

# PICKING A FISCAL YEAR, TIMING AND NATURE OF DISTRIBUTIONS

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It is hardly news that one of the principal duties of an attorney advising an executor is to work out a plan that will produce the most favorable tax results for the estate and the beneficiaries. The Internal Revenue Code permits a number of alternatives that must be examined and weighed. This means, as a practical matter, making a great many computations. Only by doing the arithmetic is it possible in many cases to determine what is the best course to follow. Many times it seems we march up the hill only to march down again. What may seem desirable from one viewpoint will be bad from another. Nevertheless, all of the alternatives must be weighed to determine the course which is best from the standpoint of both the estate and all of the beneficiaries.

This article will note some of the opportunities which are available for minimizing taxes and which are often overlooked. These opportunities arise through the proper selection of a fiscal year for the estate and the proper timing of distributions made from the estate.

Through proper use of the alternatives permitted by the code, it is possible to control to some extent the year of reporting income and the year of taking deductions. In this way the overall tax burden of the estate and of the beneficiaries can be reduced, thereby leaving more of the income for ultimate enjoyment by the beneficiaries. There are a number of opportunities to control not only the amount of tax but also the time when it will become due, and, of course, postponement of the time for paying taxes means that the beneficiaries will enjoy the income from the property which has to be used for the payment of taxes for a longer period.

The first of these opportunities arises out of the fact that the estate is a new taxpayer and can elect a tax year of its choosing. The tax year can be a calendar year or it can be a fiscal year ending on the last day of some month other than December. In any event, the first tax year cannot cover a period of more than twelve months, and it must end on the last day of a month. Section 441(b)(3) brings within the definition of "taxable year" a period of less than twelve months if the return is made for such a short period. Section 443(a)(2) authorizes a return for a short period, *i.e.*, one of less than twelve months "when the taxpayer is in existence during only part of what would otherwise be his taxable year."

The first factor to be considered by the executor or administrator in selecting a taxable year is whether there is any advantage to be gained by making the first year, and possibly the last year, short taxable

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years. This may result in less income being included in those periods and this may have distinct advantage in our system of graduated tax rates. In other words, by picking a short year with less income, that income will be subject to lower rates than would be the case if a full twelve-month year were used during which greater income would be received and subjected to higher tax rates. This will be particularly true where it is anticipated that the bulk of the income to be received during the period of administration of the estate will be received during the months immediately following death. The advantage lies in splitting the income between two or more tax periods.

Similarly, it may be advantageous to have a short year at the time of termination of the estate, again reducing the top bracket rate to which the income is subject. Another possible advantage to a short year at the close of the estate lies in the fact that Section 642(h) of the code permits excess deduction in the year of termination of an estate to be taken by the beneficiaries on their individual returns. If the beneficiaries happen to be in higher tax brackets than the estate, it will be advantageous to put as many of the deductions as possible into the last tax year of the estate, thereby enabling the beneficiaries to take advantage of those deductions on their individual returns.

The executor must bear in mind the fact that amounts distributed to beneficiaries will reduce the taxable income of the estate. He should also remember that in the case of property which is not specifically bequeathed, a deduction to the estate and income to the beneficiary may result from a distribution in kind.

The ideal arrangement for minimizing taxes of the estate and all of its beneficiaries would be to create, through properly timed distributions, a situation in which the tax brackets of the estate and the beneficiaries are the same. This can be accomplished where the estate is in a relatively high bracket before distributions and the beneficiaries are in lower brackets.

It frequently happens that an executor cannot make distributions to the beneficiaries in the calendar year of death without a risk that may not be justifiable. This is due to the fact that, in Ohio, he must wait until six months have expired after the probate of the will to be certain that there will be no will contest. Only by analyzing the situation of the particular estate will it be possible to determine whether there would be any great risk involved from a probate standpoint in making a distribution during the calendar year of death. If there is any great risk in making such a distribution, the executor or administrator may be well advised to select a fiscal year ending more than six months after the probate of the will. This will enable him to make distributions during the first tax year of the estate, thereby reducing the tax bracket to which the income of the estate is subjected.

Where the decedent was the member of a partnership, it is particularly important to use care in selecting the fiscal year of the estate.

The decedent's share of the partnership income will probably be taxed to the estate rather than to the decedent. This being the case, it probably will be desirable for the estate to be in a position to distribute a part or all of the partnership income to the beneficiaries during the first taxable year of the estate. In this connection it should be noted that the estate is not subject to the usual limitation against selection of a taxable year different than that of the partnership.<sup>1</sup>

Selection of the proper fiscal year for the estate will permit some control over the year in which the partnership income is to be taxed. It will also make it possible to determine whether the estate or the beneficiaries will pay the tax on the partnership income. If there is a surviving spouse and the partnership agreement has not been drawn so as to permit her to receive directly the partnership income, it may be desirable to select a fiscal year for the estate which ends concurrently with the partnership year at the end of the calendar year of death and to make a distribution to the surviving spouse even though the six month period for the filing of a will contest case has not yet elapsed. Under these circumstances a distribution may preserve the benefits of income splitting.<sup>2</sup>

The selection of a taxable year for the estate is important for two reasons; not only will it permit a leveling of income within tax periods of the estate, but it will also determine when the beneficiary must include in his income distributions from the estate. Section 662(c) of the code contains the rules as to when a beneficiary must include in his income distributions from an estate. The beneficiary must report the income during his taxable year within which the tax year of the estate ends. If, for example, the beneficiary and the estate both use the calendar year, 1958 distributions from the estate will be included in the 1958 return of the beneficiary. On the other hand, if the estate and the beneficiary have different taxable years, the beneficiary will report the distributions from the estate in his return for the year during which the fiscal year of the estate ends. This is true even as to income which may have been actually distributed to the beneficiary during his prior taxable year.

One further factor should be borne in mind in selecting the taxable year of an estate. This is the distinction which is drawn in Section 661 of the code between income which is required to be distributed and other amounts which are properly paid or credited to a beneficiary during the taxable year of the estate. This distinction is dis-

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<sup>1</sup> Rev. Reg. § 1.706-1(c)(3) example 1. The national office of the Internal Revenue Service has indicated informally that it will permit an estate to select a fiscal year different from that of the partnership of which the decedent was a member.

<sup>2</sup> Dye, *Tax Problems in the Administration of an Estate*, 20 OHIO ST. L.J. 1, 7 (1959).

cussed in detail elsewhere.<sup>3</sup> In this article it will be assumed that the situation is the usual one found in an estate where there is no requirement of distribution of income and all distributions are discretionary. It is only in connection with discretionary distributions that the executor is in a position to make substantial savings in taxes by proper timing of the distributions from the estate. In the case of mandatory distributions of income, there is no choice as to the fact that the income will be taxed to the beneficiary rather than to the estate and the only opportunity for tax saving lies in choice of the fiscal period for the estate which will result in the income being taxed to a beneficiary at the most advantageous time.

Termination of the administration of the estate cannot be unduly delayed merely to secure the tax benefits inherent in having another taxable entity. The regulations state that the period of administration is the period actually required by the executor or administrator to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies and bequests.<sup>4</sup> An estate is considered terminated when all the assets have been distributed except a reasonable amount set aside for unascertained or contingent liabilities and expenses. Termination of the estate closes its taxable year. Where the estate is using a fiscal year, the early termination may have undesirable results. It may, for example, result in as much as twenty-three months' income being taxed in one calendar year of the beneficiary. If an estate is using a January thirty-first fiscal year and terminates, for illustration, in December of 1959, there will be taxed in the 1959 return of the beneficiary the distributions during the fiscal year ended January 31, 1959, plus the distributions in the final year ending in December, 1959.

While the termination cannot be unduly delayed, wherever possible the executor should avoid having more than twelve months' distributions taxed to the beneficiaries in one year. If at all possible the estate should be closed at such time as will bring the final distribution of income into another tax year of the beneficiary. On the other hand, if the final year of the estate is one of excess deductions which can be claimed by the beneficiaries under Section 642(h)(2), the estate should be closed at a time when the beneficiaries can realize the maximum benefit from those excess deductions.

With the foregoing basic rules in mind, let us turn now to an example which will illustrate how savings in the overall tax burden of the estate and its beneficiaries can be made by proper selection of a fiscal year and proper timing of distributions from the estate to the beneficiaries.

For our example let us use the case of Atlee Doolittle who was a member of the law firm of Doolittle and Waite. Atlee died on

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<sup>3</sup> Dye, *supra* note 2. See also Polster, *Provisions of Wills Affecting Estate Administration and Their Tax Consequences*, 20 OHIO ST. L.J. 36 (1959).

<sup>4</sup> Rev. Reg. § 1.641(b)-3(a).

September 1, 1957. He was survived by a wife, a son aged twenty-two, and a daughter, fifteen. He left a will leaving one half of his estate to his wife and the other half in equal shares to his son and daughter. To simplify the example, we will assume that the only income of the estate or the beneficiaries other than the partnership income is \$2,000 per year received by his widow and \$5,000 per year earned by the unmarried son. The income from the partnership was \$18,000 in the year of death, of which \$4,000 had been drawn by Atlee prior to his death. The partnership is on a calendar year, and under the agreement, Doolittle's estate receives \$8,000 of income for each of the calendar years 1958 and 1959. For simplicity, a standard deduction is assumed.

First, let us see what happens if the executor selects a calendar year for the estate and makes no distributions of income during administration which continues until 1960.

In the last return of the decedent which is a joint return with the wife, the only income is her income of \$2,000 due to the fact that the partnership income will not be included in that return. There would be no tax on this return since the three exemptions and the standard deduction equal the taxable income. The tax of the son would be \$813 on his salary. The executor would report the partnership income of \$18,000 which includes the amount drawn before death. The only deduction would be a single exemption of \$600, leaving taxable income of \$17,400 on which the tax would be \$5,900. This makes a total tax for the family of \$6,713 on income of \$25,000.

In 1958, the widow's tax on her \$2,000 with the daughter as a dependent would be \$118. The son's tax would be the same \$813. The estate would pay tax on \$7,400 (\$8,000 partnership income less the \$600 exemption). Its tax would be \$1,780, making the total tax for the family \$2,711 on an income of \$15,000. The tax in the third year would be the same. In 1960, only Mrs. Doolittle and the son would pay tax. Their combined tax would be \$931, making the tax of the family and the estate for the four years a total of \$13,066.

Now, let us assume that in the second two years the executor is able to make appropriate distributions to the beneficiaries, but is unable (perhaps because the partnership income is not actually paid to the estate until after the close of its year) to make any distributions in the first year. The distributions are \$2,000 to the widow each year and \$1,000 each year to each of the children.

The tax in the year of death will be the same, namely \$6,713. In 1958 and 1959, the widow will now have gross income of \$4,000. She is classed as a surviving spouse under the code and will therefore pay a tax of \$476. Even though the daughter has income of more than \$600, she is still a dependent under Section 151(e) thereby entitling her mother to qualify as a surviving spouse. The daughter's tax will be \$58 and the son's tax \$1,048. The estate will have taxable income of \$3,400

(\$8,000 less distributions of \$4,000 and the exemption of \$600) on which it will pay a tax of \$708. This makes the total tax for the family \$2,290 for each of the years 1958 and 1959. For 1960, the tax of the family will be the same as in the first example, \$931. This makes a total tax for the four years of \$12,224, or a savings of more than \$800 over the amount which would have been due without the distributions.

For our third example, let us assume that the estate adopts a fiscal year ending March thirty-first and prior to the end of its first fiscal year distributes \$12,000 to the beneficiaries, \$6,000 to Mrs. Doolittle and \$3,000 to each of the children. Prior to the end of its fiscal year ending in 1959, the estate distributes \$2,000 to Mrs. Doolittle and \$1,000 to each of the children. The same is done after December 31, 1959, and the estate is finally closed in 1960.

In 1957 the estate would pay no tax. There would be no tax on the joint return, and the daughter would pay no tax. Only the son would pay a tax which would be \$813.

In 1958 Mrs. Doolittle would have gross income of \$8,000 (her own \$2,000 plus the \$6,000 distributed during the fiscal year of the estate which ends within the calendar year 1959) and as a surviving spouse would pay a tax of \$1,240. The son's tax on his salary and the \$3,000 from the estate would be \$1,540 and the daughter's tax \$420. Finally, the estate would have taxable income of \$5,400 (\$18,000 less \$12,000 distribution and \$600 exemption) on which it would pay a tax of \$1,204. This makes a family tax of \$4,404.

In 1959 the tax of the three members of the family and the estate would be \$2,322, and in 1960, since Mrs. Doolittle now qualifies only as head of a household, it would be \$2,325. This makes a total tax for the four years of \$9,864.

The income during the four years was identical in the three examples, yet the aggregate tax of the entire family and the estate was reduced from \$13,066 in the first example to \$9,864 in the third, a savings of nearly twenty-five per cent. Actually, even greater savings might have been realized if the executor had felt that it was possible to make distributions to the widow and daughter while retaining the son's share of the income. In any event, this simple illustration shows clearly how it is possible to reduce substantially the overall burden of taxes by proper selection of a fiscal year and by using care in determining the amount and time of distributions from the estate.

One further comment on Mr. Doolittle's case. If he had owned Series E or similar government bonds, the year of death would have been an excellent year in which to make the election to report the accumulated interest on those bonds as provided in Section 454(a), since the joint return for the year of death was one of very low income.

It should also be noted that in the above example there was no

great tax cost involved in the inability to get a part of the partnership income taxed on the last joint return, since the widow qualified as a surviving spouse under Section 2 in the next two succeeding years. If the widow had not so qualified by reason of having a dependent minor child, it would have been most important to find some way in which a part of the partnership income could have been included on the final joint return.

One conclusion, at least, seems certain. The benefits and disadvantages which may result from the selection of a fiscal year, the proper timing of distributions and payment of deductible expenses and the timing of the closing of the estate can be ascertained only by generous use of arithmetic.