Elections and Discretions Under the Code: The Executor's Dilemma

Byron E. Bronston
Indiana University School of Law

Follow this and additional works at: http://www.repository.law.indiana.edu/facpub
Part of the Taxation-Federal Commons, and the Taxation-Federal Estate and Gift Commons

Recommended Citation
http://www.repository.law.indiana.edu/facpub/1721
to the corporation at capital gain rates?
The regulations provide that "When . . . a person ceases to be a beneficiary, stock owned by him shall not thereafter be considered owned by the estate . . . ." Apparently the executor can satisfy the bequest to the brother, and the rule attributing the brother's stock to the estate will no longer apply.

Conclusion
The changes in the income tax law brought about by the 1954 Code require an extremely thoughtful consideration of the income tax characteristics of each asset which passes through an estate, whether the item is a marketable stock, a Series E bond, a municipal bond, an installment contract, a restricted stock option or stock of a closely held corporation. In handling each item, one should be aware of the possibility of the effect of a constructive sale or a distribution which carries with it the attributes of a distribution of estate income.

One should also keep in mind the effect of the broadening of the application of the "income in respect of a decedent" concept with regard to installment contracts, stock options and partnership income. The availability of loss carry-overs and excess deductions on termination is also very significant. One should realize, however, that where an estate is poured over into a living trust or a life insurance trust, as is the case with the Bernard Butterfield estate, or into a residuary trust, excess deductions on termination are usually not available to the beneficiaries of the trust. The excess deductions on termination do, however, reduce the distributable net income of the trust and may permit distribution of tax-free trust income to the trust beneficiaries.

[The End]
when income is generated, he who reaps the ultimate benefit shall pay the tax.

A rule, which has grown into the body of our case law and has been adopted by statute in many states, is that one who is compelled to pay or satisfy the whole or to pay more than his just share of a common burden or obligation upon which several persons are equally liable, or which they are bound to discharge, is entitled to contribution against the others to obtain from them payment of their respective shares. This doctrine had its origin in courts of equity upon the principle that equality among those in aequali jure is deemed to be equity.

Elections to Take Administration Expenses as Income Tax Deductions

The election by the executor to treat administration expenses as an income tax deduction may sometimes operate to increase the marital deduction and, thus, effect an estate tax saving. The Internal Revenue Service in Rev. Rul. 55-643, 1955-2 CB 386, ruled that administration expenses treated as income tax deductions should not be subtracted from the gross estate in order to determine the adjusted gross estate.

The effect of the ruling may be seen in the following example: Assume that the gross taxable estate is valued at $800,000 and that the debts, claims and administration expenses total $60,000. If $40,000 of administration expenses are used as an income tax deduction, the adjusted gross estate will be $780,000 instead of $740,000. If the election is not used, the maximum marital deduction will be $370,000; if the election under Section 642(g) is used, the maximum marital deduction will be $390,000.

The effect of the foregoing ruling is to give the surviving spouse more than one half of the distributable estate, namely, $390,000 instead of $370,000. Not only has the federal estate tax been increased by the use of the election, but the residuary estate has additionally been reduced by the increase, namely $20,000, in the amount distributable to the widow under the formula bequest and the executor's deduction.

The ruling is predicated on the assumption that the increased amount resulting from the election constitutes an "interest in property which . . . passed from the decedent." The ruling also suggests that beneficiaries other than the widow might have the right under the local law to question the authority of the executor to decrease their interests under the will by increasing the widow's share.

The courts are increasingly recognizing that the use of the election under Section 642(g) may give the estate a present net tax advantage but do injustice to the interests of some of those beneficially interested in the estate. The first such case reported was In re Warms' Estate, 140 N. Y. S. (2d) 169 (Surr. Ct., N. Y. Cty., March 4, 1955). The pecuniary trust for the widow in this case did not involve a marital deduction formula clause and, therefore, the sole detriment to estate principal resulting from the election was due to the increase in the federal estate tax. The court held that there should be charged against income account and credited to principal account an amount equivalent to the detriment suffered by the principal account as the result of the election. However, the court allowed the income account to retain that portion of the increase in income after taxes resulting from the election which remained after making the equitable adjustment. In California a similar problem in principle was dealt with in In re Bixby's Estate, 295 Pac. (2d) 68 (Calif., Div. 2, Div. 2, Dist., Div. 2, Calif., March 28, 1956, reh'g den.). After citing the Warms case, the court stated that it adopted the rule of an equitable allocation of the increase in the income account resulting from the election because it places the burden of the income tax on the income legatee, where it properly belongs, and obviates any dislocation of the testator's bounty by shifting the burden of an income tax to a residuary legatee.

To be distinguished in part from the two cases cited, a recent New York case, Estate of Samuel Levy, New York Law Journal, July 17, 1957, page 3, (Surr. Ct., N. Y. Cty.), dealt with the adjustments required when a marital deduction formula clause is used and expenses are taken as income tax deductions. The court stated that the election has a different result for tax purposes than for accounting purposes. The election permitted by the Internal Revenue Code does not authorize the executor to vary the interests of the legatees. Estate tax deductions, the court stated, should not be credited to the widow's bequest since it is freed of tax. The executors were directed to credit the benefit of all deductions, which would have been available to the estate principal, to the residuary estate. It may be questioned, except for the possible operation of accounting procedures under New York law, whether the court is wholly correct in giving all of the benefits to the residuary estate. If Section 642(g) is not availed of,
estate tax deductions are taken against the whole estate in arriving at the adjusted gross estate. If the deductions are less and the adjusted gross estate is larger because of the election, the marital share will be larger but the residuary estate will be restored out of the income tax savings. Thus, the residuum actually loses nothing; the saving is paid for by a lower total tax burden.

Walter L. Nossaman in *Trust Administration and Taxation*, Section 17.03, has stated that the election of the executor to use expenses of administration as an income rather than as an estate tax deduction should not affect the substantive rights of the beneficiaries of the trust. This view, he says, is consistent with the principle that the expenses of administration are primarily payable from principal rather than from income of an estate. He believes that in determining the substantive rights of beneficiaries, the executor's utilization of administration expenses as income rather than estate tax deductions should be treated as irrelevant and the interests of the beneficiaries computed in the same manner as though all such expenses had been paid from the residue or as the will otherwise directs.

In some jurisdictions, such as Illinois, the foregoing conclusion may still require an adjustment to be made by the executor at the termination of administration of the excess income tax savings remaining after full restoration to corpus.

In determining whether to take administration expenses as an income tax deduction under the provisions of Section 642(g) or to take them as an estate tax deduction under Section 2053, it is not sufficient to weigh the respective tax rates alone. If there is a formula type of marital trust, there will, in addition to the increase in estate tax, be a "swing" of principal from the residuary estate to the marital share because of the larger adjusted gross estate. In no event should the election be made unless the income tax savings resulting therefrom will be greater than the combined increase in the amount of the federal estate tax and the amount of the "swing" from residue to the marital share.

If the election is made, then the residuary estate should be wholly restored out of the income tax savings on the ground that equality is equity. There should, after this complete restoration, be left over some excess of income saved which must ultimately be subject to adjustment. Accounting procedures will seemingly require that the executor adjust this excess of income saved between those who enjoy the income from both the marital share and the residuary estate.

Especially is it important that the foregoing adjustments in their entirety be made if the income beneficiary of the residuary trust is not the surviving spouse. The election is purely a tax-saving act and does not alter the substantive rights of the beneficiaries under the will. The restoration, out of the income saved because of a lower income tax, to the corpus of the residuary estate will in fact reduce the amount of the marital share; the restoration retains corpsewise the advantages of the election, but no beneficiary has suffered a diminution of his interest. The "swing" back is made entirely out of tax savings. The adjustments to be made with respect to the excess of the income tax saved will be automatic, for example, in Illinois under the Principal and Income Act. The bulk of the excess will go to the residuum, although the marital share should derive some benefit out of the computation of interest on the formula bequest at the average rate of return on the whole estate. In those states which follow the Massachusetts rule with respect to the distribution of income earned during the administration of the estate, the excess will presumably follow the income to the beneficiaries of the residuary estate.

It is, as a general rule, the duty of an executor to administer an estate to the best advantage of all concerned. Minimizing the estate's taxes may well be within the line of duty. The exercise of the election, however, may carry with it burdens and risks for the executor which go beyond those which reasonably attach to his office. Income tax accounting and trust accounting often produce results that bear little resemblance to each other.

The intent of the testator is important. He may well wish to relieve the executor from the duty of making adjustments. He may wish to incorporate a direction that the executor claim as income tax deductions any expenses of administration whenever, in the executor's sole judgment, such action will achieve an over-all reduction in income and death taxes for the benefit of the estate and of the income beneficiaries thereof. He may wish to direct that there be no compensating adjustments made between income and principal. If this direction takes
the form outlined, there will be no "swing" back to the residuum of the amount of the increase in the federal estate tax nor the increase in the marital deduction share. If the testator, in order to protect the fiduciary and to avoid mere guessing as to what power the latter has, incorporates a provision in the will giving the executor the authority in his sole discretion to exercise the election to take either the income tax deductions or estate tax deductions whenever the law permits such an election, the executor must make the accounting adjustments if the election is used. In the final analysis, the testator should direct whether or not such adjustments shall be made. The complications which may arise because of the impact of the election upon the interests of beneficiaries are too grave oftentimes for the testator not to relieve the executor of some of the risks.

If the executor elects to take administration expenses as income tax deductions, may he be deemed to have exercised a power of appointment? Section 20.2041-1(a) of the Proposed Federal Estate Tax Regulations provides that under Section 2041 a decedent's gross estate includes the value of property in respect of which the decedent possessed or released certain powers of appointment. Section 20.2041-1(b) provides that the mere power of management, investment, custody of assets or the power to allocate receipts and disbursements as between income and principal exercisable in a fiduciary capacity whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties, is not a power of appointment.

If the enlargement or shifting of any beneficial interest by an executor is an incidental consequence of the discharge of his fiduciary duties, such an action is not the exercise of a power of appointment for estate tax purposes. But if the executor elects under Section 642(g) and the adjusted gross estate is thereby increased in amount, may this increase in the marital share be considered an incidental consequence of the discharge of the executor's fiduciary duties, especially in the absence of a clear direction in the will? If the will directs that there shall be no readjustment of interests, the executor's election would obviously be incidental to the discharge of his fiduciary duties.

If the widow has a power of appointment over the marital deduction share, may any specific problem resulting therefrom confront the executor in making the election? It would seem that such a power of appointment adds no new problems in so far as the executor is involved. In the absence of a clear direction in the will, he must still make his adjustments between the share for the widow and the residuary trust.

Allocation of Federal Estate Tax Where There Is Taxable Non testamentary Property

In the drafting of wills, unfortunately all tax clauses are not clear and unambiguous in declaring the intention of the testator, especially where there are nontestamentary assets. The construction of the tax clause in a will rests upon the question of not what the testator meant to say, but of what he meant by what he did say. (Swole v. Burnham, 111 Conn. 120, 122, 149 Atl. 229, 230.)

For federal estate tax purposes, the gross taxable estate includes not only the value of property which the testator owned at his death, but also property not subject to administration or not passing under his will, such as the dower or curtesy interests of the surviving spouse and statutory interests in lieu thereof, transfers in contemplation of death, transfers taking effect at or after death, revocable transfers made during the decedent's lifetime, property owned jointly with some right of survivorship, property over which the testator had a power of appointment and the proceeds of life insurance policies. Under many state inheritance and estate tax laws, a tax is imposed upon or with respect to such nontestamentary benefits.

The basis for the allocation of the estate tax where there are taxable nontestamentary assets is cogently discussed in Carpenter v. Carpenter, 267 S. W. (2d) 632 (Mo., 1954). The general rule followed in many states clearly is that in the absence of a state statute or testamentary provision to the contrary, the ultimate burden of the federal estate tax falls on the residuary estate, but a testator has the right by testamentary provision to place the burden of the tax where he wishes, and the federal estate tax statute makes provision for the exercise of that right. The general rule referred to apparently developed during a period in which many courts construed the federal estate tax statute as evidencing the intent of Congress to cast the burden of the tax upon the residuary estate; but later the Supreme Court held in Riggs v. Del Drago, 42-2 ustc
property. The mere fact that the executor upon both testamentary and non-testamentary estate seems to provide a fair and impartial basis for dis-tribution of the tax burden in question, where the testator in his will has not (in our opinion) otherwise provided except as to devises and bequests under the will. We have seen that there is nothing in the federal estate tax statutes to prevent a proper application of equitable principles to prevent injustice where the tax is based upon both testamentary and non-testamentary property. The mere fact that the executor has an obligation to pay a particular tax does not negative a right which he may have to contribution from someone else on account of that payment."

The Court concluded that the federal estate tax should be prorated and that the beneficiaries of the nontestamentary property should pay the tax attributable to their respective interests therein.

It is interesting to note, as reported in 37 A. L. R. (2d) 171, that in jurisdictions which have passed upon the question for the first time since 1942, it is generally held that the burden of estate taxes must ultimately be borne by every part of the taxable estate and that every beneficiary must pay a prorated share of the tax. The reason why the doctrine of contribution is applicable with respect to the federal estate tax is that the tax is imposed upon the estate as a whole, the lien of the tax extends to every asset of the taxable estate and the government may seize any part of the taxable estate or enforce payment against any part of the estate. The tax is thus a common burden and is no more the obligation of one than of the other obligors. If, therefore, one of the obligors pays all or more of his share of the common obligation, he should be permitted to have contribution from the others. In many jurisdictions in which the courts had early held against apportionment of the estate taxes, such jurisdictions have retained the rule primarily because of the principle of stare decisis, but notwithstanding many of them recognize that there are allowable exceptions to such a general rule, such as where the testator leaves no residuary estate or where the tentative residuary estate is less than the sum due for estate taxes; or where the residuary is real estate, debts and taxes being required to be paid out of personalty; or where the decedent's probate estate is insolvent; or where the decedent died intestate. With respect to the last exception, the Indiana court in Peary v. Citizens Bank & Trust Company of Bloomington, 121 Ind. App. 136, 96 N. E. (2d) 918 (1951), held that where the decedent left no will, the estate tax must be apportioned equitably between the probate and nonprobate estates and between personality and realty in accord with the maxim "Equality is equity."

In jurisdictions where taxes may be apportioned and the surviving spouse elects to take against the will, the value of the elective share enters into the gross taxable estate, and if no special deduction is attributable to her share, the survivor is liable to apportionment on the same basis as an heir or other beneficiary of the taxable estate. (In re Gallagher's Will, 57 N. M. 112, 255 Pac. (2d) 317, 37 A. L. R. (2d) 149 (1953). In jurisdictions in which the estate taxes on nontestamental assets are not apportioned but must be paid from the residuary estate, it seems...
obvious that the taxes cannot be apportioned directly against the share which a surviving spouse receives when electing to take against the will where there is in fact a residuary estate. But where the survivor's intestate share is described by statute as a portion of the "net estate" or a portion of the estate after the payment of all just claims, the share is a portion of what is left after the deduction of estate taxes as well as debts and expenses, so that the survivor's share is diminished proportionately by the tax even if there is no formal apportionment of taxes. (Northern Trust Company v. Wilson, 344 Ill. App. 508, 101 N. E. (2d) 604 (1951); In re Uihlein's Will, 264 Wis. 362, 59 N. W. (2d) 641, 37 A. L. R. (2d) 187 (1953).)

In Campbell v. Lloyd, 162 Ohio St. 203, 122 N. E. (2d) 695 (Ohio, 1954), the court reversed previous holdings and held that the federal estate tax should be deducted before computing the widow's share where she elects to take against the will under a statute allowing her an amount "not to exceed one-half the net estate," and it is established that in computing the net estate the federal estate tax is deducted like other debts, and failure to deduct would result in the widow's receiving more than one half.

In Illinois the right of the executor to obtain contribution when there are taxable nontestamentary assets seems to merit review by the courts. Like most of the midwestern states, Illinois has no apportionment statute. A leading case in this area of the law is that of the People v. Pasfield, 284 Ill. 450, 120 N. E. 286, which was decided in 1918. The decedent died testate in 1916. In the determination of the inheritance tax upon his estate, which included only testamentary assets, the appraiser deducted the claims and costs of administration, exclusive of the amount of the federal estate tax, when determining the net taxable estate. The county judge approved the report of the appraisers with one change, namely, the federal estate tax was deducted from the gross value of the decedent's property before computing the amount of inheritance tax due the state. The sole question before the court was whether or not the amount paid the United States as estate tax should be first deducted from the appraised value of the estate before the state inheritance tax was computed. The court found that the effect of the federal statute then in force was to make the death duty an expense or charge against the estate of the decedent and not an express charge against the shares of the legatees or distributees of the decedent. A number of Illinois cases have since been decided in which, regardless of the facts at issue, the oversimplified statement that the federal estate tax is an expense of administration has been followed as the guiding rule.

The federal statute did not invade the right of the state to require contribution, nor was the question of the right of the executor to obtain contribution before the court in the Pasfield case. Even though it might be conceded that the nature of the federal estate tax does not require contribution from the legatees and devisees of a testate estate, it does not follow that those who receive nontestamentary assets will be relieved of the obligation to assume their proportionate share of the estate tax burden by way of contribution. The executor may be required in equity to allocate this burden between testamentary and nontestamentary properties.

Northern Trust Company v. Wilson, cited above, in effect recognizes apportionment of the estate tax when the widow renounces. It might be inferred that Pasfield and other similar Illinois cases have thereby been limited in their application to a taxable estate containing only testamentary assets.

Sometimes the testator has been presumed to have made an intentional gift in contemplation of death. Where the courts have found such a gift to have been intentional, some of them have required contribution on account of the estate tax on the gift.

Is there a gift tax liability if contribution is consented to by a donee in the absence of either a statute or case law requiring contribution and in the absence of a court decree? If the nontestamentary property is in trust, the trustee cannot be a volunteer in making contributions; but if the nontestamentary property is not in trust, the recipient may well have made a gift by consenting to contribution to the estate.

Whether or not joint tenancy property should be subjected to contribution has received little apparent attention from the courts. In a recent district court case in Minnesota, Goodson v. U. S. 57-1 ustc ¶11,697, the court reasoned that the testator probably intended to impose a legal obligation, if he had the power to do so, to impress the estate tax on nontestamentary property which included both joint tenancy and inter vivos transfers in trust. The court reasoned that any convincing manifestation of local law having a clear root in judicial conscience and responsibility, whether resting in direct expression or obvious implication and infer-
ence, should accordingly be given appropriate heed. Based upon dicta in two Minnesota cases, it required contribution from both the surviving joint tenants and the beneficiaries of the inter vivos trust.

The rationale of the court in the Goodson case followed in the main the principles enunciated in Gallagher v. Smith, 55-1 US Rev ¶9485, 223 F. (2d) 218, (CA-3). In this decision, the court discussed the different types of tax cases with respect to which the effect of state court decisions, even though differing greatly, will have a bearing upon their controlling effect upon the federal courts. Where federal law has imposed no qualification upon or criterion for the taxability thereof, Congress has made the operation of the tax law in such a case solely dependent upon state law. An adjudication of such a question of title by a court of the state must accordingly be given effect not because it is rei judicata against the United States, but because it is conclusive of the parties' property and rights which alone are to be taxed. Of course, a state court must first adjudicate the rights of all parties claiming interest in the income or property in question, and it must have had jurisdiction to do so.

A recent case involving the right to contribution and the effect of renunciation by the widow is Merchants National Bank (Will of G. E. Street) v. U. S., 57-2 US Rev ¶11,703 (CA-7), cert. applied for. The court held that in the absence of an apportionment statute in Indiana, the widow's renunciation caused her share of the estate to bear its proportionate part of the estate and inheritance taxes which, in turn, reduced the amount of the otherwise allowable marital deduction by the amount of her proportionate share of the taxes. The federal court relied substantially upon decrees which were entered in the state court.

Widow's Award

In the absence of an apportionment statute or direction in the will, the widow's award does not bear any part of the estate tax; it is paid out of testamentary assets. Unless paid out of income, it is a charge against the estate, although it is not under present law deductible in arriving at the net taxable estate under the estate tax statute. If not paid out of income, the election by the executor to take administration expenses as an income tax deduction under Section 642(g) in itself has no effect. If the award qualifies for the marital deduction, the amount of the formula bequest to be set up out of testamentary assets will be reduced by the amount of the spouse's award, the dollar amount thereof being the same whether or not an election is made. If the award is paid out of income, which may be done in some states, the election under Section 642(g) will undoubtedly require accounting adjustments within the area of the applicable principles and procedures heretofore discussed.

In many instances, as a practical matter, the executor's views with respect to the amount of the award will have some bearing on the amount allowed by the court. If there is a formula bequest for the spouse and if the entire award qualifies for the marital deduction, the executor's views may be said to have had some effect upon the net amount set aside for the widow's testamentary share of the estate. If the award does not qualify for the marital deduction, its size will give the spouse more than the intended marital share if the will provides for the maximum deduction. Of this latter possibility, both the testator and the draftsman should be fully aware.

What to Do?

The recent report of the Committee on Draftsmanship: Wills and Trusts of the Real Property, Probate and Trust Law Section of the American Bar Association, of which Mr. Harrison F. Durand of New York was the chairman, is "must" reading for the lawyer who drafts wills.

The report very aptly states that the function of the lawyer-draftsman is not that of a mere scrivener who reductions to writing in legal form the estate plans conceived by others; on the contrary, the draftsman is the heart of the estate planning team. The probate bar must accept this responsibility and train itself to the point of understanding the elements which entered into a complex estate plan and the legal principles which are applicable thereto.

In its discussion of the marital deduction, the committee cites the advantages claimed by adherents of the formula-clause share of the residue type, and it also summarizes the disadvantages of the use of this clause. Notwithstanding that the share bequeathed to the wife is uncertain and that the use of the formula clause may create conflicts of interest between the widow and other residuary legatees and that the share of the widow will depend upon whether the executor uses administration expenses as an
income tax deduction, the formula clause has wide usage and will presumably be in use for a long time to come. Wise drafting, a clear and unambiguous declaration of intent on the part of the testator, a comprehensible delineation of the duties, the limitations and the risks imposed upon the executor become all the more important. [The End]

Tax Planning for Professional Partnerships

By PAUL LITTLE

The author is with the law firm of Wickes, Riddell, Bloomer, Jacobi & McGuire, New York.

WITH THE ENACTMENT of Subchapter K of the Internal Revenue Code of 1954, major strides were made in the clarification of the principles applicable in the taxation of partnerships. This clarification, with its attending possibilities for accurately forecasting the tax consequences of various provisions in partnership agreements, places a substantial premium upon advance planning of partnership transactions. This is true in the case of professional partnerships as well as commercial partnerships generally. Despite the fact that the major portion of income earned by professional partnerships will be noncapital in nature, other areas are available to the members of such partnerships in which tax planning may result both in the avoidance of particular tax difficulties and in the accomplishment of particular and favorable tax results.

Planning for Sharing Partnership Profits

Under the 1954 Code, partners are granted wide latitude in agreeing upon the methods for sharing partnership profits and losses. In professional partnerships, which are essentially organizations engaged in rendering personal services, the sharing of losses is usually not a serious factor since the firm will usually cease to exist within a relatively short period after losses begin to be consistently incurred. Therefore, for planning purposes, the various possibilities for sharing profits of the firm will be of more interest to the partners, although the same general considerations will usually be applicable as well to the sharing of losses.

The statute1 sets forth the one basic limitation upon the right of the partners to agree among themselves as to the sharing of items of current income. Such agreements must not be designed principally to avoid or evade federal income taxes. The regulations2 contain various factors which will be considered in a particular case in determining whether or not this forbidden purpose exists. For example, the presence or absence of a business purpose motivating the agreement, as well as the presence or absence of substantial economic effect, will play an important role in determining the validity of the agreement.

Since the professional partnership will usually be concerned with simply allocating the amount of its ordinary income among its members, the principal effect of the 1954 Code is to remove any doubt as to the right of the parties to enter into special allocation agreements as long as they have a business purpose and substantial economic (as contrasted with income tax) effect.

On the basis of the statute and regulations, it would seem clear, for example, that the partners by agreement could encourage certain of their number who were responsible for the production of new business, by entering into an agreement which would provide for one set of percentages of interest in income earned up to a specified amount, with a different set of percentages

1 1954 Code Sec. 704(b)(2). See also Regs. Sec. 1.704-1(a)(2).
2 Regs. Sec. 1.704-1(a)(2).