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Planning estate distributions

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ESTATE PLANNING is one of the oldest arts of the civilized world. It is generally considered to comprise lifetime planning for the orderly passing of wealth from one generation to the next, with minimum shrinkage, consistent with the desires and objectives of the testator.

A great deal has been said and written concerning the planning of estates. An important aspect of estate planning that is sometimes neglected or is not given the importance it deserves is planning the administration of an estate.

While this discussion is directed to planning estate distributions, other factors that play such an important part in planning the administration of an estate cannot be ignored, as they likewise play an important rôle in planning distributions.

The executor has the right to make many important elections that will materially alter the tax consequences to the estate and its beneficiaries. One of the important elections is the right he has to deduct administration expenses for either estate tax or income tax purposes. When the estate is created, a new taxable entity comes into being with the rights and privileges of making elections available to new taxpayers. The rules governing the income taxation of estates are such that the timing of an action may alter the tax consequences tremendously. This is true in all areas of taxation, but it is particularly critical in the case of estates. By his decisions, then, the executor can aid greatly in the conservation of the estate and assure the beneficiaries maximum retention of the decedent's bounty.

INCOME TAXATION OF ESTATES

GENERAL PRINCIPLES

Without going into many of the bewildering complexities of the income taxation of estates I should like to review a few of the general principles. Generally speaking, the taxable income of an estate is computed in the same manner as that of an individual taxpayer except that there is an unlimited deduction for charitable contributions. In addition, the estate is allowed a deduction from income for amounts required to be distributed to a beneficiary and for certain other amounts actually distributed to a beneficiary. Of course, the beneficiary is taxable on the amount deductible by the estate.

TAXED TO ESTATE OR BENEFICIARY

Income received by an estate is taxed to the estate as a separate taxpayer or to the beneficiaries. This is accomplished by a fairly complicated set of rules which treat the income of the estate as being shifted to the beneficiaries under certain circumstances. If the provisions of the will require that income be distributed currently to a beneficiary, that person will be taxed on the income irrespective of whether or not it is distributed. Actual distributions of income by the estate will shift for income tax purposes the taxability to the recipient; the estate will be relieved of tax to that extent. The amount of income that is shifted to the beneficiary is limited by the distributable net income of the estate for that period. Distributable net income is the taxable income of the estate reduced by income that is considered corpus income, such as capital gains, and is subject to certain other modifications. The beneficiary receiving the distribution will be taxed on the lesser of the amount of the distribution or the amount of the estate's distributable net income for the year in which distribution is made. In effect distributable net income puts a ceiling on the maximum amount that can be taxed to beneficiaries.

CLASSES OF DISTRIBUTION

There are classes of distributions to beneficiaries which will shift the income to them and there are other classes of distributions which will not accomplish this result. The rules governing this are somewhat difficult to understand because they do not follow the rules of logic. Distributions that would be considered distributions of principal by everyone (other than the tax collector) may result in taxable income to the person receiving the distribution.

Distribution of principal will be treated as a distribution of income unless it is a gift of a specific sum of money or a gift of specific property and the satisfaction of this bequest or gift is made in three installments or less. This permits gifts of specific property to be distributed without any tax consequences to the recipient unless it is distributed or required to be distributed in more than three instalments. Persons receiving other distributions of corpus may be treated as receiving income. This applies to distributions that may in no way be prompted by tax motives, such as a distribution of an automobile that was not specifically bequeathed.

It is apparent that the executor does have the power, in many instances, to control the taxability of amounts distributed to beneficiaries.

CHOICE OF ACCOUNTING PERIOD

Planning distributions can produce substantial tax savings. It is vital that this planning be timely and coordinated with other alternatives available to the executor.

The choice of an accounting period is extremely important and unless this matter is kept in mind at all times it may be that the savings possible in an intelligent choice of an accounting period will have been reduced or eliminated altogether.

At the outset it is desirable to get as good an estimate as possible on the length of the period of administration. The complexity of the estate will be a big factor in determining this. The income should be projected for the entire expected period of the estate's existence, taking into account the effect that payment of death taxes and other costs will have on income of succeeding periods. It is extremely important to determine whether the income flow is level throughout the year or if there is a definite peaking. It will of course be necessary to know whether there are mandatory distributions of income and whether or not discretionary distributions of income will be made to beneficiaries during administration. This will affect the amount of income taxable to the estate. At this point, too, it is necessary to know what the administration expenses of the estate will be and whether there is a definite schedule of payments planned, and whether these administration expenses will be claimed as income tax deductions. In choosing the accounting period for the estate it is not too early to be considering what will happen when the estate is terminated and the effect termination will have on the beneficiaries.

DEFERRING INCOME

Choosing the right accounting year results in deferring or delaying the realization of taxable income, which results in the retention of tax dollars and is equivalent to an interest-free loan.

Most individuals report income on a calendar year. If distributions are going to be made to the beneficiaries, a fiscal year will defer taxability. If the estate and beneficiary are both using a calendar year a distribution to the beneficiary would be taxable in the same year it was made. However, if the estate were to adopt an accounting period ending January 31 it could make a distribution to the beneficiary sometime during the month of January which would result in its deduction by the estate. The beneficiary would have the use of at least a portion of the distribution for an eleven month period as compared with immediate payment of all the tax if both were on a calendar year. The beneficiary's basis in arriving at the amount paid on estimated tax will determine whether he would have the use of a part or all of the distribution for the 11-month period.

SPECIAL SITUATION

Special situations will come into play. For instance there could be a case where the beneficiary is independently wealthy but for some reason a fairly large distribution will have to be made by the estate during administration. If this were to be done and the entire distribution were to be taxable to the beneficiary, the net amount retained after income tax might be nominal. A possible solution to this situation would be for the estate to adopt a fiscal year ending shortly after the estate comes into being, and before any appreciable amount of income is earned. During this short period the distribution would be made to the beneficiary. The tax on that distribution would be limited to the taxable income of the estate for the short period.

SETTING UP TESTAMENTARY TRUSTS

Setting up testamentary trusts early in the administration of the estate can result in a splitting of income among several entries. For example, if a will provides for testamentary trusts for the benefit of the children, a portion of the principal could be transferred to each of the trusts. While these distributions are of principal, under the income tax rules they would be taxable to the trust to the extent of the estate's distributable net income. The trusts should not be required to distribute any of these amounts to the beneficiaries because they were distributions of principal. This would serve to spread the estate's taxable income among many taxable entities. Principal of the trust in this case is bearing a share of tax that is attributable to income. It may be necessary that income restore to principal the tax that the trusts paid.

Matters to be considered in exercising the election to deduct administration expenses income-tax wise ordinarily include a good deal more than a mere comparison of the top-bracket estate and income tax rates and planned distributions to beneficiaries. Numerous factors will require careful study before determining the policy to pursue in deducting administration expenses to insure the greatest over-all tax savings.

COMPUTATION OF SAVINGS

The first step obviously will be to see whether the income tax saving resulting from the election to deduct the administration expenses for income tax purposes will outweigh the increased estate tax caused by forgoing the deduction. In making this mathematical test it may become obvious that the maximum savings will be achieved if there is some allocation to each return. It is important to keep in mind that it is the year of payment that determines the period in which the income tax deduction may be taken. This may call for a program of instalment payment of the various fees and expenses over the period of administration.

The income of the estate may vary a great deal from year to year. If distributions are contemplated to the beneficiaries, then the tax bracket of the estate may be much lower in that year. If all the income of a single year is to be distributed to the beneficiaries it may still be advantageous to claim administration expenses, but this can only be determined by knowing the tax brackets of the individual beneficiaries. Quite often the beneficiaries will be in varying tax brackets so that it may be beneficial to some to have the deductions claimed income-tax wise and for others the estate tax deduction may produce the better result. If the beneficiaries share in income and principal in the same proportion, it would appear that the savings to the group on an over-all basis should be the determining factor in making the choice.

TIMING OF PAYMENT

If the deductions are claimed on the estate tax return there is no problem of timing because the deductions will be allowed as long as they are ultimately paid. The situation is quite different if the deductions are going to be claimed for income tax purposes. If the executor is going to give the estate the maximum tax advantage, the timing of the payment is of utmost importance. The estate may have fluctuating income during administration and if the deductions are to be utilized to maximum advantage they should be paid in the year that the estate has a large amount of income with consequently higher tax brackets. Payments made when the estate is in a 50 per cent bracket are obviously worth much more as deductions than in a year in which the top tax bracket of the estate is 30 per cent.

In some cases it may be determined that the payments should be postponed until termination of administration. Payment of administration expenses in the final period may result in the estate's showing a loss and this will permit the heirs succeeding to the property of the estate to claim the excess deductions on their own individual returns. If the tax brackets of the heirs are considerably higher than the estate tax or income tax bracket of the estate, this plan may produce the best result. Of course this can pose a practical problem. The recipients of the fees may object to waiting until administration is completed and they may have tax problems of their own. Receiving the entire fee or even a major portion of it in a single year could be costly.

PREFERENCE TO INCOME BENEFICIARIES

EFFECT ON HEIRS

So far we have been considering only the tax advantages that can be achieved by swinging the deductions between the estate and income tax returns. The executor after comparing the possible tax savings may be confronted with the necessity of making adjustments in the beneficiaries' distributive shares of the income.

This will be so in any estate where some of the beneficiaries are given a preference over others as to income earned during administration. The income tax is a charge against income and any saving in income tax will be for the benefit of the income beneficiaries. The estate tax is paid out of principal and the increase in estate taxes resulting from the shift of principal deductions to the income beneficiaries reduces the amount of principal available for distribution. Attorneys for the estate should be consulted as to whether the income beneficiaries must reimburse the residuary legatees for the detriment suffered.

Claiming administration expenses as estate-tax deductions will not eliminate controversy. The beneficiaries can logically expect that the executor will take actions that will be for their benefit. Claiming deductions estate-tax or income-tax wise would depend on the circumstances. If he fails to exercise the election that best serves their interests, they may question his decision. The executor is faced with a dilemma.

PLANNED DISTRIBUTIONS

EXECUTOR CAN CONTROL DISTRIBUTIONS

While the executor is bound by the terms of the will in making distributions of income during administration, in many instances he may have the power to make discretionary distributions.

The executor, because he can control the time of distributions from the estate, has the power to spread taxable income among the estate and the beneficiaries and to shift it from one taxable year to another. This applies not only to distributions of income but, as previously mentioned, to some extent it applies to distributions of principal as well. This means that distributions can be used to equalize the income tax brackets of the estate and the beneficiaries. Equalization of tax brackets will result in the least income taxes being paid by the group as a whole.

SOLE BENEFICIARY

Generally, where the taxable income of the beneficiary is less than that of the estate, sufficient distributions should be made from the estate to make the taxable incomes equal.

For example, where an estate has a taxable income of $25,000 and the sole beneficiary of the estate has income of $5,000, a distribution of $10,000 of income to the beneficiary will mean that the estate and beneficiary will each have income of $15,000. This will save approximately $1,800 of tax for each year in which it can be done. This sort of equalization is simple.

SEVERAL BENEFICIARIES—INCOME DISTRIBUTION

The situation is more complicated where there are two or more equal beneficiaries and one has only a nominal amount of income and may in fact be pressing the executor for a distribution. The other beneficiaries are in high brackets and do not want an income distribution.

Consider the following circumstances. An estate has income of \$24,000 and there are three beneficiaries who share equally in the estate—A, B, and C; there are no required distributions of income specified; B and C have substantial income of their own; A's income is offset by his deductions and exemption. If distribution is made to A of his portion of the income—\$8,000—his tax on that income will be approximately \$2,000. The estate's income tax will be reduced approximately \$4,400 or a net savings to the group of \$2,400. If the beneficiary A had not received a distribution, his share retained by the estate would have been charged with one-third of the estate's income tax, which would have exceeded by approximately \$1,200 the amount that he paid personally. B and C likewise benefited approximately \$600 each because their share of the estate income has been reduced.

The executor does have an accounting problem at this point. B's and C's shares of the income reduced by the estate income tax are retained by the estate. If the retained income is invested it will produce income in which A should not be entitled to share. The fiduciary from an equitable viewpoint should account separately for their income shares. There is a question as to whether A should share in the savings to B and C. It would not be unreasonable to permit A to share. At the same time A has already benefited by the distribution. The circumstances would probably determine how this should be handled.

SEVERAL BENEFICIARIES—CORPUS DISTRIBUTION IN PART

In this same situation problems can arise if a part of corpus is distributed to Beneficiary A as well as his share of the income. The problems would not be created by the executor voluntarily, but the beneficiary himself might require a distribution desperately even with full knowledge of the income tax results.

If, instead of receiving only his distributive share of income of \$8,000, A received in addition a corpus distribution of \$4,000, he would have the entire distribution taxed to him. While this would result in an over-all saving to the beneficiaries as a group, what has really happened is that Beneficiary A is bearing the tax on \$2,000 of income that belongs to each of the other two beneficiaries. A bears a disproportionate amount of the income tax without any provision for automatic adjustment in the year of termination. When the estate is terminated, his principal distribution will be \$4,000 less.

In cases such as these it would appear that some adjustment should be made to take care of the inequity. While no completely satisfactory solutions to problems like this exist, an approach that might be reasonable in some circumstances would be that A was entitled to an adjustment for the additional tax that he was required to pay by reason of the distribution of $12,000 as compared with what his share would have been charged had it been retained by the estate. The solution to the problems raised by such a distribution is clearly one that should be worked out by the executor's advisors. Difficult accounting problems and serious legal questions are involved.

NO DISTRIBUTION

The other side of planning distributions also deserves consideration—that is, making no distributions whatsoever. Sometimes the heirs are comfortably well-off and do not require any distribution. In fact, a distribution that would be taxable would be of little benefit. The top income tax bracket of the estate may be much lower than that of the beneficiaries. In that case, the executor will probably retain the income during the entire period of administration. On termination, this income will go to the beneficiaries free of tax.

PYRAMIDING DISTRIBUTIONS

A variation of this aspect would occur where it was anticipated that administration of the estate would extend over a period of time. The beneficiaries would like a distribution prior to termination if the income tax cost is not too great. Again, the tax brackets of the beneficiaries are much higher than those of the estate. The estate could accumulate income for the first year of administration and pay the income tax. In the second year, distributions would be made not only of the income earned during the second year, but also the income of the first year. This would result in the beneficiaries' receiving a distribution of two full years of income, but having only the income of the second year subject to tax. This plan would be even more beneficial if the income of three years could all be pyramided into one year and distributed to the beneficiaries. In either case, the impact of the one year's taxable income to the beneficiaries could be softened or eliminated entirely if the estate had deferred deductions to the year of the planned distribution.

There are endless variations in which the opportunity for advantageous timing of distributions will present itself. The income tax rules in this area provide an opportunity for substantial savings by making judicious discretionary distributions.

SPECIFIC BEQUESTS

The bequests of the testator may present problems which in turn may mean that there is opportunity for planning to attain the desired objectives. The provisions of the will may provide for the satisfaction of all bequests—specific and otherwise—by a distribution in cash or in kind. Where this discretion is permitted, the exercise of the discretion will have tax consequences.

Satisfaction of a gift of a specific sum of money by distributing property is treated as a constructive sale. The estate will have to recognize gain or loss on the distribution. If a gift of specific property is paid in cash or by distributing other property, a constructive sale will also result.

There are circumstances where the exercise of discretion can be used to advantage. The estate may have capital loss carryovers and if appreciated property is distributed it will give the beneficiary a higher basis for determining gain or loss without any tax impact to the estate because of the capital loss carryovers. Or a beneficiary might particularly want an asset of the estate that he would retain permanently. If this particular asset had declined in value, the estate, because of the beneficiary's wishes, would not be in position to sell it and use the loss. If this property is used to satisfy a specific bequest to that person, the estate recognizes the loss and the beneficiary who intends to keep the asset isn't interested in basis.

MARITAL BEQUESTS

Some forms of marital bequests require careful planning. A bequest to the spouse—either directly or in trust—that is intended to qualify for the marital deduction may provide that the bequest is a certain percentage of the adjusted gross estate—a formula marital deduction. In many instances it is designed to insure the maximum marital deduction. This means that the marital deduction is determined to be a fixed dollar amount—the amount being finally fixed when the adjusted gross estate is determined. The spouse will not be sharing in any appreciation or depreciation of estate assets because the bequest has been reduced to an amount of money.

Although the marital deduction is reduced to a monetary amount, it is not considered as a bequest of a specific sum of money. The regulations state that a bequest to the decedent's spouse of money or property to be selected by the decedent's executor equal in value to a fraction of the decedent's adjusted gross estate is neither a bequest of a specific sum of money nor of specific property. The amount of money or identity of the specific property must be ascertainable under the terms of the will as of the date of death.

The formula marital deduction does not qualify for the exclusion as a bequest of specific sum of money or property because the identity of the property and the amount of money specified are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges—neither of which are facts existing on the date of death.

The constructive-sale rule will apply. Transfer or distributions of property in satisfaction of the marital deduction is a taxable event. Any appreciation in the value of the property over and above the value fixed for Federal estate purposes would result in gain. If this result is to be avoided, property that is of stable value will have to be used to satisfy the bequest. Usually there would be a mixture of gain, loss, and no gain-loss property that could be used. Selection of the property to be used in satisfying the marital deduction would have to be done carefully.

An executor who wished to bypass the problems that can arise would plan at the inception of administration to satisfy the marital deduction in cash or else in assets that would be likely to remain constant in value. This might require a program of liquidation and reinvestment.

A prudent executor would treat it much the same as any other liability of the estate and make adequate provision for its payment. A serious decline in the value of the assets of the estate prior to providing for the marital deduction could mean that there would be little left for the residuary legatees.

Finally, payment of the marital deduction may result in taxable income to the spouse or trust receiving the distribution. Gifts of specific property are excluded from income, but the marital deduction does not qualify as a specific bequest.

TERMINATION OF THE ESTATE

The precise timing of closing out an estate offers opportunity for securing advantages. While the estate is a separate taxpayer to the extent that its income is not distributed, the distribution of residue will normally shift the income from the estate to the beneficiary. It follows then that a final distribution can generally be more advantageously made shortly after the beginning of the estate year rather than toward the end.

For example, if an executor were administering a calendar-year estate and if he could reasonably wind up the affairs of the estate and make final distribution in December or in January of the succeeding year, it would generally be desirable to defer distribution until January. This would mean that the estate would be taxed on the income for the entire calendar year, generally at lower rates than the beneficiaries; in the succeeding year a distribution of that income as a corpus distribution would follow—tax-free to the beneficiary.

EXCESS DEDUCTIONS

Another factor in selecting the termination date that may be important in some cases is that excess deductions of an estate or trust in its final year will be allowed as deductions to the beneficiaries succeeding to the property. If the final reporting period of the estate includes only one or two months and a number of the expenses of the estate have been deferred and are paid during this short period, it can maximize the amount of excess deductions available to the beneficiary.

PYRAMIDING AVOIDED

If a fiscal year was initially chosen by the estate, and all income of the estate during administration has been distributed to the beneficiary, there will be a pyramiding of income during the final year of administration. The extent of the pyramiding will be determined by the choice of the termination date. For example, if an estate were on a fiscal year ending June 30 and the estate were terminated in December, it would result in 18 months of taxable income being included in a single taxable year of the distributee.

This could be avoided if distributions were withheld in the final full year of the estate. A distribution of income could be made at any time during the month of July which would have no effect on the amount taxable to the beneficiary and would actually result in six months income being taxable to the beneficiary rather than 18 months of income.

EFFECT ON CARRYOVER

The beneficiaries succeeding to the property of the estate also are permitted any unused capital loss and net operating loss carryovers of the estate. The additional short period suggested as being desirable previously would of course work against the beneficiaries here, because the short taxable year would constitute a full taxable year for determining the running of the period in which the carryovers could be utilized.

CONCLUSION

The entire area of planning the administration of an estate is complicated. The tax planning is particularly interesting because the tax consequences can be readily changed. There are so many factors that can influence the result, many dependent one upon the other. It is fascinating to work out plans which are most beneficial to the estate and its beneficiaries and everyone who participates in the planning will enjoy a deep sense of satisfaction.