

PROVISIONS OF WILLS AFFECTING ESTATE ADMINISTRATION AND THEIR TAX CONSEQUENCES

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Tax planning for the testamentary disposition of property is associated primarily with those dispositive devices such as the marital deduction, powers of appointment and "sprinkle" trusts, which are designed to produce tax savings over a long period of years or even several generations. Often overlooked are the more immediate problems of tax significance and the opportunities for tax savings that may arise shortly after a testator's death during the two or three year period of the administration of his estate.

The purpose of this article is to point out some of these problems and to suggest how, by the use of specific will provisions, their solution may be facilitated and tax savings accomplished in certain instances.

PROVISIONS FOR ALLOCATION AND PAYMENT OF DEATH TAXES

One of the most important administrative functions of the executor is in connection with the determination and payment of death taxes. In the case of an Ohio decedent with no out-of-state property, these death taxes consist of: (1) the federal estate tax, which is imposed on the transfer as a whole of all property subject to tax;¹ (2) the Ohio inheritance tax, which is imposed on each succession to taxable property of the decedent;² and (3) the Ohio additional tax, which is a form of estate tax imposed in those cases where the aggregate amount of the basic inheritance tax is less than the maximum amount of the credit against the federal estate tax allowable under the Internal Revenue Code for death taxes paid to a state.³

The executor of every estate of a citizen or resident of the United States which has a gross value of \$60,000 or more is required by law, within fifteen months after the decedent's death, to file a federal estate tax return with respect to all property that is or may be subject to tax, including not only all probate property but also any non-probate property.⁴ Examples of such non-probate property are life insurance proceeds,⁵ joint and survivorship property,⁶ property subject to a taxable power of appointment⁷ and property transferred by the decedent during his life which may nevertheless be subject to tax because it was trans-

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¹ INT. REV. CODE OF 1954, §§ 2001-2208.

² OHIO REV. CODE §§ 5731.01-.56 (1953).

³ OHIO REV. CODE § 5731.13 (1953).

⁴ INT. REV. CODE OF 1954, §§ 6018(a), 6075(a).

⁵ INT. REV. CODE OF 1954, § 2042.

⁶ INT. REV. CODE OF 1954, § 2040.

⁷ INT. REV. CODE OF 1954, § 2041.

ferred in contemplation of death or because the decedent retained control over, or enjoyment of the property.⁸ The executor also has the duty to pay the entire tax due, even though a substantial portion thereof may be attributable to the non-probate property.⁹

With two exceptions, the Internal Revenue Code does not undertake to allocate the ultimate burden of the estate taxes paid by the executor. These exceptions relate to life insurance payable to beneficiaries other than the estate¹⁰ and to non-probate property subject to a taxable power of appointment.¹¹ They expressly authorize the executor to recover from the recipients of such life insurance proceeds and power property the portion of the federal estate tax allocable thereto. Many states, however, have more comprehensive rules, adopted either by statute or as the result of case law, which allocate the burden of the federal estate tax among the beneficiaries of the property with respect to which the tax is paid.

Ohio has no statutory provisions in this regard but has reasonably well settled rules based on decisions of its supreme court. With respect to that portion of the federal estate tax attributable to property passing under the decedent's will, the general estate bears the entire burden, and specific and general bequests and devises are not reduced by reason of the tax if the balance of the estate is sufficient.¹² As to the portion of the federal estate tax attributable to non-probate property of all kinds, it appears to be reasonably well settled in Ohio, since the decision of the supreme court in *McDougall v. Central National Bank of Cleveland*,¹³ that the executor of a decedent's estate is entitled to recover from the recipient of each non-probate asset subject to the federal estate tax the portion of such tax attributable to that asset. The method of apportionment adopted by the supreme court in this case appears to be the same as that provided in the Internal Revenue Code with respect to non-probate life insurance proceeds and non-probate property subject to a taxable power of appointment.

The executor of every Ohio estate, irrespective of its size, is also required by law, within one year after the decedent's death, to file an application for the determination of inheritance tax.¹⁴ The executor is responsible for the payment of the inheritance tax imposed with respect to each succession, to the extent that the executor has in his possession property distributable to or for the benefit of the successor.¹⁵ In other words, the inheritance tax attributable to each succession to property is

⁸ INT. REV. CODE OF 1954, §§ 2033, 2035-38.

⁹ INT. REV. CODE OF 1954, § 2002.

¹⁰ INT. REV. CODE OF 1954, § 2206.

¹¹ INT. REV. CODE OF 1954, § 2207.

¹² *Y.M.C.A. v. Davis*, 106 Ohio St. 366, 140 N.E. 114 (1922), *aff'd*, 264 U.S. 47 (1924).

¹³ 157 Ohio St. 45, 104 N.E.2d 441 (1952).

¹⁴ OHIO REV. CODE § 5731.36 (1953).

¹⁵ OHIO REV. CODE § 5731.17 (1953).

payable out of that property and serves to reduce the net amount receivable by or for the benefit of the successor thereto.

The Ohio executor is also responsible for the payment of the Ohio additional tax. Inasmuch as this additional tax is an estate tax, rather than an inheritance tax, it would appear that the ultimate burden thereof is to be borne in accordance with the same rules that are applicable in Ohio with respect to the equitable apportionment of the federal estate tax.¹⁶

Despite the existence of the foregoing rules, it is believed that every Ohio will should contain an express provision for the allocation and payment of death taxes, even though this provision merely repeats the same rules that would otherwise be applicable. There is no assurance that these rules will not change prior to the testator's death or that the testator may not subsequently acquire property or become domiciled in another jurisdiction having different rules. Moreover, few testators are satisfied with the results that the existing rules produce.

Experience indicates that most testators will at least wish all specific and general legacies and devises provided for in their wills to pass to the recipients thereof without reduction on account of any estate or inheritance tax, state or federal. If this is the only change that the testator desires in the rules otherwise applicable, the following provision would appear to be adequate:

My Executor shall pay all estate, inheritance and other taxes of a similar nature (including any interest and penalties thereon) imposed by reason of my death under any domestic or foreign laws with respect to any part or all of the property passing under this Will or otherwise comprising my probate estate, whether such taxes would otherwise be payable by my estate or by any recipient of any such property. All such payments shall be made out of my general estate as part of the expense of the administration thereof, and no person shall be required to reimburse or contribute to my estate or any beneficiary hereunder on account of any part of any payment so made. Any and all taxes attributable to property which does not comprise a part of my probate estate shall be borne in the manner provided by law; and any and all taxes paid by my Executor with respect to such property may be recovered out of such property or from the recipient or recipients thereof in the manner and to the extent permitted by law or pursuant to the terms of any trust agreement or other instrument under which such property is held.

The testator may also desire the general estate to bear the burden of the death taxes attributable to some part or all of the non-probate property which may be subject to tax at his death. Here again, an appropriate provision is necessary to accomplish this result. Before the decision is reached to include such a provision, however, it is imperative to ex-

¹⁶ 1932 Ops. Atty. Gen. Ohio 4551.

amine the nature and extent of the non-probate property that may be subject to tax at the testator's death. If this property constitutes a substantial part of all property subject to tax, the death taxes attributable thereto may consume the entire general estate and may even impair the specific and general legacies and devises provided for in the will. Where the testator has created during his life trusts that may be subject to tax at his death, and where the testator may have at his death a taxable power of appointment over property held in a trust created by another, the trust instruments must also be carefully examined to determine whether they contain any provisions for the payment of death taxes arising by reason of the testator's death.

If the decision nevertheless is made to have all death taxes paid out of the general estate, the provision used should make it clear that such a result is contemplated. Otherwise the residuary legatees may question the intended scope of the tax provision.¹⁷ The following provision would appear to be adequate:

My Executor shall pay all estate, inheritance and other taxes of a similar nature (including any interest and penalties thereon) imposed by reason of my death under any domestic or foreign laws with respect to any and all property taxable under such laws, whether or not such property passes under this Will and whether such taxes would otherwise be payable by my estate or by any recipient of such property. All such payments shall be made out of my general estate as part of the expense of the administration thereof, and no person shall be required to reimburse or contribute to my estate or any beneficiary hereunder for any part of any payment so made.

One trap for the unwary that warrants particular mention is often found in the will of a widow whose husband has provided for her benefit a typical marital deduction trust under which she is given all the income for life and a general testamentary power of appointment at her death that will cause the power property to be included in her estate, whether or not the the power is exercised. If the widow's will fails to exercise this power of appointment, as is often the case, and if her will also unwittingly contains a clause providing for the payment out of her own probate estate of all death taxes assessed by reason of her death, her own estate may be entirely consumed by taxes, with nothing left for the beneficiaries designated in her will. It is usually imperative in cases of this kind for the widow's will to provide that the power property shall bear its own share of the death taxes payable at her death.

It should also be remembered, in providing for the payment of death taxes out of the general probate estate, that such a provision will reduce the residuary estate and accordingly affect the amount of any marital or charitable deduction to be obtained from a bequest of a

¹⁷ Cf. *In re Estate of Gatch*, 153 Ohio St. 401, 92 N.E.2d 404 (1950).

fractional share of the residue to a surviving spouse or for charitable purposes.¹⁸

PROVISIONS AUTHORIZING EXECUTOR TO FILE JOINT INCOME
TAX RETURNS AND SPLIT GIFTS WITH DECEDENT'S SPOUSE

Tax questions relating to the final income tax return of a decedent and the use of a joint return with the surviving spouse for the year of death are discussed *supra*.¹⁹ Although it may be unnecessary to do so, many careful lawyers, particularly where both spouses have taxable income, have adopted the practice of including in the will of each spouse a provision expressly authorizing the executor to file such a joint return and also to agree with the spouse on the allocation of the monetary benefits and burdens that arise from its use. This same provision usually also authorizes the executor to split with the other spouse for gift tax purposes gifts made by such spouse prior to the testator's death.

A typical provision in this regard is as follows:

My Executor may join with my wife, or with the representative of her estate, in filing any joint income tax return or returns for any period or periods for which such may be permitted, and also may consent for federal gift tax purposes to gifts made by my wife as having been made one-half by me. Any and all income and gift taxes, including any and all refunds, credits, deficiencies, interest, and penalties, arising by reason of any such action, as well as the benefits of any and all payments previously made, shall be allocated between my estate and my wife or her estate as my Executor and my wife or the representative of her estate shall agree. My Executor may exercise the foregoing authority in such manner as he in his absolute discretion shall deem advisable, whether in the interest of my estate or in the interest of my wife or her estate; and all amounts payable by my Executor by reason of the exercise of such authority shall be treated as debts of my estate.

The clause used can confer on the executor varying degrees of discretion up to the very broad discretion set forth in the foregoing typical provision. This provision in effect authorizes the executor to pay out of the decedent's estate the tax attributable to the other spouse's income. Whether so broad a clause should be used is of course a question that every testator must decide for himself. If it is used and if the executor pays the surviving spouse's tax, it should be realized that the executor is in effect making an additional bequest of the tax money to the surviving spouse which will not be deductible by the decedent's estate for estate tax purposes because it does not constitute the payment of a tax debt of the decedent. Section 2053.6 of the Federal Estate Tax Regulations

¹⁸ Cf. Rev. Reg. §§ 20.2055-3, 20.2056(b)-4.

¹⁹ Dye, *Tax Problems in the Administration of an Estate*, 20 OHIO ST. L.J. 1 (1959).

sets forth in detail how much of a deduction will be allowed in such a situation.

PROVISIONS AUTHORIZING EXECUTOR TO DEDUCT ADMINISTRATIVE
EXPENSES FOR ESTATE TAX OR INCOME TAX PURPOSES

The election that the executor has under the Internal Revenue Code to take administration expenses either as deductions for estate tax purposes or as deductions for income tax purposes is discussed *supra*.²⁰ When the will contains a formula marital deduction clause or creates both income interests and remainder interests in the same property, the nature and extent of the election made by the executor can substantially affect the interests of the several beneficiaries of an estate. During the past several years there have been a number of reported decisions, although none in Ohio, which consider whether and to what extent the executor is required to make adjustments in the interests of the beneficiaries in order to compensate for the effects of the election which the executor has made.²¹

This is another area that can be covered by a provision in the will. For example, the will may contain a provision which not only confers upon the executor express authority to make the elections available to him under the tax laws but also purports to confer upon the executor absolute discretion to determine whether the interests of the beneficiaries affected by the election made should be adjusted and, if so, the nature and extent of the adjustments to be made. Typical of such a provision is the following:

My Executor may exercise, in such manner and to such extent as he shall deem advisable, any elections available under the federal tax laws permitting certain deductions to be claimed either in computing my taxable estate for federal estate tax purposes or in computing the taxable income of my estate for federal income tax purposes, even though such action may be advantageous to one or more of the beneficiaries hereunder and disadvantageous to other beneficiaries. My Executor shall have no duty to make any adjustments in his accounts for the benefit of any beneficiary adversely affected by any such election, but, if my Executor considers it advisable to do so, he may make such adjustments as he deems appropriate.

A number of thoughtful lawyers have questioned both the efficacy and the advisability of a clause giving the executor so broad a discretion.²² If the executor is an interested beneficiary, this broad discretion may result in abuse and may be productive of litigation. If, on the other hand,

²⁰ Cox, *Executor's Election to Claim Certain Deductions for Income or Estate Tax Purposes*, 20 OHIO ST. L.J. 23 (1959).

²¹ *Id.* at 27-33.

²² Gradwohl, *Current Issues on Probate Estate Income Tax Allocation*, 37 NEB. L. REV. 329 (1958); Randall, *Consequences of Executor's Elections As To Administrative Expenses*, N.Y.U. 15TH INST. ON FED. TAX 1011 (1957).

there is a corporate fiduciary, it will in all likelihood attempt to make an equitable adjustment even though exonerated from doing so.

This is a matter which in any event should be discussed with the testator before the will is drawn. It may be that the testator will wish to favor those who will be benefited if the executor elects to take administration expenses as income tax deductions. If so, the clause can be drawn to direct that no adjustment shall be made. If the testator feels otherwise, then the clause can be drawn to require such adjustments as the executor determines to be fair. It would probably be inadvisable, however, to attempt to set forth in the will the precise adjustments to be made. It is difficult enough to determine at the time the precise nature and extent of these adjustments, let alone in advance.

PROVISIONS RELATING TO CHOICE OF VALUATION DATE FOR ESTATE TAX PURPOSES

For federal estate tax purposes property is ordinarily valued as of the date of the decedent's death.²³ The executor may elect, however, the optional method of valuation provided by the Internal Revenue Code, which calls for the valuation of all property as of a year after the decedent's death, except that any property distributed, sold or otherwise disposed of within such year must be valued as of the date of disposition.²⁴

At first glance it would appear that this optional method of valuation should present no problem and that the executor will merely select the valuation date producing the lower aggregate value for the property subject to tax. The choice, however, is not always quite so simple, for the optional valuation date producing the higher value may sometimes be helpful to certain beneficiaries although detrimental to others.

Suppose, for example, that the testator has a surviving spouse to whom is made a monetary bequest in an amount equal to one-half of the testator's adjusted gross estate, the maximum marital deduction allowable by law.²⁵ In such a situation, the higher the value placed on the adjusted gross estate, the larger will be the dollar amount of the bequest to the surviving spouse. Or suppose that property specifically bequeathed increases substantially in value between the date of the testator's death and the optional valuation date. In such a situation, the election of the optional valuation date will be to the advantage of the legatee, since the property will have a basis in his hands for purposes of computing a subsequent gain or loss equal to the value placed thereon for estate tax purposes.²⁶

In other situations the election of the valuation date producing the higher value may be to the advantage of all beneficiaries. For example, if the executor is forced to sell estate assets to raise cash and

²³ INT. REV. CODE OF 1954, § 2031.

²⁴ INT. REV. CODE OF 1954, § 2032.

²⁵ INT. REV. CODE OF 1954, § 2056(c)(1).

²⁶ INT. REV. CODE OF 1954, § 1014(a).

these assets have risen in value, the increased estate tax attributable to the use of the optional valuation date may be less than the income tax on the capital gain resulting from the use of date of death values.²⁷ And if a substantial increase or decrease in value should happen to take place with respect to property specifically bequeathed for charitable purposes and the value of the testator's other property should remain stable, the election of the valuation date producing the higher value will result in a larger charitable deduction for estate tax purposes and a smaller estate tax.

The existence of these possibilities raises the question of whether any special provisions concerning the choice of the valuation date should be inserted in the will. In many respects this question is similar to the question, discussed above, of whether any provisions should be made concerning the election to take administrative expenses as income tax deductions or as estate tax deductions; and the variety of possible provisions is equally as great. For example, it would be possible, although inadvisable in this writer's opinion, to include a provision expressly authorizing the executor to elect either valuation date without regard to its effect on the total amount of the estate tax payable or on the interests of the several beneficiaries. A more sensible provision, if the testator desires to favor one or more legatees similarly situated, would be one authorizing or even directing the executor to elect the valuation date benefiting these legatees. At least one well-known expert, fearing the possibilities of pressure and abuse present in this area, has suggested the inclusion of a provision requiring the executor to elect the valuation date that will produce the lower aggregate estate tax.²⁸

LEGACY TO EXECUTOR IN LIEU OF COMMISSIONS

Commissions paid to an executor are treated for tax purposes as compensation for services rendered and accordingly are taxed to the executor as ordinary income. From the standpoint of the estate, such commissions constitute administration expenses which, as elsewhere noted, may be taken either as income tax deductions or as estate tax deductions.

In lieu of commissions, a testator may bequeath to the person named as executor a specific sum of money or specific property which will not constitute taxable income to the executor and will not be reduced by death taxes if the will provides for the payment thereof out of the general estate. Since the legacy will not be treated as an expense of administration, the estate will be deprived of any income or estate tax deduction for commissions paid to the executor.

To accomplish these tax results, however, the legacy must not be

²⁷ The basis for computing gain or loss on the sale or exchange by the executor of property acquired by the estate from the decedent depends on its valuation for estate tax purposes. INT. REV. CODE OF 1954, §§ 1001, 1011, 1014.

²⁸ CASNER, *ESTATE PLANNING* 647 (1956).

conditioned on the recipient's rendition of services as executor.²⁹ An appropriate form would be as follows:

I bequeath to John H. Jones, if he survives me, the sum of Five Thousand Dollars (\$5,000.00). The foregoing bequest to John H. Jones is made in lieu of any and all commissions to which he might otherwise be entitled as Executor hereunder but is not contingent upon his rendition of services in such capacity.

If the use of a legacy in lieu of commissions not only is to benefit the executor but also is to benefit or at least not harm the estate and its beneficiaries, the amount of the legacy must be larger than the executor would receive as net commissions after income tax thereon and at the same time must be less or at least no more than the net cost would be to the estate and its beneficiaries of paying commissions, taking into account the income or estate tax saving that the payment of commission would produce. Accordingly, this device is feasible only if it is certain that the executor's top income tax bracket will be higher than the top income tax or estate tax bracket of the estate and only if these respective brackets can be forecast with reasonable accuracy when the will is drawn.³⁰

PROVISIONS FACILITATING DISCLAIMERS

In the preparation of a will for a wealthy testator or for any testator who is providing for beneficiaries with substantial means of their own, there should be borne in mind the possibility that upon the testator's death one or more of these beneficiaries may desire to disclaim or renounce, in whole or in part, the property interests given to them under the will. A number of matters need to be considered in this connection.

It is relatively well settled in most states, including Ohio, that a testamentary gift of a property interest cannot be thrust upon the devisee or legatee and that he may refuse the gift within a reasonable time after obtaining knowledge thereof and before taking any action constituting an acceptance.³¹ Unless the will otherwise provides, a disclaimed specific general legacy or devise will fall into the residue of an estate, and a disclaimed residuary legacy or devise will pass as intestate property.³²

It is generally believed, however, that an inheritance by intestacy cannot be refused because it automatically passes to the heir at the decedent's death by operation of law.³³ In such a case, the heir normally

²⁹ Rev. Rul. 57-398, 1957 INT. REV. BULL. No. 36, at 7; *Cf.* United States v. Merriam, 263 U.S. 179 (1923).

³⁰ Account must also be taken of the possibility that beneficiaries of the estate may claim deductions for commissions paid during the last taxable year of the estate if and to the extent that the estate's deductions for such year exceed its gross income. See INT. REV. CODE OF 1954, § 642(h).

³¹ *Ohio National Bank v. Miller*, 57 N.E.2d 717 (1943); see 4 PAGE, WILLS §§ 1401-1412 (3d ed. 1941) for an extended discussion of disclaimers.

³² See cases cited in 4 PAGE, WILLS § 1412 (3d ed. 1941).

³³ See discussion in 4 PAGE, WILLS § 1401 (3d ed. 1941). Several states, by statute, authorize the disclaimer of intestate property.

can divest himself of the property interest only by taking affirmative action in the nature of a gift or otherwise.

A disclaimer may have more uncertain consequences if the disclaimed property interest acquired under the testator's will is less than a present interest in fee simple. For example, suppose that A leaves property in trust to pay the income to B for his life, and upon B's death to distribute the property *per capita* among A's grandchildren then living. If B disclaims his income interest and the will makes no provision for disclaimer, what will happen to the trust property pending B's death? Or suppose that A leaves property in trust to pay the income to B for his life, and upon B's death to distribute the property to C if C is then living or, if C is then deceased, to D if he is then living. If C disclaims his remainder interest but both C and D are living at B's death, will D thereupon become entitled to distribution of the trust property in the absence of any provision in the will concerning the effect of a disclaimer?³⁴

There is also substantial uncertainty in most jurisdictions whether and under what circumstances a testamentary gift of property interests may be refused in part and accepted in part. In most jurisdictions it appears that the answer to this question depends on whether the testamentary gift or gifts involved are regarded as severable;³⁵ and any expression of intention by the testator in this regard would no doubt be given great weight.

The testator who wishes to facilitate the use of the disclaimer as an instrument of post-mortem estate planning should accordingly bear in mind these problem areas and have his will drawn in such fashion as to minimize such problems. For example, in a will creating a trust a provision can readily be inserted to the effect that if any beneficiary disclaims his interest in the trust property, such property shall thereafter be administered as though the beneficiary's death had occurred. Such a provision, of course, may not always produce a result in keeping with the testator's wishes, and in that event other and perhaps more elaborate provisions may be necessary. A testator can also facilitate partial disclaimers by making two or more obviously severable separate bequests or devises to the same individual or, in the case of an otherwise indivisible gift, by expressly providing that it may be disclaimed as to any part.

From a tax standpoint, the principal problem is whether the so-called disclaimer constitutes a taxable gift. The current position of the Treasury Department appears to be that a complete and unqualified refusal to accept a property interest, if effective under local law and if made within a reasonable time after obtaining knowledge of the existence of the interest, is not a gift if title to the property interest in question has not already vested in the disclaimant. But if title has vested, whether by operation of law or otherwise, as in the case of interstate property or as

³⁴ The reported decisions in this area are few in number and appear to depend on the specific facts involved.

³⁵ See discussion in 4 PAGE, WILLS § 1410 (3d ed. 1941).

in the case of a devise of real property in those jurisdictions where title thereto passes immediately at death, then a gift will be deemed to have been made.³⁶

The proposed gift tax regulations also indicate that a partial disclaimer will not be recognized as having tax-free status under any circumstances because it does not constitute a complete and unqualified refusal to accept the property. Whether the Treasury Department will maintain this position when the final regulations are adopted is uncertain, however, in view of the somewhat more lenient attitude taken in the final Estate Tax Regulations, issued on June 23, 1958, with respect to the effect of a disclaimer of a general power of appointment over only a portion of the property subject thereto.³⁷

PROVISIONS AFFECTING INCOME TAX TREATMENT OF THE ESTATE AND ITS BENEFICIARIES

The income tax treatment accorded under the Internal Revenue Code to the income of estates and to the distributions made by an executor during the period of administration may often pose difficult problems for the executor and produce for the beneficiaries of the estate a variety of tax consequences, depending on the timing of the distributions made and the form that they take. This in an area that warrants careful consideration when the will is prepared. Although the tax-conscious executor, by careful post-mortem planning, is frequently able to avoid or minimize many of these problems and their tax consequences, the draftsman of every will disposing of a substantial estate should bear in mind, particularly where there are involved a number of beneficiaries with differing income tax situations, that it is often possible to draw the will in a form, and to include therein special provisions relating to distributions, which will greatly lighten the executor's task and achieve for the estate and its beneficiaries tax consequences more favorable than the executor would be able to accomplish without such assistance.

For income tax purposes, an estate is a separate taxable entity,³⁸ and its income and deductions are treated much like those of a single individual taxpayer. This is true even though a number of beneficiaries may be entitled to identifiable shares of the estate and its income.

There are two principal differences, however, both relating to deductions. First, there is an unlimited annual deduction for any amount of the gross income which is paid or permanently set aside for charitable

³⁶ Proposed Rev. Reg. § 25.2511-1(c). The proposed regulations appear to go farther in certain respects than the present status of the case law justifies, particularly as to disclaimers of devises of real property. *Cf. Hardenbergh v. Commissioner*, 198 F.2d 63 (8th Cir. 1952), *cert. denied*, 344 U.S. 836 (1952); *Brown v. Routzahn*, 63 F.2d 914 (6th Cir. 1933), *cert. denied*, 290 U.S. 641 (1933); *William Maxwell*, 17 T.C. 1589 (1952).

³⁷ Rev. Reg. § 20.2041-3(d).

³⁸ INT. REV. CODE OF 1954, § 641.

purposes pursuant to the terms of the will.³⁹ Second, distributions to beneficiaries are allowed as additional deductions to the extent that such distributions do not exceed the "distributable net income"⁴⁰ of the estate for the taxable year in question;⁴¹ and these beneficiaries are required to include as gross income in their own returns amounts equal to these additional deductions.⁴² To this extent the estate is treated not as a separate taxable entity but as a conduit for the flow of income from its source to the beneficiaries.

This dual treatment of an estate and its income has obvious tax savings possibilities, particularly since the executor generally has substantial discretion as to the timing of distributions. To the extent that the income of the estate is retained by the executor, it will be taxed to the estate as a separate taxable entity, and to the extent that it is distributed it will be taxed to the beneficiaries.⁴³ However, as the result of changes made in the operation of the conduit theory by the Internal Revenue Code of 1954, the income tax burden with respect to distributions made by an estate is often allocated among the beneficiaries thereof in a wholly inequitable manner, particularly in those instances where principal is distributed as well as income.⁴⁴

In order to avoid many of the problems of tracing that had theretofore existed, the Internal Revenue Code of 1954 does not give the estate a deduction for *income* distributed and does not tax to the beneficiaries the *income* received. Instead, the estate is given a deduction, to the extent of the amount of its distributable net income, for any amount of income (in the estate accounting sense) required to be distributed currently and also for any other amounts (irrespective of their treatment for estate accounting purposes) properly paid or credited or required to be distributed.⁴⁵ In other words, the distribution of what is otherwise considered as principal may generate a deduction for the estate and income to the recipients. The only exception generally applicable is that the estate shall not have a deduction, nor shall the recipient have gross income, with respect to any amount which, under the will, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property

³⁹ INT. REV. CODE OF 1954, § 642(c).

⁴⁰ By definition, INT. REV. CODE OF 1954, § 643(a), the distributable net income of an estate for any taxable year is equal to its taxable income, except that no deduction is taken for the personal exemption or for distributions to beneficiaries. Tax exempt interest may be included, and capital gains or losses are excluded in certain instances.

⁴¹ INT. REV. CODE OF 1954, § 661.

⁴² INT. REV. CODE OF 1954, § 662.

⁴³ The so-called "five-year throwback rule" imposed by INT. REV. CODE OF 1954, § 665-68 does not apply to estates, only to trusts.

⁴⁴ A bill (H.R. 11977) designed to rectify many of the inequities mentioned was introduced in the House of Representatives during the last session of the 85th Congress but was never full considered. It is understood that the reintroduction of this proposed regulation is contemplated for the 86th Congress.

⁴⁵ INT. REV. CODE OF 1954, §§ 661, 662.

and which is paid or credited all at once or in not more than three installments.⁴⁶

If the amounts properly paid, credited or required to be distributed to beneficiaries during any taxable year of the estate, and not falling within the foregoing exception, exceed the amount of the distributable net income of the estate for such year, these amounts are placed in two classes or tiers for the purpose of determining how much of each amount is to be included in the gross income of a beneficiary. First tier amounts consist of amounts of income (in the estate accounting sense) required to be distributed currently. These amounts are includible in the gross income of the beneficiaries thereof, to the extent that the aggregate of such amounts does not exceed the distributable net income of the estate. If it does, the gross income attributable to each such beneficiary is reduced proportionately. All other amounts properly paid, credited or required to be distributed to beneficiaries are in the second tier and are included on a proportionate basis in the gross income of the beneficiaries thereof to the extent that the distributable net income of the estate exceeds the first tier amounts.⁴⁷

These provisions create the greatest problems in connection with the timing of the distributions of the income and principal of a residuary estate having two or more beneficiaries. Since all amounts distributed to the residuary beneficiaries will constitute second tier amounts, any distribution to any of the beneficiaries, even though consisting entirely of principal for estate accounting purposes, will be considered a distribution of distributable net income in whole or in part, depending on the extent of other distributions during the same taxable year. To achieve the same tax treatment for each beneficiary, it is thus necessary either to defer all distributions to any of them until the administration of the estate is completed or to make sure that no partial distribution of income or principal for estate accounting purposes is made to any of these beneficiaries unless a proportionate distribution of the same character is made to each of the others.

In any effort to achieve the greater flexibility with respect to distributions which the varying needs and income tax situations of the several beneficiaries make advisable, the conscientious executor may seek to reach agreement with the affected beneficiaries on such adjustments in the final distribution of the estate as will compensate for the inequitable tax treatment that may result from partial interim distributions. However, it is not always easy to determine what a proper adjustment should be; and if agreement cannot be reached, protracted litigation may result. For this reason every draftsman of a will disposing of an estate of any substantial size should consider the various possible special provisions that may be inserted in a will to minimize the foregoing problems.

⁴⁶ INT. REV. CODE OF 1954, § 663.

⁴⁷ INT. REV. CODE OF 1954, § 662.

One type of provision that may be advisable merely recognizes the problems of adjustment that may exist and gives the executor express authority to make interim distributions of both income and principal to one or more beneficiaries and to determine in conclusive fashion the nature and extent of any adjustments to be made as the result thereof. Through the use of such a provision litigation may be avoided if the beneficiaries are unable to agree as to the adjustments to be made and if the executor acts in good faith. The problem is very much the same as the adjustment problem discussed earlier in this article with respect to the effect of the executor's treatment of administration expenses for tax purposes.

It should also be noted that in wills creating trusts, the executor should be expressly authorized to make to the trust beneficiaries any distributions which the trustee is directed or authorized to make. In the absence of such a provision, the executor would probably find that his hands are tied until the trustee is appointed by the probate court and the trust becomes operative.

Other possible provisions lighten the executor's task by minimizing the need for adjustments, although they have the disadvantage in many instances of limiting the broad discretion which it is generally believed that every executor should have. One such provision requires the executor to make annual distributions of some part or all of the estate's income. Income so distributed will thereby become first tier amounts, and other amounts distributed will accordingly be included in the gross income of the recipients only to the extent that the distributable net income of the estate exceeds the required income distributions.

The foregoing problems may also be minimized in appropriate cases simply by reducing the size of the residuary estate through the use of additional bequests of specific sums of money or of specific property, even though made to the same persons who are also the residuary legatees.⁴⁸ The distribution of the principal amount of these bequests will not give to the estate any income tax deduction or generate income for the recipients unless payable out of income only or in more than three installments.

Consideration may also be given, in those instances where the testator would otherwise make pecuniary bequests to charitable organizations or to individuals in low income tax brackets, to the inclusion of provisions requiring the executor to pay these pecuniary sums out of estate income to the extent that the income is sufficient for the purpose. Even though provision will have to be made for distribution of slightly larger amounts to the low bracket beneficiaries to compensate them for the amount of tax that they will have to pay, the residuary beneficiaries may be sub-

⁴⁸ In Ohio, the legatee of specific property is entitled to the income thereon from the date of death. However, pecuniary and other general bequests bear no interest unless the will otherwise provides. All remaining net income of the estate, including income derived from property sold by the executor to pay taxes and other costs, generally belongs to the residuary legatees in proportion to their respective interests in the residue.

stantially benefited in this manner and the problems of the executor minimized. Similar but generally less beneficial results may also be accomplished by deliberately providing for the payment of specific bequests to low bracket beneficiaries in four or more installments.⁴⁹

Tax savings can also be accomplished in appropriate cases through the utilization of the provisions of the Internal Revenue Code of 1954 which permit the specific allocation of different classes of income to different beneficiaries.⁵⁰ Since income retains the same character in the hands of the recipient that it had in the hands of the executor, it is obvious that advantages may be achieved if certain classes of income, such as tax exempt interest, income in respect of a decedent and income from property subject to depreciation or depletion, are allocated to specific beneficiaries. Unless the will makes such specific allocation, however, the portion of the distributable net income of the estate included in the gross income of each beneficiary will be treated as consisting of the same proportion of each class of items included in the distributable net income as the total of each class bears to total distributable net income. These same provisions are also applicable to charitable distributions.⁵¹

PROVISIONS FOR DISINTERESTED EXECUTOR

The importance of giving the executor broad and sufficient powers of administration cannot be overemphasized. However, certain of these powers may, in the hands of an executor who is also a beneficiary, be claimed to constitute taxable general powers of appointment. Although it is often advantageous for a member of the testator's family to serve as an executor even though he may be a beneficiary under the will, it is accordingly advisable to appoint as co-executor a bank or other disinterested person and to confer solely upon the disinterested co-executor such powers as may constitute taxable powers of appointment if possessed by a beneficiary.

⁴⁹ Mandatory distributions of income are first tier distributions and thus reduce the amount of distributable net income allocable to other distributees, whereas distributions of principal in four or more installments are second tier distributions.

⁵⁰ INT. REV. CODE OF 1954, § 662(b).

⁵¹ See Rev. Reg. § 1.661(b)-2.