. BULL. 164.

income, and a charitable deduction can not be claimed with respect to such income.<sup>108</sup> The amount of the charitable gift is less the charges (taxes, administrative expenses, etc.) attached to it by the will or state law.<sup>109</sup>

It is well to reflect again on the allocation and flow of income. For example, California provides:

Unless otherwise provided by the will of the testator, (a) all net income received during the period of administration from real and personal property not specifically or demonstrably devised or bequeathed, including net income from property sold during said period, shall be distributed pro rata as income to any trust or trusts of all or any part of the residuary estate, and to any tenant or tenants for life or for a term of years of all or any part of the residuary estate, and to any person or persons entitled absolutely and free of trust to all or any part of the residuary estate but (b) no such income shall be distributed as income of a general pecuniary legacy in trust, except that the interest on a pecuniary legacy in trust provided for in Section 162 shall be distributed as income to said trust.<sup>110</sup>

A major charitable bequest is usually from the residue and hence the income of the estate will follow that bequest. Under prior law, considerable litigation arose over the question of charitable remainders as to whether the charity would take at all, and if so, how much.<sup>111</sup> The Tax Reform Act of 1969 settles this litigation by limiting the amount deductible under section 2055 of the 1954 Code to charitable remainders in annuity or unitrusts.<sup>112</sup> The 1969 Act also establishes elaborate rules for the deductibility of income interests given to charity under the terms of a trust, usually with individual remaindermen.<sup>113</sup> For income tax purposes an individual donor usually is allowed a de-

108. Rev. Rul. 57-133, 1957-1 CUM. BULL. 200; cf. *Maloney v. Glover*, 171 F.2d 870 (9th Cir. 1948), *cert. denied*, 337 U.S. 917 (1949).

109. *Guaranty Trust Co., Executor*, 31 B.T.A. 19 (1934), *aff'd per curiam*, 76 F.2d 1010 (2d Cir.), *cert. denied*, 296 U.S. 591 (1935). Cf. e.g., CAL. PROB. CODE § 970 (West 1956).

110. CAL. PROB. CODE § 162.5 (West Supp. 1970).

111. Ordinarily, the deduction for charitable remainders is claimed under INT. REV. CODE of 1954, § 2055. The issue could arise in an income tax context where the charity participates in income along with individual beneficiaries or in the capital gains situation discussed in the text. To the extent that a charity has both the income and remainder interests, however, a full deduction should be allowed. Cf. *id.* § 170(f) (2) (D).

112. *Id.* § 170(f) (2) (A), § 2055(e) (2) (A).

113. *Id.* § 170(f) (2) (B), § 2055(e) (2) (B).

deduction for charitable income interests in trusts only (1) where the grantor is taxed on the trust's income, and (2) the income interest is payable in the form of a guaranteed annuity, or the trust instrument requires that the charity receive an annual fixed percentage of the fair market value of the trust property.<sup>114</sup> These rules do not control estates and the estate may receive a deduction, for example, if the will provides that the estate is to make certain pecuniary bequests from income.

In accordance with section 642(c) of the 1954 Code, such a deduction is dependent upon whether (1) the will sets aside or provides for such bequests, and (2) whether the estate has "income" in hand to either distribute or set aside.

To the extent that amounts paid, permanently set aside, or used for charitable purposes include long-term capital gains, "the deduction allowable under section 642(c) must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss."<sup>115</sup> The regulations give an example,<sup>116</sup> but generally speaking, if the charitable bequest includes long-term capital gains the allowable charitable deduction attributable to such gains is reduced by one-half, *i.e.*, the fifty percent of the capital gains allowed as a deduction by section 1202 of the Code of 1954 (but this fifty percent is also allowed to the estate as a deduction). Ordinarily capital gains are treated as part of the corpus and are taxed to the estate, so the issue arises only where the charity receives or participates in the residue of the estate or is bequeathed specific properties. In the usual situation, where one-half of the residue is bequeathed to the charity, if the estate sells properties at a gain, the charity is entitled to have, in the absence of directions otherwise in the will, one-half of the gains added to the corpus allocable to them, and the estate should receive a charitable deduction equal to the capital gains so allocated, less the capital gains deduction. In short, because of the fifty percent capital gains deduction, plus the charitable deduction, the estate should in effect receive an income tax deduction for the full amount of the charity's share of the gain.<sup>117</sup>

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114. *Id.* § 170(f) (2).

115. Treas. Reg. § 1.642(c)-3 (1956).

116. *Id.*

117. Charitable remainders in trust, as indicated in the text, are limited by the Tax Reform Act of 1969, tit. II, § 201, 83 Stat. 549 (codified at INT. REV. CODE of 1954, § 170).

### *Other Deductions*

An estate is entitled to use the net operating loss deduction (with carryovers or carrybacks) modified to exclude the charitable deduction, and the deduction for distributions of income. Presumably an estate is also required to make the modifications specified for determining the deduction for individual taxpayers such as excluding the personal exemption.<sup>118</sup>

An estate is entitled to the depreciation and depletion deductions unless the deductions are apportioned to the estate's beneficiaries.<sup>119</sup> These deductions are "apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each."<sup>120</sup> As indicated above, a charity is a beneficiary for this purpose.

### *Double Deductions*

The estate has an election whether to claim amounts allowed under section 2053(a)(2) of the 1954 Code (administrative expenses) or under section 2054 (casualty or theft losses) as income or estate tax deductions but such a deduction cannot be claimed in both instances.<sup>121</sup>

Administrative expenses include only [those] as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee . . . . Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses.<sup>122</sup>

Miscellaneous administrative expenses may be numerous:

(1) Miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in preserving and distributing the estate are deductible, including the cost of storing or maintaining property of the estate, if it is impossible to effect immediate distribution to the beneficiaries.

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118. INT. REV. CODE OF 1954, § 642(d); Treas. Reg. § 1.642(d)-1, § 1.172-3 (1965).

119. INT. REV. CODE OF 1954, § 642(e); Treas. Reg. § 1.642(e)-1 (1964).

120. INT. REV. CODE OF 1954, § 167(h); Treas. Reg. § 1.167(h)-1(c) (1969); INT. REV. CODE OF 1954, § 611(b)(4); Treas. Reg. § 1.611-1(c)(5) (1965).

121. INT. REV. CODE OF 1954, § 642(g); Treas. Reg. § 1.642(g)-1 (1956). The regulation specified the requirements for the election.

122. Treas. Reg. § 20.2053-3(a) (1965).

Expenses for preserving and caring for the property may not include outlays for additions or improvements; nor will such expenses be allowed for a longer period than the executor is reasonably required to retain the property.

(2) Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one. Where an item included in the gross estate is disposed of in a bona fide sale (including a redemption) to a dealer in such items at a price below its fair market value, for purposes of this paragraph there shall be treated as an expense for selling the item whichever of the following amounts is the lesser:

(i) the amount by which the fair market value of the property on the applicable valuation date exceeds the proceeds of the sale, or (ii) the amount by which the fair market value of the property on the date of the sale exceeds the proceeds of the sale. The principles used in determining the value at which an item of property is included in the gross estate shall be followed in arriving at the fair market value of the property for purposes of this paragraph.<sup>123</sup>

Under the regulations the following operating rules apply:

(1) The election may be made among deductions and presumably any single item can be allocated in part to the estate tax and in part to the income tax.<sup>124</sup>

(2) The prohibition on the double deduction of certain items has no application to taxes, interest and business expenses<sup>125</sup> allowed both under section 2053(a)(3) of the 1954 Code as claims against the estate and also as income tax deductions to the estate for income in respect to a decedent.<sup>126</sup>

(3) A single deduction does apply to taxes, interest, and business expenses which arise during the course of administration which are allowable as administrative expenses under section 2053(a)(2) of the 1954

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123. *Id.* § 20.2053-3(d) (1965).

124. *Id.* § 1.642(g)-2 (1956).

125. INT. REV. CODE of 1954, § 691 (b); Treas. Reg. § 1.691(b)-1 (1957), indicating that the Code sections concerned are 162, 163, 164, and 212.

126. INT. REV. CODE of 1954, 642(g); Treas. Reg. § 1.642(g)-2 (1956).

Code<sup>127</sup> vis-à-vis section 2053(a)(3) pertaining to "claims against the estate."

(4) A single deduction does apply to items such as medical expenses which are allowed as claims against the estate (Int. Rev. Code of 1954, § 2053(a)(3)) but which are not accrued at death and which are not allowable under sections 162, 163, 164, and 212.<sup>128</sup>

A widow's alimony claim<sup>129</sup> is allowable both as a claim against the estate and as a deduction against the estate's gross income.<sup>130</sup> Selling expenses in connection with the sale of the estate's assets are allowable both as administrative expenses for estate tax purposes and as an offset against the selling price in computing the estate gain for income tax purposes.<sup>131</sup>

### *Carryovers*

The three applicable carryovers are: (1) the net operating loss carryovers provided in section 172 of the 1954 Code, (2) the capital loss carryovers allowed by section 1212, and (3) excess deductions not already covered by items (1) and (2).<sup>132</sup>

If the estate has unused operating loss and capital loss carryovers when it terminates, the carryovers are allowed "to the beneficiaries succeeding to the property of the estate . . ." <sup>133</sup> The carryovers in the hands of the beneficiary are the same as in the estate except that a capital loss carryover in the hands of a corporate beneficiary is a short-term capital loss regardless of its nature in the estate.<sup>134</sup> The losses carry over to the beneficiary's year in which the estate terminates<sup>135</sup> and the last year of the estate (usually a short year) and the first taxable year of the beneficiary into which the loss is carried each count as separate taxable years for purposes of determining the number of carryover years available to the

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127. Treas. Reg. § 1.642(g)-2 (1956).

128. *Id.*

129. *Laughlin's Estate v. Commissioner*, 167 F.2d 828 (9th Cir. 1948).

130. Rev. Rul. 67-304, 1967-2 CUM. BULL. 224.

131. *Estate of Viola E. Bray*, 46 T.C. 577 (1966), *aff'd*, 396 F.2d 452 (6th Cir. 1968).

132. INT. REV. CODE OF 1954, § 642(h). Treas. Reg. § 1.642(h)-2(c) (1956) provides: Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate . . . for its last taxable year shall not be taken into account again in determining excess deductions on termination of the . . . estate. . . .

133. Treas. Reg. § 1.642(h)-1(a) (1965).

134. *Id.*, § 1.642(h)-1(b) (1965).

135. *Id.*

beneficiary.<sup>136</sup> If the year in which the estate terminates is the last year in which the loss carryover may be used (*i.e.*, the last year to which the carryover may be carried), it is treated as an "excess deduction" to the extent it is not used.<sup>137</sup>

If the estate has unused deductions in the year it terminates, such as a net operating loss carryover for the final year, and (1) the deductions are not part of the operating or capital loss carryover, and (2) are other than the \$600 personal exemption or the charitable deduction, such deductions are allowed to the "beneficiaries succeeding to the property of the estate . . . ." <sup>138</sup> Unlike the net operating loss carryover,<sup>139</sup> excess deductions are not allowed in computing adjusted gross income.<sup>140</sup> The deduction is allowed only in the year in which the beneficiary's estate terminates (usually a short year) and if the excess deductions exceed the beneficiary's income for such year, the unused portion may not be carried over to the beneficiary's subsequent year.<sup>141</sup>

The "beneficiaries succeeding to the property of the estate" are those who bear the burden of the loss or expense which gives rise to the carryover or excess deduction.<sup>142</sup> Generally speaking, in intestate estates, the beneficiaries are the heirs and next of kin to whom the estate is distributed<sup>143</sup> and for testate estates, they are the residuary beneficiaries.<sup>144</sup> The carryovers or excess deductions are allocated among the class of beneficiaries who are entitled to claim such deductions proportionately as they share in the distributions from the estate.<sup>145</sup>

#### DISTRIBUTABLE NET INCOME

The theory of taxing a decedent's estate is to tax the income either to the estate or to the beneficiaries. This is accomplished by allowing the estate to deduct income distributed to the beneficiaries and taxing

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136. Cf. *id.* § 1.381(c)(1)-1(e) (1960) for a comparable rule in corporate acquisitions.

137. *Id.* §§ 1.642(h)-1(b) (1965), -2(b) (1956). In effect *id.* § 1.642(h)-1(b) (1965), discussed *supra* note 136, is mitigated.

138. INT. REV. CODE OF 1954, § 642(h) (2).

139. Treas. Reg. § 1.642(h)-1(b) (1965).

140. *Id.* § 1.642(h)-2(a) (1956).

141. *Id.*

142. The matter is covered in detail in *id.* § 1.642(h)-3(a) (1956).

143. *Id.* § 1.642(h)-3(b) (1956).

144. *Id.* § 1.642(h)-3(c) (1956).

145. *Id.* § 1.642(h)-4 (1956). See *id.* § 1.642(h)-5 (1964).

such distributions to the recipients. The starting point is distributable net income.

### *Non-Distributable Net Income Items*

Initially it should be stated that certain distributions are neither deductible by the estate nor taxable to the beneficiaries.<sup>146</sup> Pecuniary bequests and specific bequests<sup>147</sup> payable in a lump sum or in three installments or less<sup>148</sup> and which are not: (1) by the terms of the will or applicable state law, paid from income;<sup>149</sup> (2) annuities;<sup>150</sup> (3) the residue of the estate;<sup>151</sup> or (4) a lump sum in lieu of four or more installments as provided in the will,<sup>152</sup> are "not allowed as a deduction to an estate . . . and . . . [are] not included in the gross income of a beneficiary . . . ." <sup>153</sup> Thus, the rule operates only in testate estates. In determining whether a particular bequest is payable in four or more installments: (1) personal use items (*e.g.*, personal effects) are disregarded;<sup>154</sup> (2) real property specifically devised which under state law passes directly from the decedent to the devisee is not counted;<sup>155</sup> (3) bequests for which the will provides no specific time of payment, if made in the ordinary course of administration, are considered as paid in a single installment;<sup>156</sup> and (4) bequests payable at any specified time under the will are treated as a single installment.<sup>157</sup> Note that section 102(a) of the 1954 Code which excludes from gross income "the value of property acquired by gift, bequest, devise or inheritance," does not make an exception for bequests paid in four or more installments.

Treasury Regulation section 1.663(a)-1(c)(2) (1956) gives the following examples of the installment rule:

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146. INT. REV. CODE OF 1954, § 663(a).

147. Treas. Reg. § 1.663(a)-1(a) (1956): "a specific sum of money or specific property . . . ." See also *id.* § 1.663(a)-1(b) (1956): "the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death . . . ."

148. INT. REV. CODE OF 1954, § 663(a)(1); Treas. Reg. § 1.663(a)-1(a) (1956).

149. INT. REV. CODE OF 1954, § 663(a)(1); Treas. Reg. § 1.663(a)-1(b)(2)(i) (1956).

150. Treas. Reg. § 1.663(a)-1(b)(2)(ii) (1956).

151. *Id.* § 1.663(a)-1(b)(2)(iii) (1956).

152. *Id.* § 1.663(a)-1(b)(2)(iv) (1956).

153. *Id.* § 1.663(a)-1(a) (1956).

154. *Id.* § 1.663(a)-1(c)(1)(i) (1956).

155. *Id.* § 1.663(a)-1(c)(1)(ii) (1956); *cf. id.* § 1.661(a)-2(e) (1956).

156. *Id.* § 1.663(a)-1(c)(1)(iii) (1956).

157. *Id.* § 1.663(a)-1(c)(1)(iv) (1956).

*Example (1).* (i) Under the terms of a decedent's will, \$10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, \$10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, \$25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and \$50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The \$10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The \$10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

*Example (2).* Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Amounts paid, set aside, or used for charitable purposes under sec-

tion 642(c) of the 1954 Code and which are allowed as charitable deductions to the estate are not treated either as a deduction to the estate for income distributed or, as income to the charitable beneficiary.<sup>158</sup>

Finally, distributions do not include amounts required to be paid by a decedent's estate pursuant to a court order or decree as an allowance or award under local law for the support of the decedent's widow or other dependent for a limited period during the administration of the estate, except to the extent such amounts are payable out of and chargeable to income under the order or decree or local law.<sup>159</sup>

This regulation is questionable from a theoretical point of view because ordinarily the widow's allowance would be payable from the estate's personal property which would include income.<sup>160</sup> In *Estate of Lawrence R. McCoy*,<sup>161</sup> a deduction was allowed for the widow's allowance even though paid from the corpus of the estate, but the question as to whether the widow was taxable on the allowance was unanswered. A question could arise as to whether the allowance arises from income even if the will so directs where the local probate court is not required to follow the will in making the allowance.<sup>162</sup>

### Definition

The term "distributable net income" (DNI) means the estate's taxable income for the year, computed with the following modifications:

1. DNI is determined without regard to the deduction allowed under section 661 of the 1954 Code for amounts paid, credited, or required to be distributed to beneficiaries.<sup>163</sup>

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158. INT. REV. CODE OF 1954, § 663(a)(2); Treas. Reg. § 1.663(a)-2 (1956).

159. *United States v. James*, 333 F.2d 748 (9th Cir. 1963), *cert. denied*, 379 U.S. 932 (1964); Treas. Reg. § 1.661(a)-2(e) (1956).

160. *Estate of Xydias*, 102 Cal. App. 2d 404, 227 P.2d 468 (1951); *cf.* UNIFORM PROBATE CODE §§ 2-403, -404 indicating that the executor may select the source from which payment is made.

161. 50 T.C. 562 (1968).

162. *See* CAL. PROB. CODE § 750 (West 1956).

163. INT. REV. CODE OF 1954, § 643(a)(1) reads, in part "[n]o deduction shall be taken under [section] . . . 661 (relating to additional deductions)." It is not clear what the parenthetical clause means. Treas. Reg. § 1.643(a)-1 (1956) states: "amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income." INT. REV. CODE OF 1954, § 661(a) refers to two types of distributions: (1) amounts required to be distributed currently, and (2) "any

2. No deduction is allowed in computing DNI for the \$600 personal exemption allowed the estate under section 642(b).<sup>164</sup>

3. Capital gains (long or short term) are excludable from DNI if (a) the gains are allocated to corpus, and (b) either are *not* paid, credited, or required to be distributed to any beneficiary during the taxable year,<sup>165</sup> or, (c) are *not* "paid, permanently set aside, or . . . used . . ." for charitable purposes.<sup>166</sup> Capital gains are ordinarily allocated to the corpus<sup>167</sup> unless (a) allocated to income by the terms of the will or local law,<sup>168</sup> or (b) utilized under the directions of the will or by the practice of the fiduciary in determining the amount of income or corpus which is distributed or required to be distributed to the beneficiary.<sup>169</sup>

4. Capital losses (long or short term) are excluded from DNI unless such losses are "netted" in determining the amount of capital gains which are paid, credited, or required to be distributed to a beneficiary.<sup>170</sup>

5. The fifty percent capital gains deduction allowed by section 1202 of the 1954 Code is not allowed in computing DNI except to the extent it is allocated to capital gains paid, set aside, or used for charity.<sup>171</sup>

6. Extraordinary dividends and taxable stock dividends, to the extent otherwise includable in taxable income, are treated as DNI even if allocated to corpus.<sup>172</sup>

7. Tax-exempt interest (as provided in section 103 of the 1954 Code), less expenses allocable to such income which would have been allowed as deductions but for section 265, is included in DNI.<sup>173</sup> If a charitable contribution paid or set aside includes tax-exempt income, however, the tax-exempt income includable in DNI under the general rule stated here

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other amounts properly paid or credited or required to be distributed for such taxable year."

164. INT. REV. CODE of 1954, § 643(a)(2); Treas. Reg. § 1.643(a)-2 (1956).

165. Treas. Reg. § 1.643(a)-3(a)(2) (1969).

166. INT. REV. CODE of 1954, § 643(a)(3). Subject to the will's directions or applicable local law, capital gains paid or set aside for charity are included in DNI. Treas. Reg. § 1.643(a)-3(a) (1969). The charitable gift includes its proportionate share of all items of income including capital gains. Treas. Reg. § 1.642(c)-2 (1956).

167. See 96 C.J.S. WILLS § 1030(1) (1957).

168. Treas. Reg. § 1.643(a)-3(a)(1) (1969).

169. *Id.* § 1.643(a)-3(a)(3) (1969); see Rev. Rul. 68-392, 1968-2 CUM. BULL. 284.

170. INT. REV. CODE of 1954, § 643(a)(3); Treas. Reg. § 1.643(a)-3(b) (1969). See, e.g., *Marion Shainwald Sevier*, 14 B.T.A. 709 (1928).

171. INT. REV. CODE of 1954, § 643(a)(3); Treas. Reg. § 1.643(a)-3(c) (1969).

172. Treas. Reg. § 1.643(a)-4 (1969).

173. INT. REV. CODE of 1954, § 643(a)(5); Treas. Reg. § 1.643(a)-5 (1956). For allocation of expenses see *Tucker v. Commissioner*, 322 F.2d 86 (2d Cir. 1963); Rev. Rul. 63-27, 1963-1 CUM. BULL. 57.

is reduced by the amount of exempt income included in the charitable gift.<sup>174</sup>

8. The dividend exclusion (as provided in Int. Rev. Code of 1954, § 116) is also included in DNI.<sup>175</sup>

### DNI DEDUCTION

In addition to the deductions discussed *infra*, an estate is allowed a deduction for distributions to beneficiaries of the amount of income<sup>176</sup> for the taxable year required to be *distributed currently*,<sup>177</sup> and any other amounts properly paid or credited or required to be distributed for the year involved,<sup>178</sup> but the income distributions deduction cannot exceed the estate's DNI.<sup>179</sup> Generally, *income required to be distributed currently* is income which the will requires to be distributed as earned whether from corpus or income to the extent it is paid from income.<sup>180</sup> The estate obtains the deduction whether or not such income is in fact

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174. Treas. Reg. § 1.643(a)-5(b) (1956). Unless the will states a source from which the charitable gift is made, such gift includes a proportionate share of each class of income. *Id.* § 1.642(c)-2 (1956). Of course, a deduction is not allowed under INT. REV. CODE of 1954, § 642(c) from gross income for a charitable contribution or set aside to the extent the gift includes tax-exempt income. Treas. Reg. § 1.642(c)-2 (1956). INT. REV. CODE of 1954, § 643(a)(5) prevents a double disallowance by excluding the exempt income portion of the charitable gift from the amount of exempt income included in DNI.

175. INT. REV. CODE of 1954, § 643(a)(7); Treas. Reg. § 1.643(a)-7 (1956).

176. Treas. Reg. § 1.643(b)-1 (1956) states: "the amount of income of an estate . . . for the taxable year determined under the terms of the governing instrument and applicable local law."

177. INT. REV. CODE of 1954, § 661(a)(1); Treas. Reg. § 1.661(a)-2(a)(1) (1956). Code § 661(a) referring to the estate's deduction and § 662(a) concerning the inclusion of income to the beneficiary are divided into two categories: (1) "income for such taxable year required to be distributed currently . . ."; (2) "amounts properly paid or credited or required to be distributed for such taxable year . . ." Presumably, the distinction between (1) "required to be distributed currently," and (2) "required to be distributed" is the word "currently." Thus, the will may provide for the distribution as earned ("currently") or require distribution but without specifying a time.

178. INT. REV. CODE of 1954, § 661(a)(2); Treas. Reg. § 1.661(a)-2(a)(2) (1956).

179. The estate cannot create a loss by income distributions.

180. Treas. Reg. § 1.661(a)-2(b) (1956); § 1.651(a)-2(a) (1956). Cf. Estate of Andrew J. Igoe, 6 T.C. 639 (1946).

The executor must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the estate's taxable year. Treas. Reg. § 1.651(a)-2(a) (1956). An estate is seldom placed under a burden to pay out income currently. The will specifies who is entitled to the income earned from a stated date but the executor is seldom directed as to when the income should be paid out.

paid out to the beneficiary so long as it is required to be distributed currently to the beneficiary. All other "amounts properly paid or credited or required to be distributed . . ." include all income payments not included in currently distributable income, as, for example, distributions from an estate where the executor has discretion as to the amount of and time for distribution of such income.<sup>181</sup> The latter concept also includes distributions in kind.<sup>182</sup>

The following rules apply to DNI distributions in kind:

1. No gain or loss is recognized to the estate by reason of the distribution, unless to satisfy a specific bequest of property other than that distributed or a pecuniary bequest.<sup>183</sup>

2. The measure of the deduction to the estate and the income to the beneficiary is the property's fair market value at the time distributed.<sup>184</sup>

3. The beneficiary's basis in the property is its fair market value to the extent it is included into his income at such value.<sup>185</sup> If the property is not includable in the beneficiary's income, as, for example, where the value exceeds DNI, the basis rules provided in sections 1014 and 1015 of the 1954 Code apply.<sup>186</sup> If both cash and property is distributed, the cash is first treated as income and the property counts against income only to the extent of the excess of DNI over the cash.<sup>187</sup> If several items of property are distributed, a pro rata portion of the total value of each item is treated as income.<sup>188</sup>

Amounts paid to an estate creditor who is also beneficiary is not a distribution of income but a repayment of a debt and hence not deductible by the estate.<sup>189</sup> Property distributed in kind (real estate) to a beneficiary is not a DNI deduction to the estate if, under local law, title passes directly to the devisee even though the executor is entitled to possession.<sup>190</sup> A distribution by the estate of a right to receive future payments (*e.g.*, measured by a share of future partnership earnings) is

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181. Treas. Reg. § 1.661(a)-2(c) (1956).

182. *Id.* § 1.661(a)-2(c) (1956).

183. *Id.* § 1.661(a)-2(f) (1) (1956).

184. *Id.* § 1.661(a)-2(f) (2) (1956).

185. *Id.* § 1.661(a)-2(f) (3) (1956). See Rev. Rul. 64-314, 1964-2 CUM. BULL. 167.

186. Treas. Reg. § 1.661(a)-2(f) (3) (1956).

187. *Id.*

188. *Id.*

189. *Thomas Lonergan Trust*, 6 T.C. 715 (1946); *cf.* Rev. Rul. 68-48, 1968-1 CUM. BULL. 301.

190. Rev. Rul. 68-49, 1968-1 CUM. BULL. 304.

not a distribution in kind which qualifies the estate for a DNI deduction.<sup>191</sup> A distribution by the estate of alimony pursuant to a separation agreement, is deductible by the estate against its income.<sup>192</sup> Where the estate is under an obligation to make monthly payments to a beneficiary for life, and purchases an annuity in favor of the beneficiary, the annuity is a distribution of DNI and the estate is entitled to a deduction for that amount, not in excess of current DNI.<sup>193</sup>

A distribution of income from one estate to another qualifies as a DNI deduction to the distributing estate,<sup>194</sup> but income with respect to a decedent taxable to the estate under section 691 of the 1954 Code is actually corpus to the estate and hence no DNI deduction is afforded for a distribution of such income to a trust or other beneficiary.<sup>195</sup>

Two limitations apply. As indicated above, the estate's deductions can never exceed its distributable net income,<sup>196</sup> and no deduction is permitted with respect to any item of distributable net income which is not included in the estate's gross income.<sup>197</sup> The latter limitation is illustrated in the regulations.

[I]f in 1962, a trust, which reports on the calendar year basis, has distributable net income of \$20,000, which is deemed to consist of \$10,000 of dividends and \$10,000 of tax-exempt interest, and distributes \$10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to \$10,000 consisting of \$5,000 of dividends and \$5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is \$4,975, since no deduction is allowable for the \$5,000 of tax-exempt interest and the \$25 deemed distributed out of the \$50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.<sup>198</sup>

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191. Rev. Rul. 68-195, 1968-1 CUM. BULL. 305.

192. Rev. Rul. 67-304, 1967-2 CUM. BULL. 224.

193. Rev. Rul. 69-432, 1969 INT. REV. BULL. No. 33, at 17.

194. *Commissioner v. Bishop Trust Co.*, 136 F.2d 390 (9th Cir. 1943); *Estate of Robert W. Harwood*, 3 T.C. 1104 (1944).

195. *Huesman's Estate v. Commissioner*, 198 F.2d 133 (9th Cir. 1952); *Estate of Ostella Curruth*, 28 T.C. 871 (1957).

196. INT. REV. CODE OF 1954, § 661(a).

197. *Id.* § 661(c); Treas. Reg. § 1.661(c)-1 (1964).

198. Treas. Reg. § 1.661(c)-1 (1964). Although the example taken from the regulations refers to "trusts," the principles illustrated apply to estates as well.

## DNI: CHARACTER OF INCOME

Unless the will specifically directs otherwise or local law so provides, the amount deductible for distributions to beneficiaries under section 661(a) of the Code of 1954 is treated as consisting 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. . . ."<sup>199</sup>

The deductions which determine distributable net income and which determine the relative amounts of taxable income making up the total distributed, are allocated among the items of income according to the following rules:<sup>200</sup> (1) Deductions directly attributable to one class of income are allocated to such class.<sup>201</sup> For example, repairs to, taxes on, and other expenses attributable to the maintenance of rental property or the collection of rental income are allocated to rents.<sup>202</sup> Excess deductions are allocated proportionately to other items of income or as the executor may select but a proportionate share must be allocated to exempt income and expenses attributable to the production of exempt income (Int. Rev. Code of 1954, § 265) may not be allocated to taxable income.<sup>203</sup> (2) Deductions not directly attributable to any specific class of income may be allocated to any item of income but a proportionate share must be allocated to exempt income.<sup>204</sup> For example:

[I]f the income of a trust is \$30,000 (after direct expenses), consisting equally of \$10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to \$3,000, one-third (\$1,000) of such commissions should be allocated to tax-exempt interest, but the balance of \$2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph.<sup>205</sup>

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199. INT. REV. CODE OF 1954, § 661(b); Treas. Reg. § 1.661(b)-1 (1956).

200. Treas. Reg. § 1.661(b)-2 (1956).

201. *Id.* § 1.652(b)-3(a) (1956).

202. *Id.*

203. *Id.* § 1.652(b)-3(d) and 3(b) (1956).

204. *Id.* § 1.652(b)-3(b) (1956).

205. *Id.*

An example of an indirect expense is the executor's fee.<sup>206</sup> (3) In the absence of specific directions in the will, or local law, a charitable deduction "is deemed to consist of the same proportion of each class of the items of income of the estate . . . as the total of each class bears to the total of all classes."<sup>207</sup>

The allocation rules outlined above clearly provide opportunities for sound estate planning. While this article is not concerned with planning, the following examples are offered:

The decedent may in his will provide for the allocation of types of income going to charity or to beneficiaries. If this privilege is taken advantage of, it may produce very favorable results.

For instance, absent a direction, if half of the net income of an estate consists of taxable income, and the balance, of tax-exempt interest, only half of the amount going to charity will be deductible. A provision in the decedent's will prohibiting the distribution of tax-exempt interest to charity, if other income is available, evidently would permit a full deduction.

Similarly, the testator can direct that all tax-exempt interest shall go to beneficiary A who is expected to be in high brackets. The same direction could be made with respect to dividends, capital gains, etc.

A may get a further advantage if the estate holds assets subject to depreciation or depletion allowances. These deductions are divided between the estate and its beneficiaries on the basis of the income of the estate allocable to each. If the term "income" means income under the will, rather than taxable income, A may get a lion's share of the allowances even though he receives mostly non-taxable income.<sup>208</sup>

The Act of 1969 emphasizes the need for estate planning. The minimum tax for tax preferences<sup>209</sup> levies a 10 percent tax on certain preference items, *e.g.*, capital gains.<sup>210</sup> The new 35 percent capital gains rate (phased-in) applicable to individual capital gains in excess of \$50,000

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206. *Id.* § 1.652(b)-3(c) (1956).

207. Treas. Reg. § 1.643(a)-5(b) (1956); § 1.661(b)-2 (1956).

208. Stern, *The Income Tax Problems of Estates*, N.Y.U. 13TH INST. ON FED. TAX 147, 161-62 (1955).

209. Tax Reform Act of 1969, tit. III, § 301, 83 Stat. 580 (codified at INT. REV. CODE of 1954, §§ 56-58).

210. INT. REV. CODE of 1954, § 57(a) (9).

(subject to the 25 percent rate)<sup>211</sup> suggests that the shifting of capital gains to a particular beneficiary may not be warranted. Also, the new 50 percent maximum tax on earned income<sup>212</sup> takes into account tax preference items<sup>213</sup> in excess of \$30,000, and hence a shift of capital gains to a particular beneficiary may cause him to lose the maximum tax on part of his income. Thus, where it was formerly advantageous to direct in the will the payment of capital gains to a high-bracket beneficiary, today such a direction may prove costly to the beneficiary.

#### BENEFICIARIES' INCLUSION OF DNI IN INCOME

The concomitant to the estate's deduction is the beneficiary's inclusion in his income of amounts required to be *distributed currently* to him, and of all other amounts properly paid, credited, or required to be distributed to him.<sup>214</sup> Again, DNI is the overall limit on the amount of income distributed by the estate that is taxable to the beneficiary.<sup>215</sup> The operation of the inclusion rules merits discussion.

##### *DNI—Current*

Each beneficiary must include in his income "the amount of income for the taxable year of the estate . . . required to be distributed currently to him. . . . Such amount is included in the beneficiary's gross income whether or not it is actually distributed."<sup>216</sup> The following limitation applies:

If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary

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211. Tax Reform Act of 1969, tit. V, § 511(b), 83 Stat. 635 (codified at INT. REV. CODE of 1954, § 1201).

212. *Id.* § 804.

213. INT. REV. CODE of 1954, § 1348(b).

214. *Id.* § 662(a); Treas. Reg. § 1.662(a)-1 (1956).

215. Treas. Reg. § 1.643(a)-0 (1956).

216. *Id.* § 1.662(a)-2(a) (1956).

bears to the amount required to be distributed currently to all beneficiaries.<sup>217</sup>

Note that, as to currently distributable income, DNI is computed without regard to the charitable deduction. Hence, if the estate has \$5,000 DNI without regard to a charitable deduction of \$500 and is required under the terms of the will to distribute \$5,000 of income, the full \$5,000 is taxable to the beneficiary even though DNI, for other purposes, would only be \$4,500 if the charitable deduction were applied. Although the character rule determines whether the income is ultimately taxable to the beneficiary, the recipients of "DNI—current" bear the initial burden of tax (especially since the charitable contribution is not allowed to determine DNI for this purpose). In effect, whatever net taxable income the estate has (plus the charitable gifts) is shifted to the current income distributees. Treasury Regulation section 1.662(a)-2(e) (1956) gives the following examples:

*Example (1).* Assume that under the terms of the trust instrument \$5,000 is to be paid to X charity out of income each year; that \$20,000 of income is currently distributable to A; and that an annuity of \$12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of \$30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total \$25,000 (\$20,000 to A and \$5,000 to B). Since the charitable contribution is out of income, the amount of income available for B's annuity is only \$5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of \$5,000 as provided by section 661(a)(1), is \$30,000. Since the amounts treated as distributed currently of \$25,000 do not exceed the distributable net income (as modified) of \$30,000, A is required to include \$20,000 in his gross income and B is required to include \$5,000 in his gross income under section 662(a)(1).

*Example (2).* Assume the same facts as in paragraph (1) of example (1), except that the trust has, in addition, \$10,000 of

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217. *Id.* § 1.662(a)-2(b) (1956).

administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1) total \$25,000 (\$20,000 to A and \$5,000 to B), since trust income under section 643(b) remains the same as in example (1). Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contributions deduction of \$5,000 as provided by section 662(a)(1) is only \$20,000. Since the amounts treated as distributed currently of \$25,000 exceed the distributable net income (as so computed) of \$20,000, A is required to include \$16,000 (20,000/25,000 of \$20,000) in his gross income and B is required to include \$4,000 (5,000/25,000 of \$20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

### *DNI—Other*

The beneficiary must also include in income an amount of income properly paid, credited, or required to be distributed to him which is other than: (a) currently distributed income (already taxed to him to the extent of DNI); (b) distributions excluded under Code section 663 (discussed *infra*), and which does not exceed DNI.<sup>218</sup> The regulations give the following examples:

(1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661(a)-2); and (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.<sup>219</sup>

If an amount is "credited or required to be distributed," it is treated like currently distributable income and must be included in the beneficiary's

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218. *Id.* § 1.662(a)-3(a) (1956).

219. *Id.* § 1.662(a)-3(b) (1956).

income whether or not it is actually distributed.<sup>220</sup> Also, if the total of currently distributable income plus other distributions paid, credited, or required to be distributed exceeds DNI, then the beneficiaries have taxable income only to the extent of DNI or, stated another way, in the amount by which DNI exceeds currently distributable income.<sup>221</sup> If the distributions exceed DNI, each beneficiary includes his proportionate share of DNI in income.<sup>222</sup> The regulations provide the following example:

The terms of a trust require the distribution annually of \$10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has \$20,000 of income after the deduction of all expenses. Distributable net income is \$20,000. The trustee distributes \$10,000 of income to A. Of the remaining \$10,000 of income, he distributes \$3,000 each to B, C, and D, and also distributes an additional \$5,000 to A. A includes \$10,000 in income under section 662(a)(1). The "other amounts distributed" amount to \$14,000, includable in the income of the recipients to the extent of \$10,000, distributable net income less the income currently distributable to A. A will include an additional \$3,571 ( $5,000/14,000 \times \$10,000$ ) in income under this section, and B, C, and D will each include \$2,143 ( $3,000/14,000 \times \$10,000$ ).<sup>223</sup>

As an example of this theory, assume that distributable net income is \$10,000, currently distributable income is \$5,000, and that the executor distributes \$15,000 to the widow (W). W first includes in her income the \$5,000 of currently distributable income (this leaves only \$5,000 of DNI). She next includes, as properly paid to her, \$5,000 (the balance of \$5,000 DNI). She is not required to include the \$5,000 in excess of the \$10,000 DNI, but rather treats it as an inheritance or bequest.

Note that this second level of distributions of DNI is computed by taking into account the estate's charitable deduction. In the example given, assume that the executor sets aside \$1,000 of income for charity.

220. *Id.* § 1.662(a)-3(a) (1956). If income is distributed to satisfy a legal obligation it is treated as DNI and taxable to the recipient, *e.g.*, alimony. *Id.* § 1.662(a)-4 (1956). Presumably such income not being directed by the will is not DNI-current.

221. *Id.* § 1.662(a)-3(c) (1956).

222. *Id.*

223. *Id.* § 1.662(a)-3(d), Example (1956).

W is still required to include into her income \$5,000 of "DNI—current" but she includes only \$4,000 as other income paid to her (DNI less the charitable deduction) and hence she has received corpus in the amount of \$6,000.

### CHARACTER OF INCOME

The DNI required to be included in the income of the beneficiary under section 662(a) of the 1954 Code "shall have the same character in the hands of the beneficiary as in the hands of the estate . . . ." <sup>224</sup> Unless the will or local law provides otherwise, the income is "treated as consisting 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 . . . ." <sup>225</sup> As mentioned previously, this is the starting point for planning. For example, a son in a high tax bracket, perhaps by directions in the will, should receive the tax-exempt interest while the daughter married to a real estate speculator should be assigned the dividend income.

Charitable deductions require special treatment: Absent directions in the will or under local law, the charitable deduction consists of the same proportion of each class of income as the total of each class bears to the total of all classes.<sup>226</sup> For purposes of determining the amount of income required to be distributed currently, the amount of the charitable deduction is disregarded to the extent that it exceeds the income of the estate for the taxable year reduced by amounts for the taxable year required to be distributed currently.<sup>227</sup> For example,<sup>228</sup> assume that the will provides that \$30,000 of the estate's income must be distributed currently to the widow and the balance may be distributed to other individual beneficiaries and to a designated charity. The estate has \$50,000 in net income: \$40,000 taxable dividends and \$10,000 tax-exempt interest. The executor distributes \$30,000 to the widow, \$50,000 to the charity and \$10,000 to other individual beneficiaries. DNI as to the widow is \$30,000 because the charitable deduction is taken into account only to the extent of \$20,000 which is the difference between the estate's \$50,000 DNI for the year and the \$30,000 required to be distributed currently. Recall that there is first included in the gross income of each

224. INT. REV. CODE OF 1954, § 662(b); Treas. Reg. § 1.662(b)-1 (1956).

225. Treas. Reg. § 1.662(b)-1 (1956).

226. *Id.* § 1.643(a)-5(b) (1956); *id.* § 1.662(b)-2 (1956).

227. *Id.* § 1.662(b)-2 (1956).

228. *Id.* Example (1).

beneficiary the amount of income required to be distributed currently to him and this is computed without taking into account the charitable contributions deduction.<sup>229</sup> Applying the proportions of 80:20 (\$50,000 DNI composed of \$40,000 dividends and \$10,000 tax-exempt interest) the charitable deduction of \$20,000 includes \$16,000 dividends and \$4,000 interest; the distribution of \$30,000 to the widow consists of \$24,000 dividends and \$6,000 interest. The other beneficiaries, however, have no taxable income: (1) the full DNI of \$50,000 was distributed either to the widow or to the charity; (2) taxable income of \$40,000 dividends is covered by the distributions to the widow (\$24,000) and the charity (\$16,000); and (3) because the charitable deduction is taken into account for any amount paid or required to be distributed<sup>230</sup> and the \$50,000 the charity received is more than a sufficient amount to cover the taxable income (\$40,000) even considering that no deduction is allowed for the tax-exempt interest (\$10,000).<sup>231</sup>

#### TIME OF INCLUSION

The amount of DNI includable into the beneficiary's income is included in his year within which the estate's year ends.<sup>232</sup> This general rule does not apply if the beneficiary dies during an estate's taxable year, as, for example, where the estate is on a fiscal year ending on January 31, and the beneficiary dies on December 2.<sup>233</sup> The gross income for the last taxable year of such a beneficiary, on a cash basis, includes only income actually distributed to the beneficiary prior to his death.<sup>234</sup> Income required to be distributed (whether currently or not), but in fact distributed to his estate, is included in the estate's income as income in respect of a decedent under section 691 of the Code.<sup>235</sup> Where the beneficiary is not an individual (another estate or a trust) and its existence is terminated before the estate's year ends, income required to be distributed which is actually distributed to the trust's beneficiaries because of the trust's termination is includable in the trust's last taxable year<sup>236</sup> and not in the beneficiaries' income.

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229. Treas. Reg. § 1.662(a)-2(b) (1956).

230. *Cf. id.*

231. *Id.* § 1.643(a)-5(b) (1956).

232. INT. REV. CODE of 1954, § 662(c); Treas. Reg. § 1.662(c)-1 (1956).

233. Treas. Reg. § 1.662(c)-2 (1956).

234. *Id.*

235. *Id.*

236. *Schimberg v. United States*, 365 F.2d 70 (7th Cir. 1966); Treas. Reg. § 1.662(c)-3 (1956).

## APPLICATION OF PRINCIPLES

A major difficulty facing most practitioners is the integration of the federal income tax rules with local probate law concerning the allocation of income and expense among the participants in the estate. The executor of an estate usually is under no duty to distribute income during the administration of an estate unless the testator directed otherwise although the beneficiaries may petition the probate court to make preliminary distributions of income to them.<sup>237</sup> Estate income is seldom required to be distributed currently.<sup>238</sup> Usually the executor or the beneficiary is concerned with other amounts of income properly paid or credited during the taxable year involved.<sup>239</sup> The rule as to when distributions are required does not necessarily control when the right to income accrues and thus, for example, it has been held that the life tenant's right to income from a trust accrues from the date of the testator's death; that is, the trust has the right to the income arising on trust property from the date of death until distributed to the trust by the estate and in turn the life tenant has the right to the income from the trust as of that date.<sup>240</sup> The expenses of administration of the estate, unless the will directs otherwise, are often chargeable to the corpus of the estate and not to income.<sup>241</sup> The expenses attributable to income arising with respect to property specifically bequeathed are charged to that income, however, and the devisee or legatee receives the net income.<sup>242</sup> The California statutory approach to the right to income earned during probate is an example:

Delay in probating the will by reason of pending contests does not affect the right to interest in general legacies, commencing one year from testator's death, even though the executor was unable to pay. Loss or waiver of the right to interest does not result from acceptance of the principal sum of the legacy.

A bequest to be paid to a trustee a year after death of testator carries interest earned on the fund in a bank from the day

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237. *Estate of Marre*, 18 Cal. 2d 184, 114 P.2d 586 (1941). *See also* *Estate of McGirl*, 125 Cal. App. 310, 13 P.2d 746 (1932).

238. *Cf. INT. REV. CODE OF 1954*, § 661(a)(1).

239. *Cf. id.* § 661(a)(2).

240. *Hale v. Anglim*, 140 F.2d 235 (9th Cir. 1944); *Estate of Pratt*, 21 Cal. 2d 343, 131 P.2d 825 (1942); *Estate of Feldman*, 145 Cal. App. 2d 19, 301 P.2d 627 (1956).

241. *Estate of Schiffman*, 86 Cal. App. 2d 638, 195 P.2d 484 (1948). *But cf. Estate of Xydias*, 102 Cal. App. 2d 404, 227 P.2d 468 (1951).

242. *Estate of McSweeney*, 123 Cal. App. 2d 787 (1954).

of an order for payment to the trustee to the time of actual payment.

In 1953 said section 162 was amended to provide that annuities commence at testator's death. When a person is entitled to periodic payments he is entitled to 4% interest on the amount of any accumulations of such payments or income held by the estate on each anniversary of decedent's death. . . .

Income from a trust is payable to the beneficiary from the date of the testator's death. Irrespective of whether the executor is directed to pay the income over, the requirements of the statute are applicable.

The executor and trustee being the same person and the trust requiring certain payments for maintenance, he may not neglect to have funds transferred to himself to invest and to carry out the terms of the trust. If he fails to do this he may be liable for 7% interest in accordance with Civil Code, section 2262, instead of the 4% required by the Probate Code.

General pecuniary legacies are to be paid before the first anniversary of the testator's death. If not so paid they bear 4% interest until paid.

The Probate Code provides that a bequest of the interest or income of a certain sum or fund carries the income thereon from testator's death.

It is error to award gross rents to specific devisees of realty and to charge residuary estate with expenses properly attributable to realty.

The Probate Code section which provides for the payment of 4% interest on pecuniary legacies not paid one year after testator's death has been amended by adding the words *including general pecuniary legacies in trust*. This amendment actually codifies the present case law on this subject.

The provision for interest on legacies was in 1952 extended to include trust income beneficiaries. The provision for 4% interest is applicable to the trustee as well as the executor where the detained income is held by the testamentary trustee.

Interest provided for legacies is not a penalty for nonpayment but part of, or accretion to, the legacy itself. Interest must be paid even though it appears that it could not by any diligence be collected within the year.

A new section has been added setting out that unless the will provides otherwise all net income received during administration not specifically devised, is to be distributed pro rata to

trusts which are part of the residue, to any tenant for years or life, or to any devisee of the same. Excepted however is a general pecuniary legacy in trust which receives only the interest provided for in another section.<sup>243</sup>

Since the executor, absent contrary testamentary instructions, is under no duty to distribute income during administration, the beneficiary obviously is not taxed on the income until it is at least put within his control.<sup>244</sup> Thus, income applied to pay the estate's indebtedness is not taxed to the beneficiaries.<sup>245</sup> The distribution of real property which, under local law passed directly from the decedent to his devisee, is not deductible by the estate under section 661 of the 1954 Code against DNI and is not includable as income to the beneficiary.<sup>246</sup> A disclaimer of income, if effective under local law, shifts that income from the beneficiary.<sup>247</sup> For example, where the widow is given the right in the will to draw a stated percentage or fixed dollar amount against the corpus of the estate or trust to be established from the estate, she is treated as the grantor of that part of the corpus and is taxed upon the income attributable to that corpus but the right is not governed by the DNI rules.<sup>248</sup> Once the property is distributed the income attributable to it is taxable to the beneficiary and this is so even though the estate is not closed and the executor may recover the property if needed for administration expenses.<sup>249</sup> A distribution of all properties to the beneficiary upon termination of the estate includes the estate's income earned in its final year which is taxable to the beneficiary.<sup>250</sup> The interest paid on a legacy because of delay in payment is taxable to the legatee and presumably

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243. 2 CONDEE, CALIFORNIA PRACTICE § 1574, at 395-96 (1964).

244. *Caro Du Bignon Alston*, 8 T.C. 525 (1947); *Itola M. Evans Ransom*, 2 T.C. 647 (1943); *Carrie G. Cox*, 31 B.T.A. 819 (1934); *Simon S. Newman*, 28 T.C.M. 724 (1969); *Ruth A. Tuttle*, 14 T.C.M. 394 (1955). The issue is usually in the context of whether the estate is still in administration. *But see, e.g., Riker v. Commissioner*, 42 F.2d 150 (2d Cir. 1930); *Charlotte Leviton Herbert*, 25 T.C. 807 (1956); *Marie B. Hirsch*, 9 T.C. 896 (1947); *Rena S. McCahan*, 35 B.T.A. 943 (1937); I.T. 1215, I-1 CUM. BULL. 217 (1922) (attempted tax-free bequest of income).

245. *Carrie G. Cox*, 31 B.T.A. 819 (1934).

246. Rev. Rul. 68-49, 1968-2 CUM. BULL. 304.

247. Cf. Rev. Rul. 64-62, 1964-1 (Part 1) CUM. BULL. 221. *But see Robert E. Cleary*, 34 T.C. 728 (1960).

248. Rev. Rul. 67-241, 1967-2 CUM. BULL. 225.

249. S.M. 2526, III-2 CUM. BULL. 179 (1924). *But cf. Ford v. Nauts*, 25 F.2d 1015 (N.D. O. 1928).

250. *Carlisle v. Commissioner*, 165 F.2d 645 (6th Cir. 1948); *Wilma Aaron*, 22 T.C. 1370 (1954).

deductible by the estate as an interest expense.<sup>251</sup> Where an estate purchases and maintains a residence for the widow pursuant to instructions by the testator, the expenditures thereby incurred are not distributions of income to the widow.<sup>252</sup>

Book entries reflecting income set aside for beneficiaries are not sufficient to tax such income to the beneficiaries where used by the executors to pay death taxes. This income is taxable, if at all, to the estate.<sup>253</sup> Where the executors establish a reserve to meet future expenses, the income so set aside is taxable to the estate, not to the beneficiaries.<sup>254</sup>

Currently distributable income, the nemesis of estate income taxation, is "... income *directed* by a will or deed to be currently distributed; the words presuppose a periodic duty on the part of the fiduciary."<sup>255</sup> As repeatedly emphasized, this is not the usual estate,<sup>256</sup> but where the widow is given the income she is taxed upon it even if she does not withdraw it.<sup>257</sup> The right to income can be found in the power to invade the corpus<sup>258</sup> to give the widow a fixed sum each month.<sup>259</sup> Directions indicating that the widow is to receive the income from a business, amounts to a mandatory direction to distribute income to her and she is taxable on her share of the profits whether or not they are distributed to her.<sup>260</sup> In the usual situation the widow is given her share of the estate outright, or in a marital trust with the will silent as to income until the trust is established. The widow ordinarily relies on the widow's allowance or discretionary distributions of income during the interim.

It should also be noted that the throwback rules found in section 665 of the 1954 Code (as expanded by section 301 of the Tax Reform Act

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251. *United States v. Folckemer*, 307 F.2d 171 (5th Cir. 1962); cf. *Commissioner v. Pearson*, 154 F.2d 256 (3rd Cir. 1946).

252. Cf. *Carson v. United States*, 317 F.2d 370 (Ct. Cl. 1963). The open question is whether the estate may deduct the expense (although the purchase of the house would be a capital expenditure). Presumably, for example, the estate could deduct the real property taxes.

253. *Sitterding v. Commissioner*, 80 F.2d 939 (4th Cir. 1936).

254. *Whitfield v. Commissioner*, 311 F.2d 640 (5th Cir. 1962).

255. *Smith's Estate v. Commissioner*, 168 F.2d 431 (6th Cir. 1948).

256. See, e.g., *Lane v. United States*, 233 F. Supp. 856 (M.D. Ala. 1964).

257. *Smith v. United States*, 265 F.2d 834 (5th Cir. 1959).

258. *Koffman v. United States*, 300 F.2d 176 (6th Cir. 1962) (a life estate plus power to take corpus); *Hirschmann v. United States*, 309 F.2d 104 (2d Cir. 1962).

259. Cf. *Estate of Edward H. Wadewitz*, 32 T.C. 538 (1959).

260. *Caldwell v. United States*, 102 F.2d 607 (7th Cir. 1939); *Brown v. United States*, 21 F. Supp. 214 (E.D. Mo. 1937); cf. *Ethel Holmshaw Fickert*, 15 T.C. 344 (1950). *Mary Haller*, 14 B.T.A. 488 (1928).

of 1969) do not apply to income accumulated by estates pending final distribution.

### CONCLUSION

The income taxation of estates is more complex than this outline suggests. In view of the ascendancy of the accounting profession, however, the generalist will probably not be required to know the mechanics involved. He should appreciate, however, the importance of timing as to when to distribute income to the beneficiary or when to allow the estate to pay the tax. Nirvana, to a tax specialist at least, is an estate planned for estate and income tax purposes with the estate and all the beneficiaries in identical income tax brackets. At equilibrium, no deductions have been wasted and all income has been properly disbursed. He should also understand that while requiring the distribution of income to the widow from the date of death may comfort the testator, it may also impute income to the widow although no cash is available in the estate for distribution to her. A family allowance, especially if the probate court will order it paid from income or corpus as the executor may request, may be the preferred solution. Payment of charitable bequests with capital gains, rents sheltered by depreciation, and tax-exempt income is wasteful. Additionally, pecuniary bequests to relatives and issue may be appropriately paid from income, especially if the burden of taxable income rests upon the widow. A minor grandchild in primary school can well bear the tax on a \$1,000 bequest from income, especially with the increased personal exemption (to \$750 in stages) provided by section 801 of the Tax Reform Act of 1969. Other instances of appropriate planning present themselves in each estate; however, it is axiomatic that whatever estate planning scheme is presently envisioned, close reference must be made to the new tax reform legislation.

### APPENDIX

#### CHARITABLE REMAINDERS UNDER THE TAX REFORM ACT OF 1969

##### *General*

Charitable remainders allowable as tax deductions are now limited to three types: (1) a remainder interest in a personal residence or farm;<sup>261</sup>

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261. INT. REV. CODE OF 1954, § 170(f)(3).

(2) a charitable remainder annuity trust, and (3) a charitable remainder unitrust.<sup>262</sup> The concern here is the annuity trust and the unitrust.

An annuity trust is one which specifies in dollar terms the amount of the annuity which is to be paid to the income beneficiary.<sup>263</sup> A unitrust is a trust which specifies that the income beneficiary is to receive annual payments based on a fixed percentage of the net fair market value of the trust's assets, as determined each year.<sup>264</sup>

### *Description*

Both types of remainder trust have these common characteristics:

(1) The sum certain or the fixed percentage must not be less than 5% (but the application of the percentage is different for each type of trust).<sup>265</sup>

(2) The amount distributable to the income beneficiary must be paid at least annually.<sup>266</sup>

(3) The income beneficiaries must include at least one non-charitable beneficiary (*e.g.*, an individual, estate, trust, or corporation).<sup>267</sup>

(4) If the income beneficiary is an individual, he or she must be living at the time of the creation of the trust.<sup>268</sup>

(5) The right to income must be for a term of years (but not in excess of 20 years) or for the life or lives of the named beneficiary or beneficiaries.<sup>269</sup>

(6) Only the specified income beneficiaries can participate in the income right.<sup>270</sup>

(7) A charity or the charities must have absolute vested remainders; at the time the income right terminates, a charity must take the remainder or the remainder must be held for charitable uses.<sup>271</sup>

Obviously this type of trust cannot be used with respect to afterborn

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262. *Id.* §§ 170(f) (2) (A), 2055(e), and 2522(c).

263. H.R. REP. No. 91-413, pt. 1, 91st Cong., 1st Sess. 59 (1969); S. REP. No. 91-552, *supra* note 43, at 89.

264. *Id.*

265. INT. REV. CODE OF 1954, § 664(d) (1) (A)-(2) (A).

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.*

270. *Id.* § 664(d) (1) (B)-(2) (B).

271. *Id.* § 664(d) (1) (C)-(2) (C).

beneficiaries.<sup>272</sup> Thus, the trust cannot provide: "[stated sum] or [fixed percentage] to my son and his issue for their lives" without the clause that the trust shall apply only to "issue living at the time of the creation of the trust." Presumably the income right is limited to one term of years (not exceeding 20) and one life in being and cannot include successive terms of years or life estates but concurrent life estates are permitted. The wording of the statute indicates that the income beneficiaries must themselves be the measuring lives; an estate measured by the life of another seems prohibited.<sup>273</sup>

### *Annuity Trust*

An annuity trust measures the minimum 5% against the *initial* net fair market value of all property placed in trust. This includes, unless the testator provides otherwise in his will, income earned with respect to the portion of the assets to be set aside in trust as well as the assets ultimately to be distributed in trust.<sup>274</sup> If the testator provides that income during probate is to be paid, for example, to his widow during probate administration, several results follow: (1) The allowable charitable deduction for estate tax purposes is decreased because such deduction is measured at the time the trust is created against "5 percent of the net fair market value of its [either type trust] assets (or a greater amount, if required under the terms of the trust instrument) . . . to be distributed each year."<sup>275</sup> Without the income, the base against which the percentage is applied is obviously smaller. (2) No charitable deduction is allowable for income tax purposes to the estate for income which otherwise would have been attributable to the charity.<sup>276</sup> The income beneficiary, however, is not affected because his or her annuity is fixed in amount (whether from income or principal). A different result may apply in a unitrust situation because the fixed percentage is applied to the net assets which, because of the direction in the will, does not include the income which otherwise would have been distributed in trust.

Where the will is silent as to income, unless distributed to the trust, it is retained by the estate.<sup>277</sup> The estate pays an income tax on such

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272. *Id.* § 664(d) (1) (A)-(2) (A); S. REP. NO. 91-552, *supra* note 43, at 90.

273. *Id.*

274. *Estate of Pratt*, 21 Cal. 2d 343 (1942).

275. INT. REV. CODE OF 1954, § 664(e).

276. Treas. Reg. § 1.642(c)-1 (1956).

277. *Estate of Marre*, 18 Cal. 2d 184 (1941).

income to the extent that it is not entitled to a charitable deduction.<sup>278</sup> If the estate is administered for three years and distributes to the trust in the third year, the distribution includes corpus plus income for two years upon which an income tax may have been paid by the estate (unless a charitable deduction was allowed) and the trust's share of income for the third year upon which a tax has not yet been paid. The estate secures a deduction for the income earned in the third year which is distributed,<sup>279</sup> and the trust is required to include such income into its gross income unless it is entitled to a charitable deduction with respect to such income.<sup>280</sup> While not pertinent in an annuity situation, ordinarily the income beneficiary is entitled to income from the date of decedent's death.<sup>281</sup> The charitable deduction allowable to the estate for estate tax purposes is measured against the larger fund,<sup>282</sup> but the income beneficiary, being an annuitant, does not share to any greater extent than fixed in the will. Hence, whether or not accumulated income is distributable by the estate to the trust makes little practical difference to the annuitant.

A problem does arise, however, as to whether the estate is entitled to a charitable deduction for income tax purposes for income which will ultimately pass to the trust. In an annuity situation, the income beneficiary is entitled to a stated sum payable from income to the extent thereof and then from corpus if necessary. It seems that where the will treats the income accumulated during the administration of the estate as corpus to the trust and hence not distributable to the income beneficiary, the estate should be entitled to the income tax deduction for amounts set aside to the trust.<sup>283</sup> The result is less clear where the trustee has discretion to treat the estate's accumulated income as income to which the annuitant has a right, as for example, where the annuitant has a right to income from the date of death. Thus, if upon establishing the trust, the trustee pays the accumulated income to the beneficiary as, so to speak, the annuitant's right to the annuity during probate administration, it would seem that no charitable deduction for income tax purposes should be allowed to the estate. If the charitable deduction was allowed for income tax purposes, the estate paid no tax on that income (having

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278. Cf. *Commissioner v. Bishop Trust Co.*, 136 F.2d 390 (9th Cir. 1943).

279. INT. REV. CODE of 1954, § 661(a)(2).

280. *Id.* § 662(a)(2).

281. See CAL. PROB. CODE § 162.5 (West 1956).

282. INT. REV. CODE of 1954, § 664(e).

283. *United States v. Bank of America*, 326 F.2d 51 (9th Cir. 1963).

claimed the charitable deduction) and the trust would have received the accumulation as "corpus." For that matter, even if the income during probate is accumulated and treated as corpus to the trust, it is questionable whether a charitable deduction should be allowed because the annuitant may share in such "corpus" and may do so during the first year if the fund does not produce sufficient income.

### *Unitrust*

A unitrust involves a fixed percentage but not less than 5% of the net fair market value of its assets valued annually (*vis-à-vis* valuation at the outset of the annuity trust).<sup>284</sup> Presumably the valuation date once adopted must be uniformly applied during succeeding years or some manipulation may be possible. Otherwise the distributable amount can vary depending on whether a bull or bear market exists. The charitable deduction is determined presumably as of the date the trust is created against a fixed value for the assets. If the trustee is at liberty thereafter to select the valuation date to determine the amount distributable, the distribution can be maximized by selecting a date when the value of the assets exceeds the value originally used to determine the charitable deduction.<sup>285</sup>

A unitrust may also provide for the payment to the income beneficiary of the LESSER of (1) the fixed percentage (not less than 5%) or (2) the amount of trust income.<sup>286</sup> The trust agreement may also cover this type situation: the "lesser" approach applies. In 1970, income is zero but the percentage limitation is \$100. Under the formula nothing would be distributed to the income beneficiary. In 1971, the trust has income of \$200; the percentage limitation is \$100. For 1971, the amount distributable is the lesser of income (\$200) or the fixed percentage (\$100), or \$100. However, the trustee, if the trust instrument so provides, may distribute \$200 to the beneficiary; \$100 currently and \$100 with respect to 1970. In short, subsequent income, to the extent it exceeds the limitations for a later year, may be distributed with respect to prior years where the lesser of income or the fixed percentage formula worked to reduce or eliminate distributions in such prior years but the amount distributable for such prior years cannot exceed the fixed per-

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284. INT. REV. CODE OF 1954, § 664(d)(2)(A).

285. Cf. H.R. REP. NO. 91-413, pt. 1, *supra* note 263, at 60.

286. INT. REV. CODE OF 1954, § 664(d)(3)(A); H.R. REP. NO. 91-782, *supra* note 96, at 296; S. REP. NO. 91-552, *supra* note 43, at 89.

centage for a prior year.<sup>287</sup> Using the above example, if income for 1971 is \$300, only \$100 can be thrown back to 1969 because the percentage limitation for 1969 was \$100.

A question arises as to where the lesser of income or the fixed percentage formula is appropriate, if at all. The charitable bequest allowed as a deduction to the estate is determined on the fixed percentage regardless of whether only income is paid out. Assuming that the testator has a "pet" charity, the formula approach is an attractive solution. If the testator establishes a qualified, charitable private foundation in his will, no individual beneficiary participation would be permitted, *i.e.*, income and corpus would remain intact solely for charity. A qualified unitrust permits the participation of private individuals. Thus, for example, a grandchild can be given an income right. Qualified charitable remainder trusts are exempt from income tax.<sup>288</sup> In effect, then, the testator has established a foundation but he knows that corpus will remain intact for the charitable purposes he prescribed and yet he has given an individual the benefit of the income.<sup>289</sup> But note that the private foundation rules apply to charitable remainder trusts.<sup>290</sup> The Senate Report on this matter made this comment:

On the other hand, requiring a charitable remainder trust to distribute currently at least the amount of its income (other than long-term capital gains), if this is less than a 5 percent payout and the requirement that the charitable remainder interest be valued by assuming at least a 5 percent payout to the income beneficiary will prevent a charitable remainder trust from being used to circumvent the current income distribution requirement imposed on private foundations. In the absence of these rules, a charitable remainder trust could be established which provided for a minimal payment to the noncharitable income beneficiary (substantially less than the amount of the trust income). Since the trust generally is exempt from income taxes this would allow it to accumulate trust income in excess of the payout requirement of the unitrust or annuity trust without tax for the future benefit of charity.<sup>291</sup>

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287. INT. REV. CODE of 1954, § 664(d) (3) (B).

288. *Id.* § 664(c).

289. S. REP. NO. 91-552, *supra* note 43, at 90.

290. INT. REV. CODE of 1954, § 4947.

291. S. REP. NO. 91-552, *supra* note 43, at 90.

But neither the annuity nor unitrust approach are appropriate notwithstanding the loss of the charitable deduction where the testator is concerned for his family. The right to participate must be limited to a stated sum (annuity), a fixed percentage or income (unitrust). There can be no emergency or discretionary invasion of corpus.<sup>292</sup> Presumably, however, the widow can be given the right to withdraw a stated sum or a fixed percentage of the corpus (whether or not cumulative) since this should be considered as part of the fixed payout. If the testator persists in his desire for a charitable remainder trust, then the widow or other members of the family should be given a stated sum or a fixed percentage tied into the statutory 5% rate because the charitable deduction is measured by an assumed payout of at least 5% each year.<sup>293</sup> Nothing is gained by limiting the family to income or a stated sum measured by income which amounts to less than 5%.

#### APPLICATION OF INCOME TAX—AMOUNT OF CHARITABLE DEDUCTION

As previously noted qualified remainder trusts are exempt from income tax but as with other exempt organizations, they are subject to the tax on unrelated business income as levied by Internal Revenue Code of 1954, sections 511 and 644(c). The income tax exemption, however, is not the blessing it appears to be. Distributions from the trust to the income beneficiary are from the following sources of the trust (in the order shown):

(1) Current taxable income (except capital gains);<sup>294</sup> (2) Undistributed taxable income from prior years (except capital gains);<sup>295</sup> (3) Current taxable capital gains;<sup>296</sup> (4) Undistributed taxable capital gains from prior years;<sup>297</sup> (5) Other current income (*e.g.*, tax exempt interest);<sup>298</sup> (6) Other undistributed income from prior years;<sup>299</sup> and (7) Corpus.<sup>300</sup> The trust is required to determine the amount of its undistributed capital gain on a cumulative net basis.<sup>301</sup> Gains, therefore, never become tax-free corpus. And because the trust is tax-exempt, undistributed taxable

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292. *Id.*; INT. REV. CODE OF 1954, § 664(d) (1) (B)-(2) (B).

293. INT. REV. CODE OF 1954, § 664(e).

294. *Id.* § 664(b) (1).

295. *Id.*

296. *Id.* § 664(b) (2).

297. *Id.*

298. *Id.* § 664(b) (3).

299. *Id.*

300. *Id.* § 664(b) (4).

301. *Id.* § 664(b).

income never assumes the status of previously taxed income. The statutory scheme differs from the traditional approach (*i.e.*, Internal Revenue Code of 1954, §§ 651, 652, 661 and 662). For example, under the usual trust rules, unless local law or the will directs otherwise each beneficiary shares pro rata in each class of income and expense.<sup>302</sup> Under § 664(b) of the 1954 Code even if the trust has exempt income, the beneficiary is charged first with the taxable income. Thus, the statutory scheme outlined above insures that the income beneficiary, up to the amount of the distribution, receives taxable income to the extent thereof. A House of Representatives Report expresses the rule as follows:

A charitable remainder trust which qualified as an annuity trust or a unitrust would be exempt from taxation. Undistributed ordinary income and capital gains would be considered allocated to the charitable remainder subject to the unlimited carryforward of these income characteristics for purposes of determining the nature of amounts received by the noncharitable income beneficiary.<sup>303</sup>

Section 664(d) (1) (A)-(1) (B) of the 1954 Code sets forth no particular source from which the stated sum or fixed percentage may be paid; the sums could be paid from corpus, but section 664(b) of the 1954 Code, outlined above, treats the distribution as being from taxable income for income tax purposes regardless of the actual source.

The statutory scheme, however, does maintain the distinction between capital gains and ordinary income and taxable income or gains vis-à-vis exempt income. The question, then, is whether the trustee's discretionary and customarily broad powers play any role in the allowance of the charitable deduction or the determination of distributable amounts. To understand this, the computation of the allowable charitable deduction should be explained. The House Report, discussed above, gives this explanation:

The amount of the charitable contributions deduction to be allowed a taxpayer upon the creation of a charitable remainder interest in trust would be computed on the basis of the actual relative interests of the income and remainder beneficiaries in the trust property as provided by the trust instrument. In other words, rather than assuming, for purposes of determining the

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302. Treas. Reg. § 1.662(b)-1 (1956).

303. H.R. REP. NO. 91-413, pt. 1, *supra* note 263, at 59.

value of the income interest, that the amount to be received by the income beneficiary each year would be  $3\frac{1}{2}$  percent, the actual relative amount to be received by the income beneficiary would be used. These interests, of course, would be discounted according to standard assumptions to determine their present value.

The application of this rule may be illustrated by the following example: assume a donor makes a completed gift of \$100,000 to a trust which provides for a \$5,000 annuity to A for life and the remainder to charity. With a  $3\frac{1}{2}$  percent discount rate, the present value of the income interest would be valued by determining A's life expectancy and discounting the annual \$5,000 payments by  $3\frac{1}{2}$  percent. This amount, when subtracted from the total value of property transferred, would indicate the present value of the charitable remainder. If, on the other hand, the trust was a unitrust which specified a payout of 5 percent of the fair market value of the trust property each year, A's interest would be determined (as was the value of A's annuity) on the assumption that each year the trust will earn  $3\frac{1}{2}$  percent on the existing fund and will, therefore, be distributing principal to the extent of  $1\frac{1}{2}$  percent each year (a declining balance calculation). The fact that under the unitrust A may actually receive more or less than \$5,000 each year depending on the success of the investment is irrelevant in determining his relative interest in the given amount (\$100,000) that must be allocated between his interest and the charitable remainder interest.<sup>304</sup>

The Senate Finance Committee suggested a 6% factor,<sup>305</sup> and a 6% rate of return was suggested by the Conference Committee.<sup>306</sup>

It seems, therefore, that the statute was assuming a certain income factor. It would make a difference, for example, if the trustee tacitly understood that the trust assets were to be invested in low yield appreciation property such as land or growth stocks. The trusts, therefore, might not support the assumed rate of return. Thus, the testator could set aside the marital trust as a balanced or conservative fund and use the annuity or unitrust as the hedge against inflation. The income beneficiary in such a situation would be receiving capital gains or corpus and his or her tax would be minimized. Another example is a unitrust utilizing the lesser of income or a fixed percentage formula. The fixed per-

304. *Id.* at 59-60.

305. S. REP. NO. 91-552, *supra* note 43, at 89.

306. H.R. REP. NO. 91-782, *supra* note 286.

centage is measured each year against the net fair market value of the trust assets. Suppose at the outset of the trust it has assets valued at \$90,000. This is the basis upon which the charitable deduction is computed using a 6% rate of return.<sup>307</sup> Several years later the trust has \$90,000 corpus and \$10,000 capital gains for the year. The fixed percentage (assume 5%) of \$100,000 is \$5,000. The trust has no ordinary income. It would be assumed that under the "lesser" formula nothing would be distributable. The trustee, exercising his authority, allocates \$5,000 of the capital gains to income and pays out that sum. The trustee has paid out what the Senate Finance Committee assumed would be corpus: "The determination of what constitutes trust income is to be made under the applicable local law and, thus, is not to include items such as capital gains which must be allocated to trust principal."<sup>308</sup> The beneficiary, of course, would enjoy the lower capital gains tax rates. Obviously, the above result would have followed without the "lesser" formula and by a straight fixed percentage. But suppose the beneficiary indicated his disinclination for capital gains in the particular year and the trustee allocates the capital gains to corpus. The following year, the trust corpus then being worth \$100,000, triggers capital gains of \$10,000. The fixed percentage is \$5,500; assume no ordinary income. The beneficiary indicates a desire for capital gains. The trustee allocates the \$10,000 capital gain to income. He may pay out the full amount, \$5,500 for the current year and \$4,500 as a throwback to the prior year (Internal Revenue Code of 1954, section 664(d)(3)). Since there has been no accumulation distribution in this instance, the throwback rules do not apply. It should be noted that if a "lesser" formula applies, and the lesser amount is the fixed percentage so that income is accumulated, presumably the throwback rules provided in Internal Revenue Code of 1954, section 665 will apply if such income is subsequently distributed.<sup>309</sup> The statement is "presumably" since a unitrust situation differs from an ordinary accumulation trust because a unitrust never pays income taxes. The application of the throwback rules is helpful in this situation because if they apply, the beneficiary computes the tax on the prior year as if he received the income in that year. Hopefully, the regulations will cover this point.

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307. INT. REV. CODE of 1954, § 664(e).

308. H.R. REP. No. 91-413, pt. 1, *supra* note 263, at 59; S. REP. No. 91-552, *supra* note 43, at 89.

309. *See also* INT. REV. CODE of 1954, § 666(a).

Consider the question of the depreciation reserve.<sup>310</sup> In an annuity trust the computations are based on a sum certain determined at the time the trust is created.<sup>311</sup> Assuming that the cash flow can be predicted, suppose the testator establishes the stated sum based on the prediction. The amount of the charitable deduction is determined upon the assumption of certain rates of return. It may be that the trustee's discretion to establish a depreciation reserve or not can upset the assumptions because if the testator fixed the stated sum upon the assumption that the trustee will not, all income will flow out to the beneficiary and the corpus will be depleted, assuming that the depreciation theory has any validity. Seemingly, the charity will ultimately obtain less than the rate of return and discount factors would predict.

In the case of a fixed percentage unitrust, whether or not a reserve is established would seemingly make no difference because the payout is based on a percentage of the net fair market value of the assets each year.<sup>312</sup> The charitable deduction, computed by the estate, is based on the assumption of that fixed percentage distribution each year.<sup>313</sup> The question is open in a "lesser" formula trust. What is "income" in such a situation—income actually received or taxable income? A depreciation reserve may make a difference as to whether "income," if the term is equated with "taxable" income, is less than the fixed percentage.

On the whole, however, the discretionary powers given to the trustee would seemingly make little difference to an annuity trust or fixed percentage unitrust. But until the regulations for the Internal Revenue Code of 1954, section 664 are issued it would appear prudent, if absolute qualification of the remainder trust is desired, to provide that the trustee be guided by statutes similar to the Principal and Income Law of California.<sup>314</sup>

In simplest form, the value of a life estate is found as follows: First, the present value factor is found in a mortality table for the age of the income beneficiary. Assume this to be 8.9493. A rate of return is assumed (e.g., 5%). The rate of return and the value of the fund with respect to which the beneficiary has income rights, are then multiplied. Assume a fund of \$10,000. The product is \$500. This product is then multiplied by the present value factor (\$500 x 8.9493) to arrive at a

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310. Cf. *id.* § 170(f) (4).

311. *Id.* § 664(d) (1) (A).

312. *Id.* § 664(d) (2) (B).

313. *Id.* § 664(e).

314. CAL. CIV. CODE §§ 730 to .15 (West 1954).

value for the life estate or \$4,474.65. The assumption is that the fund will earn the interest rate (5%). If the fund is depleted (*e.g.*, by paying out principal through depletion or depreciation) the formula obviously has no validity. Seemingly, the Treasury Department would wish some assurance that a reasonable amount of principal would be maintained.

The major problem facing the trustee is valuing assets, particularly since no "penalty" is prescribed for error. No mechanics are provided for correcting honest errors.<sup>315</sup> What is the penalty even if the error is intentional? The charitable deduction may have been allowed years ago and the statute of limitations long since closed. In view of the rules set forth in section 664(b) of the 1954 Code most, if not all, of the income has already been paid out to and taxed to the beneficiary. Hence, loss of the income tax deduction can be relatively meaningless. The House of Representatives Report, previously discussed, states:

It is contemplated that a charitable contribution deduction would be denied where assets which do not have an objective, ascertainable market value, such as real estate or stock in a closely held corporation, are transferred in trust, unless an independent trustee is the sole party responsible for making the annual determination of value.<sup>316</sup>

The statute, however, does not so provide; a hiatus which the regulations will no doubt remedy.

### *Effective Dates*

The new rules are effective for transfers in trust made after July 31, 1969.<sup>317</sup>

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315. Cf. INT. REV. CODE of 1954, § 4942(h).

316. H.R. REP. NO. 91-413, pt. 1, *supra* note 263, at 60.

317. Tax Reform Act of 1969, tit. II, § 201(g), 83 Stat. 564.