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FEDERAL INCOME TAX PLANNING FOR ESTATES AND TESTAMENTARY TRUSTS

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Federal estate tax will ordinarily be by far the largest single tax paid by a sizeable estate. Estate planners therefore must and usually do give considerable attention to preventing this tax from exceeding the legal minimum. Occasionally, this great concern with federal estate tax results in too little emphasis being placed on the federal income taxes for which the estate and any trusts created by the will are liable each year after decedent's death. This article is intended to explain the significance of this income tax and point out a number of relatively simple approaches to the problem of keeping this tax at a reasonable amount.

Since the income tax paid by an estate or trust is computed at the same rates applicable to a single individual,¹ it is clear that this tax can, over a period of years, be a very substantial amount. The income tax is especially significant when a large part of the estate corpus will be income for tax purposes when collected. For example, if the decedent was a professional man, the amount receivable from his clients at the date of death is part of the estate corpus but is nevertheless taxable income when subsequently collected.² In the same manner, deferred compensation receivable by an employee, renewal commissions due an insurance man and a partner's share of the partnership income for the year in which he dies are all taxable income when collected in years following death. Many times, when the estate includes large amounts of these items, the total income taxes due thereon can actually exceed the total federal estate tax. In such cases, the importance of properly planning the income tax results is clear.

Even when the estate does not have the above types of assets among its corpus, the income taxes payable by estates and trusts on their annual incomes are ordinarily substantial. With proper attention to income tax planning, much can be done to reduce these taxes, while still completely fulfilling the family's non-tax desires. A great deal of this planning takes place after death, but the proper groundwork must be laid before death, at the time the wills and trust instruments are drafted so that possibilities for post-death planning are not precluded by express provisions of the legal instruments. It is then equally important that the proper thought be given after death to income tax

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¹ INT. REV. CODE OF 1954, §641.

² INT. REV. CODE OF 1954, §691.

considerations. The principles involved are in fact quite simple, even though in their application the situations can be fairly complex.

The first basic principle is that, graduated tax rates being what they are, it is best to time the receipt of income and the payment of deductible expenses so that the annual taxable income of the estate will be fairly constant from year to year. It is readily apparent that a level amount of income in each year will cause the total taxes paid over the years to be less than would be paid if the taxable income fluctuated drastically from year to year.

While many items of income and deduction can in no way be controlled by the executor, certain items, particularly deductions, can be made available in whichever year is most desirable. A prime example is the executor's own fee and other professional fees incurred by the estate, which can normally be paid in whatever year the maximum tax benefit will result. It would be extremely unfortunate if the executor paid these fees without giving due attention to the income tax consequences of selecting the year in which payment is made.

The estate has a special consideration regarding the allocation of deductions among years. Many of the items which are deductible on the income tax return in the year paid may, if the executor prefers, be deducted instead on the federal estate tax return of the estate.³ This further complicates the determination as to what to pay in what year, as some amounts may best be deducted on the estate tax return, in which case a lesser amount becomes available for deduction on the income tax return. A little simple arithmetic will provide the answer to this problem. In making this determination, however, the executor should keep in mind the fact that some items may be claimed twice, both on the income tax return and on the estate tax return.⁴ Items eligible for this double deduction include amounts for which decedent was liable at date of death representing his business expenses, interest, taxes and investment expenses. While this allowable double-deduction may seem overly generous to the taxpayer, it is really merely the other side of the coin which subjects income receivable at the date of death to both estate tax and a later income tax.

In most instances today, a decedent's will creates one or more trusts for his widow or heirs. These trusts are separate taxpayers for income tax purposes,⁵ and a saving can result each year by having part of the estate's net income taxed to the trusts rather than having the entire income taxed to the estate. Shifting a portion of the income to a separate taxpayer will move it into a lower bracket and result in an over-all saving. If there is more than one trust, the taxable income can

³ Treas. Reg. §1.642(g)-1 (1956).

⁴ Treas. Reg. §1.642(g)-2 (1956).

⁵ INT. REV. CODE OF 1954, §641.

be divided among the estate and all of the trusts in equal amounts, thereby resulting in an even greater saving.

Shifting a portion of the estate's taxable income to the trust is accomplished quite simply, by making a distribution from the estate to the trust. To the extent that the estate distributes cash or property to the trust, the estate becomes entitled to a deduction and the trust reports a like amount as income.⁶ By carefully considering the amount to distribute each year, the taxable incomes of the estate and trust (or trusts) can be leveled off, with the result that the total taxes are reduced.

Distributions from an estate to a trust normally have this income-passing effect even if the distributions are legally out of principal rather than out of income; for tax purposes, all distributions are treated alike,⁷ with very limited exceptions. The executor must therefore be careful not to distribute such large amounts of principal that more than the optimum portion of the estate's income is passed along to the trust.

When making distributions, the estate has a unique opportunity to prevent the application of a capital gains tax to appreciation on assets owned by the estate. If a distribution is made in property and the distribution is fully taxable to the trust or other beneficiary, the recipient takes the property at a basis equal to its fair market value at the time of distribution, even though the estate's tax basis for the property may have been considerably less.⁸ It is therefore prudent to make distributions in property to the extent this is possible, and to select the property with the greatest spread between value and tax basis. Since the estate's basis for the property will normally be its value as of the date of death,⁹ it is fairly unusual for the market value to greatly exceed the tax basis. However, if the Internal Revenue Code is amended, as has been suggested, to provide that the estate's basis is whatever the decedent's basis was, the probability of substantial appreciation and the resulting benefit of distributing property instead of cash will naturally be increased.

Distributions in connection with the termination of an estate have precisely the same effect as all other distributions; that is, they cause the income of the year of termination to be taxed to the recipient of the distribution. The estate's income for the year of distribution will not be divided between the estate and trusts, but will all be taxed to the trusts. It is therefore generally appropriate, if possible, to keep an estate open until just after a year-end, so that the desired portion of the income of the last full year will be taxable to the estate. It is of

⁶ INT. REV. CODE OF 1954, §§661(a), 662(a).

⁷ INT. REV. CODE OF 1954, §§662(a), 663(a).

⁸ Treas. Reg. §1.661(a)-2(f) (1956).

⁹ INT. REV. CODE OF 1954, §1014(a).

course not possible to unduly prolong the period of administration for this purpose, but these considerations may prevent an executor from hastily closing an estate which would in the normal course of events otherwise remain open for a short while longer.

In planning the division of income between the estate and trusts, the executor must of course take into account any income which the trust has on its own. The trust may have some investments which produce income, and in leveling out the income between the estate and trust such income must be taken into consideration.

Just as the estate's distributions to the trust may, if properly planned, result in a tax saving by equalizing the taxable incomes of the estate and trust, the trust's distributions to its beneficiaries may result in a saving by leveling out the taxable income between the trust and beneficiaries. This operates in exactly the same manner as the distributions from the estate to the trust; that is, every distribution, whether from income or principal, entitles the trust to a deduction and causes a like amount to be taxable to the beneficiary.¹⁰ Each year, the trustee should compare the taxable incomes of the trust and its beneficiaries and determine the optimum amount of distribution to keep taxes to a minimum. Again, distributions in kind rather than in cash offer a possibility of giving the property distributed a new basis equal to its fair market value without having the appreciation thereon subjected to capital gains tax.

If the will or trust instrument requires the trust to distribute its entire income, the trustee will not be able to level out the income of the trust and beneficiaries, as the trust will not retain any income. Unless there are good reasons (as there often may be) for requiring the trustee to distribute the entire income each year, consideration should be given to having the instruments authorize the trustee to distribute or accumulate as he sees fit. Of course, a trust qualifying for the marital deduction must be required to distribute its income each year.¹¹

Even if the trustee must distribute the entire income, there may still be a limited amount of income-splitting between the trust and the beneficiaries, as the income which he must distribute will be construed to mean the real economic income of the trust, which may be less than the taxable income of the trust. If such is the case, a portion of the amount representing the taxable income may be accumulated by the trust, taxed to the trust, and result in an over-all saving. For instance, if the trust received some *taxable* income as a result of a principal distribution from the estate, which principal distribution was for tax purposes considered a distribution of income, the trust's taxable income

¹⁰ INT. REV. CODE OF 1954, §§661(a), 662(a).

¹¹ INT. REV. CODE OF 1954, §2056(b)(5).

would be greater than its income in an economic sense. If it distributed to its beneficiaries (as required) its real income, it would have accumulated a portion of its taxable income, and the trust would be taxed on this amount. Therefore, even if the entire income must be distributed, some tax planning may still be possible. It may in fact be possible to so plan the principal distributions from the estate which carry income that the best possible tax splitting is realized under the circumstances.

Another provision in a will which eliminates the possibility of equalizing incomes between a trust and its beneficiaries is a clause allowing the beneficiary to draw income or principal at his own discretion. Such a provision causes the beneficiary to be taxable on the entire net income of the trust, leaving nothing to be taxed to the trust and putting the entire income at the beneficiary's rates.¹² If this right of the beneficiary required the agreement of someone else, such as the trustee, the income would not be taxed to the beneficiary unless in fact distributed.¹³ Draftsmen should give due consideration to this result.

Even if a trustee uses great care to even out the tax brackets of the trust and beneficiaries, as discussed above, an event happening at a future time may undo the entire tax benefit resulting from the planning. The event which would cause this result is a distribution within the following five years of an amount greater than the income for the year in which the distribution is made. To the extent that such an excess distribution is made, the excess causes a like amount of the income accumulated by (and taxed to) the trust to become instead taxable to the beneficiary, thereby eliminating the tax benefit obtained by dividing the income in the first instance.¹⁴ This result follows even if the excess distribution is in fact a principal distribution in a later year (including in some cases distributions upon the termination of the trust). For instance, if the trust instrument requires a large principal distribution at age 30, such a distribution, assuming it exceeds the taxable income of the year in which it occurs, causes an amount equal to the excess to be taxed to the beneficiaries as a distribution from the income of whichever of the last five years the trust accumulated income. The trustee must therefore be extremely cautious for five years lest subsequent events undo the benefits of his planning. Further, the drafter of the instruments must keep this point in mind so that a requirement of the distribution does not eliminate the fruits of the trustee's planning. This problem of excess distributions in a later year does not apply in the case of an estate. Only a trust is subject to this taxation by reason of excess distributions at a later date. Once an estate's distributions are so arranged to achieve the maximum tax savings, those savings can never be taken away by later events.

¹² INT. REV. CODE OF 1954, §678(a).

¹³ INT. REV. CODE OF 1954, §§678(a), 674(a).

¹⁴ INT. REV. CODE OF 1954, §666.

As will be seen from the above, a portion of the income realized by the estate in the period immediately following the decedent's death may, by careful timing of distributions, flow through the trust to the widow (assuming the widow to be a beneficiary) and thereby become taxable in the final joint income tax return of the decedent and his widow. If this is to be the last opportunity to use joint return rates and the lower tax brackets resulting therefrom are important, the executor and trustee may wish to cause a substantial portion of such income to pass directly through into that joint return.

Thus far in this discussion, when illustrating the taxability of income received from an estate or trust, I have assumed that every taxpayer involved reports on a calendar year basis, so that income received from an estate or trust will be taxable to the beneficiary in the same year as the year of the estate or trust from which it came. In fact, however, any taxpayer may use whatever fiscal year it wishes, by merely selecting that year in the first tax return which it files. Since the individual beneficiaries of a trust will almost always already have elected a calendar year, we can assume that no control can be exercised over the taxable year of these beneficiaries. The estate and trusts, however, are new taxpayers free to choose whatever taxable years they wish by simply making a proper election on their first returns.¹⁵ The executor and trustee should give careful consideration to using a year other than a calendar year, as the use of a fiscal year usually results in a substantial deferral of federal income tax. This result follows because the beneficiary of an estate or trust includes amounts in income in his taxable year in which the estate or trust's taxable year ends.¹⁶ Therefore, if the estate or trust's year ends just a little later than the beneficiary's year, the time when the beneficiary pays tax on his income from the estate or trust can be postponed for almost an entire year. For example, if a trust receiving income from an estate uses a January 31 year while the estate uses a February 28 year, the trust will report its share of the estate's income for the year ending February 29, 1968 in the trust's tax return for its year ending January 31, 1969. This is true even though the distribution by which the trust received its share of that income was actually received by the trust during its year ended January 31, 1968; it is the date on which the estate's year ends that governs, regardless of when the distributions are in fact made. If a deferral of tax is desirable, choosing staggered taxable years, as in the above illustration, can be extremely helpful. Such will of course not always be the case, as the trust might, for example, expect substantial income of its own in the year ending January 31, 1969, so

¹⁵ Treas. Reg. §1.441-1(b)(3) (1957).

¹⁶ INT. REV. CODE OF 1954, §§652(c), 662(c).

that it would prefer to have its income from the estate reported in an earlier year.

This very same principle can apply in controlling the year in which the beneficiaries of the trust report their income from the trust. Assuming, as above, that the trust uses a January 31 year, the beneficiaries report their income from the year ending January 31, 1969 in their year ending December 31, 1969. Again, there is a lag of eleven months in the time when the income is reportable.

Following income through from the estate to the trust to the beneficiaries, we can see that the estate's income of the year ending February 29, 1968 can pass through to the trust year ending January 31, 1969 and from there to the beneficiaries' years ending December 31, 1969. In this manner, income earned by the estate in the year ending February 29, 1968 can be deferred and no tax paid thereon until the beneficiaries file their 1969 returns in April, 1970. The fact that the income passes through to the trust and from the trust to the beneficiaries may cause the executor and trustee to re-examine his original premise that keeping the taxable incomes level is always the wisest course. It may be worth paying a little higher tax by having the incomes a little unequal in order to obtain a substantial deferral of the time when the tax is due. Comparing various alternatives in a given situation will easily demonstrate the best course of action.

By taking into account these different possibilities, the executor and trustee, with the help of his tax advisors, can assure that the income taxes paid will be the legal minimum, paid at the latest possible time. The dollar amount of tax savings resulting from this planning can be substantial. Care must be exercised, however, to prevent this planning from conflicting with the non-tax desires of the parties. From time to time, the best tax planning must be modified to prevent the plan from distorting the real wishes of the people involved. Most often, however, the executor and trustee will find that the non-tax objectives can be effectively carried out by a program taking into account income tax saving possibilities, to the good of all concerned.