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CURRENT POST-MORTEM INCOME TAX PLANNING

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I. Introduction

This article will describe and set forth examples of various fiduciary income tax planning strategies that are available after the Tax Reform Act of 1986, the Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988. The article will also demonstrate that the tax savings from certain traditional techniques may now be so small as to be outweighed by the administrative costs of implementing them.

Nevertheless, certain tax saving opportunities still exist and other strategies, less utilized in the past, now take on greater importance. The objective remains to implement proper fiduciary income tax planning in order to minimize the overall tax burden.

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II. Optimal Use of Deductions on Federal Estate Tax Return or Fiduciary Income Tax Return

Expenses incurred in the administration of an estate, such as attorneys' fees and compensation to the personal representative of the estate, may be used as deductions on the estate tax return (Form 706) or on the fiduciary income tax return (Form 1041), but the same deduction may not be used on each return. *See, e.g.*, Treas. Reg. § 1.642(g)-1. Because the lowest estate tax rate (37%), after the use of the unified credit, is now greater than the highest marginal income tax rate (33%), the traditional analysis as to where to use these deductions becomes slightly modified.

In the case of an estate not subject to estate tax by the use of the unified credit, the fees and compensation need not (of course) and still should not be taken on the federal estate tax return (assuming a Form 706 is even filed in this situation).

If an estate is not subject to estate tax because of the use of both the unified credit against taxes and unlimited marital deduction, the executor should not automatically elect to use administration expenses as an income tax deduction. Though no estate tax will be owed, generally the use of administration expenses as an income tax deduction will decrease the credit shelter share while having no impact on the marital deduction share. *But see Estate of Street*, TCM 1988-553. In contrast, the use of administration expenses as an estate tax deduction may allowably decrease the marital deduction share of the estate while having no impact on the credit shelter share. Therefore, emphasis must be placed on the real benefit attributable to the deferral of the estate tax on the marital deduction portion of the gross estate (and the eventual estate tax exposure of the surviving spouse). For example, if both husband and wife will have large taxable estates, it may be more advantageous to use administration expenses as an estate tax deduction at the death of the first spouse in order to decrease the amount of property which must, in order to avoid federal estate tax at the first spouse's death, pass to the surviving spouse (i.e., to the marital deduction share). This conclusion would be bolstered if the surviving spouse's estate is so large that he or she intends to make lifetime taxable gifts. Further, consideration should be given to whether an administration expense will be deemed a "miscellaneous itemized deduction" subject to the 2% adjusted gross income floor. *See infra* pp. 5-6. Another factor that may militate in favor of electing to take administration expenses as a deduction on the estate tax return (even when use of the unlimited marital deduction eliminates any estate tax) is the existence of a large amount of municipal bonds or other tax-exempts in the estate.

If an estate is subject to estate tax, then use of administration expenses as an estate tax deduction should be worth more than use as an income tax deduction.

Example 1.

D dies having a gross estate of $1,100,000 and leaving her property via a fractional share residuary bequest to her spouse in trust (the credit shelter amount) and the balance to her spouse outright (the marital deduction amount). The spouse and son are named as co-executors, and fiduciary fees are estimated at $100,000. D's spouse is in good health and has no assets other than those passing from D. Under these circumstances, claiming a $100,000 deduction on the federal estate tax return could result in no benefit: there is no estate tax owed in D's estate and, if D's spouse were to die one year later with a gross estate of around $500,000, there would be no estate tax on D's spouse's estate. Hence, it would be valuable to use the $100,000 as a deduction against income earned by the estate.

Example 2.

Assume D in Example 1 dies without a surviving spouse. In that instance, there will be an estate tax

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owed by D. Use of the estimated administration fees as a deduction on the federal estate tax return could result in the following savings:

Gross Estate: $1,100,000

The estate will be taxed at a highest marginal estate tax rate of 41%.

Use of a $100,000 deduction on the FET return will reduce the gross estate from $1,100,000 to $1,000,000, thereby reducing the estate tax by $41,000 (that is, the $100,000 removed will not be taxed at the 41% rate).

Use of $100,000 on the fiduciary income tax return could result in a maximum savings of $28,650.

Therefore, a savings of at least $12,350 is possible by use of this approach.

III. Fiduciary Compensation

If a decedent dies with a taxable estate and the beneficiaries are acting as the executors, then the executors should be paid the maximum reasonable and necessary fee possible. The strategy should result in assets being passed to the beneficiaries/executors at a lower tax cost.

Example 3.

Assume D in Example 1 dies without a surviving spouse. D's son, S, is given the residue outright under the terms of D's will. S is also named as the executor of D's estate. S determines that based on the complexity of administration and time involved, he would be entitled to an executor's fee of $100,000, but he does not want to take any compensation because it will add to his other, already high, taxable income. Despite S' concern about the effect of receiving compensation on his own income tax picture, he should take the compensation as executor. If he does, he will be taxed on this amount at a flat 28% rate (assume the lower bracket and exemptions are phased out based on S' other income). But he is removing dollars from the estate that would otherwise be taxed at a 41% rate. Therefore, by receiving compensation of $100,000, S is receiving an additional $13,000 from D's estate that he would not otherwise receive (that is, $100,000 taxed at the 41% rate versus $100,000 taxed at the 28% rate).

IV. Expenses Subject to the 2% Floor and the Timing of Deductions

Section 67(e) of the Code provides:

"[T]he adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, **except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate** shall be treated as allowable in arriving at adjusted gross income" (emphasis added).

Certain administration expenses will thus not be subject to the 2% of adjusted gross income limitation (i.e., these expenses will be "above-the-line"). Commissions or fees paid to an individual executor or trustee, regardless of whether chargeable to principal or income, should be fully deductible in arriving at trust or estate adjusted gross income. This may also be the result with regard to investment advisory fees, costs incurred in the preparation of federal and state fiduciary income tax returns, and legal fees incurred in the probate of an estate.

But what if investment advisory, tax preparation and legal fees are held to be subject to the 2% limitation? In that event, the trustee should consider paying these expenses directly and having his or her compensation adjusted upward to reflect that payment. Payment by the trust of the trustee's compensation should not be subject to the 2% floor. Further, by using these expense payments on the trustee's schedule C, query whether the trustee would have to report this upward adjustment to the trustee's income.

If expenses are not being claimed as federal estate tax deductions, care should be exercised in advising personal representatives as to the timing of payments of expenses such as attorneys' fees and fiduciary commissions. For example, it may often now be the case that an estate (or trust) should not defer payment of such expenses to the final year. (Deferral of payment to the final year allows the beneficiaries to take advantage of any unused deductions on termination.) Excess deductions which pass out to beneficiaries upon the termination of an estate or trust will be subject to the 2% floor on the beneficiaries' respective returns. The fiduciary should try to ascertain if a beneficiary's other miscellaneous itemized deductions are likely to exceed the 2% floor. If the answer is yes, excess deductions on termination may still be worthwhile to a beneficiary. Ascertaining each beneficiary's expected deductions is difficult, and fiduciaries may wish to assume that for each beneficiary a 2% of adjusted gross income reduction will apply to excess deductions on termination.

Example 4.

Assume simple trust T has in the year preceding termination the following income and expenses:

Dividend Income	$40,000
Taxable Interest	$50,000
Unpaid Fiduciary and Attorneys Fees (chargeable to principal)	$100,000

T expects to have taxable income of $30,000 in the year of termination. T's two income and residuary beneficiaries, each of whom is single, annually have adjusted gross incomes of $80,000 and each has itemized deductions (none of which are miscellaneous itemized deductions, *see* § 67(b)) in excess of $5,000.

Scenario 1: Assume T pays $10,000 of the unpaid fiduciary and attorneys fees in the year preceding termination:

Dividends and Interest	$90,000
Expenses (charged to corpus)	(10,000)
DNI	$80,000

Result: $40,000 of income is carried out to each beneficiary to be taxed at a 28% rate (and there will be an additional 5% tax on this amount to the beneficiary until the 15% bracket and personal exemptions are phased out). In the year of termination, there will be an extra $60,000 of deductions ($30,000 of income earned by T, offset by the remaining expenses of $90,000) which will pass out to beneficiaries ($30,000 to each beneficiary). Each beneficiary will be able to use that amount of the deduction in excess of $1,600, the beneficiary's 2% floor. Thus, $3,200 in deductions will be wasted, or, in actual dollar terms, $896 in potential savings.

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Beneficiaries' Tax—Scenario 1

Year Preceding Termination

Income carryout of $80,000

Additional Tax, at 28% rate, of $22,400 (exclusive of additional burden imposed by 5% phase-out tax)

Year of Termination

The savings by distribution of $60,000 in deductions: $60,000 in deductions, minus the 2% floor, will offset $56,800 of adjusted gross income. The $56,800, without regard to its phase-out effect, would have resulted in tax of $15,904.

Net Tax Burden ($22,400 minus $15,904)	$6,496

Scenario 2: If $90,000 of the expenses were paid in the year prior to termination, this would have reduced DNI to zero and the beneficiaries would not have been taxable on the $40,000 distributed to each of them in that year:

Beneficiaries' Tax—Scenario 2

Year Preceding Termination

No additional tax (DNI has been reduced to zero by payment of fiduciary and attorneys fees).

Year of Termination

Tax burden by distribution of $20,000 in taxable income ($30,000 in trust income minus $10,000 in unused deductions), without regard to phase-out tax	$5,600

Conclusion:

In Scenario 1, the tax burden is $6,496. In Scenario 2, the tax burden is $5,600, resulting in a tax savings of $896. $896 in tax savings is hardly enough to justify substantial planning. Further, this tax savings is deceptive. If T does not make the additional $80,000 payment in the year prior to termination, the after-tax interest on this amount should exceed the $896 in tax savings achieved by early payment. Consider whether T should pay expenses as they accrued and not be concerned with a tax motivated course of action.

V. Timing of Distributions

Despite the reduction of tax rates to in effect two brackets (not considering the alternative minimum tax or phase-out brackets), fiduciaries must still consider the marginal tax brackets of the trust (or estate) and the beneficiaries in determining when to make discretionary, permissible distributions. For example, it may be useful (provided that state law requirements are followed) to distribute income during the course of estate administration in order to allow income to be taxed to the beneficiaries at a lower rate than if the income were retained by the estate and taxed to the estate.

Example 5.

The income items during year one of an estate are as follows:

Dividends from domestic corporations	$30,000
Taxable interest	10,000
Long-term capital gain	10,000

Taxable income of the estate ($50,000 minus the $600 exemption)	$49,400

If the estate has three beneficiaries, all of whom are minors 14 years or older and who otherwise have adjusted gross incomes each of less than $7,000, the distribution of $10,000 of estate income to each of these beneficiaries would result in the following tax savings:

Scenario 1—The estate makes no distribution: The tax for the estate is $13,832 ($49,400 times 28%, since the 15% lower bracket rate is completely phased out once adjusted gross income equals or exceeds $26,000).

Scenario 2—The estate distributes $10,000 to each beneficiary:

Distributable net income would be $40,000 (adjusted gross income minus $10,000 capital gain plus the exemption amount). Because the planned $30,000 distribution is less than distributable net income, a distribution deduction will be allowed for $30,000.

Tax on Estate Income:	
Total Income	$50,000
Distribution Deduction	(30,000)
Personal Exemption	(600)
Taxable Income	19,400
Tax	5,102
Amount of additional tax to Beneficiaries (at 15% rate since taxable income will be less than $17,850)	4,500
Total tax burden	$9,602

Conclusion

Total dollar savings by making distributions ($13,832 minus $9,602)	$4,230

As the beneficiaries' marginal tax brackets increase, the tax savings will decrease. Further, there is always the administrative inconvenience of determining the beneficiaries' tax situation, making the distribution, and completing the beneficiaries' tax returns.

One might inadvertently conclude that at a minimum it will always be possible to save at least $650 in taxes if the estate, prior to the income distribution deduction, has taxable income of $26,000 or more and distributes enough income to reduce its taxable income to $13,000. One might reason that by reducing its taxable income from $26,000 to $13,000, the estate will again be entitled to the 15% bracket for its first $5,000 of income (the difference between $5,000 taxed at the 28% rate and $5,000 taxed at the 15% rate is $650). But the above conclusion does not take into account that the distribution to a beneficiary may push the beneficiary into the 33% phase-out bracket and will increase the beneficiary's adjusted gross income, thereby decreasing the benefit of the beneficiary's miscellaneous itemized deductions. Also, a distribution to a high income beneficiary may cause the phase-out of certain tax deductions used by the beneficiary, such as the $25,000 offset for certain rental real estate activities. *See* § 469(i). In fact, a poorly planned estate distribution may increase the overall tax burden. In this regard, the fiduciary of a moderate size estate must carefully consider the effect of

a distribution on the surviving spouse's income relative to any social security the surviving spouse may be receiving. A distribution of income may increase the spouse's "combined income" (modified gross income plus one-half of the received social security benefits), thereby causing previously non-taxable social security benefits to become taxable. *See* § 86.

VI. Choice of the Initial Tax Year

The personal representative of an estate may adopt any taxable year provided that the year does not end more than twelve months after the decedent's death. The ability of a fiduciary to minimize taxes by utilizing different marginal rates has, as discussed above, been limited by the compression of tax rates. Yet, even with the current two-tier tax system, objectives in selecting a taxable year will still include deferral (and now, perhaps, acceleration) of tax, matching of income and deductions, and avoiding the bunching of income.

Example 6—Deferral.

D dies February 2, 1990. The representatives of D's estate selects a fiscal year ending January 31st. If distributions are made to a calendar year beneficiary on March 2, 1990, the beneficiary does not have to report any income carried out by this distribution until his or her 1991 return due April 15, 1992. But beware, if tax rates are higher in 1991 than 1990, the benefits from this deferral may be lost; worse, the deferral may turn out to be detrimental.

VII. Income and Deductions in Respect of a Decedent

Income in respect of a decedent ("IRD") consists of income which a decedent was entitled to during his or her lifetime, but which was not reported by the decedent as income at the time of his or her death. Common examples of IRD include accrued income for services rendered prior to death, post-death bonuses, deferred compensation payments, income from the exercise of a stock option, dividends declared and payable to a shareholder of record prior to death, and accrued but unpaid interest. *See, e.g.,* Treas. Reg. § 1.691(a)-2(b) (Examples (1)—(5)).

IRD is reported at the time of its receipt and is taxable to its recipient. Under section 691(c) of the Code, there is an income tax deduction for the incremental increase in the estate tax that is attributable to IRD. The deduction may be claimed only as an itemized deduction and not as a deduction from gross income in calculating adjusted gross income. But the two-percent floor imposed by section 67 on miscellaneous itemized deductions does not apply to the section 691(c) deduction.

Expenses relating to activities of a decedent prior to death which the decedent could have deducted if paid or accrued prior to death may constitute deductions in respect of decedent ("DRD"). Examples of DRD include unpaid business expenses, interest expenses, deductible taxes, depletion, and the credit for foreign taxes. *See* § 691(b).

In planning for IRD, the current two-tier tax system substantially reduces the potential benefits of the income tax deduction provided by Code section 691(c) (the amount of the federal estate tax attributable to the net value of the IRD). For example, if the decedent and the beneficiaries will be in the same income tax bracket, deferring the realization of IRD in order to obtain the section 691(c) deduction would result in no benefit. In a taxable estate, deferral could result in a detriment because of the credit for state death taxes.

Example 7.

Assume a decedent dies without a surviving spouse, having one beneficiary, B, and with a taxable estate of $4,000,000, which includes $400,000 of IRD. Prior to his death, the decedent could have chosen to realize the $400,000 of IRD. B is an itemizer, and his current itemized deductions exceed the standard deduction.

Had the decedent realized the $400,000 of IRD prior to his death, the effect would have been as follows:

Receipt of IRD property	$400,000
Income tax on $400,000 (at 28% rate)	(112,000)
Net amount, after payment of income tax, received by estate	$288,000
Estate tax on $288,000 (at 55% rate)	(158,400)
Net amount of IRD property passing to B	$129,600

The effect of the decedent not realizing the $400,000 of IRD prior to his death is as follows:

Estate tax attributable to IRD not yet received (at 55% rate)	($220,000)
Receipt by B of IRD property	400,000
Income tax to B on the $400,000 IRD property received after estate property has been distributed to B: Assume B is single and has other income of $100,480 which has already caused phase-out of 15% bracket and exemption. The increase in estate tax attributable to IRD property, after use of state death credit (10.4%), is $178,400. The income tax deduction allowed B for estate tax paid attributable to IRD, $178,400, offsets $400,000 of adjusted gross income. $221,600 taxed at 28% rate	(62,048)
Net amount passing to B ($400,000 IRD minus $220,000 estate tax payable which decreases B share of the total property received from the estate, minus $62,048 in income tax)	$117,952

Although it is not practical to time the realization of IRD to occur immediately prior to death, the executor can still take action with regard to certain IRD. For example, the executor should consider making the election to include all accrued interest on Series E Savings Bonds on the decedent's final income tax return (provided the decedent has not already elected to accrue interest annually on these Bonds). § 454(a). In a taxable estate situation, this election will mitigate the adverse consequences discussed in Example 7.

IRD planning must also be taken into account in structuring a Will for an individual who wishes to make charitable bequests and whose estate is likely to include IRD. Consider bequests of IRD to charity. A specific bequest of IRD to a qualified charity enables the estate to claim a

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charitable deduction and allows the noncharitable beneficiaries to avoid income tax thereon. The use of such a bequest should be considered where the estate will not be subject to estate tax by reason of the unlimited marital deduction or unified credit: in that event, noncharitable beneficiaries would be fully taxable on the IRD without benefit (or need) of the Code section 691(c) deduction.

Post-mortem planning for the distribution of IRD must also be carefully studied. One consideration in post-mortem IRD planning is selection of the estate's fiscal year. *See infra* p. 24,124. For example, if substantial amounts of IRD are anticipated on two or more dates close to the decedent's date of death, a fiscal year ending between these dates would permit the IRD to be split between two taxable years and, potentially, be subject to lower aggregate taxes than if the income were received within a single taxable year.

Another goal of post-mortem IRD planning is to avoid the recognition of income prior to actual receipt of the IRD. This could occur, for example, if the right to receive future IRD is transferred (prior to its actual receipt) to fund a pecuniary marital bequest. As a result of section 691(a)(2) of the Code, when the right to receive future IRD is transferred to fund a pecuniary marital deduction bequest, the estate will realize income before actually receiving the IRD. It would therefore be preferable to specifically designate the beneficiary who is to receive the IRD (the spouse, for example), or to pass the IRD to a specific legatee or to the marital share under a fractional share formula. If no estate tax is owed because of the use of the unlimited marital deduction, the IRD should be used to fund the marital deduction share under a fractional share formula. The marital share would eventually be reduced by the amount of the income tax resulting from the IRD, but this should not reduce or otherwise disqualify the marital deduction. Further, the IRD is not likely to appreciate and this will further benefit the marital share and the general estate planning strategy to keep the marital share as low as possible.

VIII. Accumulation Distributions

Because of the compressed tax brackets, there is less of a tax reason for creating accumulation trusts. The amount of taxable income which a trust can accumulate ($5,000) before being taxed at the top individual rate is not significant. *See infra.*

If a trust currently in existence has undistributed net income, then the trustee should consider distributing in 1990 or 1991 the income already accumulated. Under the throwback rules, if there is undistributed net income* in a trust, the distribution of accumulated income** is taxed at the beneficiary's modified, average tax rate over a certain period of time immediately preceding the distribution. The beneficiary will use the five taxable years immediately preceding the taxable year of the distribution and will eliminate the one such year in which taxable income was the highest and one such year in which taxable income was the lowest. If the trustee waits until 1991 before making an accumulation distribution, the beneficiary may benefit from the lower tax rates in effect in at least two of the years, 1987 through 1990 (even though the three years chosen are selected by reference to taxable income and not incremental tax rates). Fiduciaries should make calculations of the estimated tax that will be paid by the beneficiaries in order to determine in which year, from a tax perspective, to make an accumulation distribution.

IX. Multiple Trusts

Because of the compression of the rate schedule by the Tax Reform Act of 1986, the benefit of spreading income over a number of taxable entities through the use of multiple trusts is substantially decreased. Except in unusual circumstances (*see* Example 10, *infra*), the maximum tax benefit for each multiple trust will generally be only $650 annually (28% minus 15% × $5,000) and this benefit will be completely eliminated when taxable income of the trust is equal to or greater than $26,000 due to the phase-out of the 15% rate. To the extent a settlor's taxable income is subject to the 33% phase-out rate, the tax savings attributable to use of a trust will increase. Because of this rate compression, trustees may wish to terminate multiple trusts to avoid costs of administration. Termination may also be desirable to eliminate the possibility of a penalty tax imposed on a beneficiary who will be deemed to have received accumulation distributions from three or more trusts.

X. Trapping Distributions

A trapping distribution is a distribution of principal from an estate to a testamentary trust which carries out DNI to the trust but not to the trust beneficiaries. The purpose is to split income among a greater number of taxpayers and tax rates. Under the previous multitier tax system, the benefits of trapping distributions were clear. One must consider whether the use of trapping distributions can still be justified based on the limited potential tax savings. The answer may be that trapping distributions to a simple trust are justified, but not trapping distributions to a complex trust (other than one with a minor as the beneficiary) in which the objective of the trap is deferral.

Distributions from a probate estate to a simple trust will result in permanent tax savings as long as the estate does not distribute DNI composed of "outside income." Outside income consists of amounts included in DNI but not in the trust's accounting income, such as IRD. Treas. Reg. § 1.665(e)-1A(b). Since the distribution from the estate to the trust is classified as principal for trust accounting purposes, the trust has no net accounting income required to be distributed to the beneficiaries. There is no undistributed net income. The estate distribution is trapped and taxed at the trust level. The principal

* Undistributed net income will exist if in any year the DNI exceeds the amount of income required to be distributed currently plus any other amounts properly paid or credited. *See, e.g.,* § 665(a)(1).

** That is, the amount by which amounts distributed (other than income required to be distributed currently) exceed DNI reduced by income required to be distributed currently. § 665(b). *But see* Treas. Reg. § 1.665(e)-1A(b) for a discussion of the throwback rule and simple trusts.

distribution can be distributed in a later taxable year without being subject to the throwback rules.

Distributions to complex trusts from an estate may serve to defer income tax rather than result in permanent tax savings. Income trapped in a complex trust will eventually be subject to the throwback rules. An exception to the general rule that complex trusts are subject to the throwback rules is provided for trusts which are created for the benefit of an unborn beneficiary or for the benefit of a beneficiary who has not reached the age of 21. Therefore, a trapping distribution in such cases could result in permanent tax savings.

Example 8.

If an estate has $26,000 in taxable income and distributes $13,000 in principal to a simple trust, the estate will be entitled to a distribution deduction of $13,000 from total income. The trust will have taxable income of $13,000. The tax on the trust and the estate, ignoring the exemptions, is $2,990 each. Tax to the estate on $26,000 of income would have been $7,280. Therefore, tax savings of $1,300 result because half of the income is trapped.

Example 9.

A decedent dies in 1989 survived by a spouse and one child, age 21. The decedent's will creates a marital deduction trust A and a family trust B. Under the terms of trust A, all of the net income of the trust is paid annually to the surviving spouse, and the trustee may make discretionary distributions of principal. Trust B provides for mandatory payments of net income to the spouse and discretionary payments to the surviving spouse or child.

Assume the decedent's estate had total income in the first taxable year as follows: $20,600 of dividends, $30,000 of taxable interest, and $3,000 of administration expenses (allocable to corpus) paid "in connection with the administration of the estate ... and which would not have been incurred if the property were not held in such ... estate." § 67(e). If the estate makes no distribution in year one to fund the trusts, the estate would owe tax of $13,160.

Assume the executor funded trusts A and B with $13,000 by distributing principal in this amount to each trust. The estate receives a distribution deduction of the lesser of the amount distributed ($26,000) or DNI ($47,600). The tax to the estate is $5,630 ($47,600 minus $26,000 minus $600 times tax rate). Assuming no income was earned by the $13,000 distributions during A's and B's first taxable years, and that no distributions of principal were made by the trusts during that year, trusts A and B would pay tax on this amount, after deducting their personal exemptions, of $2,906 each. The income tax savings to the estate by making the distributions is $1,718 ($13,160 tax to estate if no distributions minus taxes of $5,630, $2,906 and $2,906 to estate and trusts if there were distributions). Under the current tax structure, assuming two simple trusts as potential recipients, a trapping distribution has a maximum potential tax savings of $2,118.[***] Is it worth the trouble?

XI. Joint Return for a Surviving Spouse

Because the tax year for a surviving spouse will continue after the close of the decedent's tax year, the filing of a joint return provides an opportunity for post-mortem tax planning. For example, the surviving spouse may offset capital gains incurred by the decedent before the decedent's death, or may make use of capital losses incurred by the decedent.

If the decedent has very large medical bills in the final year resulting in large income tax deductions possibilities, should these be utilized as income tax deductions to offset the surviving spouse's income? The executor may select to deduct medical expenses paid by the estate as a deduction on the decedent's final income tax return, Treas. Reg. § 1.213-1(d), or as a debt of the decedent on the estate tax return. Treas. Reg. § 20.2053-4. Medical expenses include those paid by the decedent's estate during the one-year period following decedent's date of death. Medical expenses deducted on the final income tax return are subject to the percentage limitations which ordinarily apply to income tax medical deductions. *See* § 213. The 7.5% of adjusted gross income limitation reduces the benefits of using these expenses as an income tax deduction (note that the nondeductible amount may not be claimed on the estate tax return as a debt of the decedent).

In an estate tax situation, medical expenses will be more useful as a deduction on the estate tax return because the minimum marginal estate tax bracket, after use of the unified credit amount, is 37%, as compared with the 33% maximum income (phase-out) tax rate. Further, as a debt of the estate, medical expenses are not reduced by the 7.5% adjustment out of gross income. Moreover, any income tax due on the decedent's final income tax return is a debt that may be claimed as an estate tax deduction. To the extent that income taxes are not reduced by use of the medical expenses on the income tax return, this deduction is not reduced.

XII. Clifford Trusts and Spousal Remainder Trusts

Under the rules in effect before the Tax Reform Act of 1986, trusts could be used for the reallocation of income, even though the principal would return to the grantor after the first to occur of ten years or the death of the beneficiary. These were known as "Clifford trusts." *See, e.g.,* Treas. Reg. § 1.673(a)-1(b). If the principal were to return to the grantor's spouse, rather than to the grantor, arguably no minimum ten-year term was required. This was known as a "spousal remainder trust." Short-term trusts as income shifting devices allowed a grantor to retain wealth while relieving the grantor, for a period of time, of the taxes incurred on the income the trust produced. An aggressive use of a spousal remainder trust

[***] For example, if without the trap, an estate has taxable income in excess of $26,000, then the distributions would allow the estate to subject the first $5,000 of its taxable income to the 15% pre-phaseout rate, thereby saving taxes of $650 (28% minus 15% times $5,000). Each trust can use its 15% bracket, again saving $650 each ($1,300 total). Each trust will also use its $300 exemption, thereby eliminating an additional $168 in tax.

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would allow husband and wife to provide for their children's college expenses out of income, taxed at their children's presumably lower rates, without being required to give up the right to the principal for more than the college term.

The Tax Reform Act of 1986 now taxes trust grantors on the income of any portion of a trust if the grantor or his spouse has a reversionary interest worth more than 5% of the value of that portion (except for certain reversionary interests which take effect on the death of a beneficiary who is a minor descendant of the grantor). This change effectively eliminates use of the Clifford and spousal remainder trusts as income shifting devices. In order for the grantor not to be treated as a grantor for income tax purposes of a short-term trust (that is, for the grantor's interest to be below the 5 percent threshold), under pre-TAMRA interest and mortality tables, the trust would have to provide for payments of income to a beneficiary for at least thirty-two years, or for the life of a beneficiary who is not more than thirty-one years old at the time the trust is created.

Even assuming that the grantor trust rules are avoided so that accumulated trust income is taxed at the trust rates, the tax savings under the current, reduced marginal rates are not excessive. In advising a client as to the efficacy and propriety of establishing a trust which will accumulate income for a minor child, the advisor must weigh the administrative inconvenience of establishing a trust and completing annual returns with the tax benefits that could result from the trust. The advisor should also consider that the trust would provide a means in which to invest in high growth, low-yield assets which can be distributed from the trust to a child when the child attains the age of 14 without concern for the so-called "kiddie tax." When the child sells the appreciated assets, the gain will be taxed at the child's presumably lower rates.

Example 10.

If a taxpayer is married, filing a joint return, has two personal exemptions available, and has exactly $71,900 of taxable income (i.e., any dollar in excess of that amount will be subject to the 5% phase-out rate), the potential maximum current saving by having income accumulated in a trust will be $4,960. This would require $99,190 of income to be accumulated in trust, which would then be taxed at a 28% rate rather than the 33% phase-out rate ($99,190 times 5% equals $4,959.50). Permutations to the above analysis are possible. Consider, for example, the tax savings that could occur from the non-phaseout of the $25,000 loss deduction available for rental real estate activities. *See* § 469(i).

It is more likely that, ignoring the marginal benefit from the exemption amount, a savings of $650 will occur each year (that is, the difference between the 28% rate and the 15% rate that applies to the trust for the first $5,000).

XIII. Section 643(e) Election: Treatment of Property Distributed In Kind

When an estate or trust distributes property in kind, no gain or loss is realized by the trust or estate unless the distribution is made in satisfaction of the beneficiary's right to receive a distribution of a specific dollar amount or specific property other than that distributed. *See, e.g.,* § § 643(e)(4) and 663(a)(1). The amount of the distribution for purposes of calculating the income distribution deduction (that is, the amount deemed paid to a beneficiary pursuant to section 661(a)(2)) is the lesser of (1) the property's basis in the hands of the beneficiary or (2) the fair market value of the property. The property's basis in the hands of the beneficiary will be either (1) the adjusted basis of the property in the hands of the estate or trust immediately before distribution or (2) if an election is made pursuant to 643(e)(3) to treat the property as having been sold by the estate or trust to the beneficiary, such adjusted basis modified by any gain or loss to the estate or trust on the distribution.

The 643(e)(3) election grants to the fiduciary the option of recognizing gain or loss on property distributions and choosing whether the trust (or estate) or the beneficiary will report such gains or losses. The section 643(e)(3) election remains a valuable fiduciary tax planning device, despite the Tax Reform Act of 1986. Making the 643(e)(3) election may or may not be favorable, depending on a number of factors. No generalizations are possible and this fact, by itself, illustrates the importance of proper fiduciary counseling. Consideration should be given to at least the following areas:

(a) Who between the estate (or trust) and the beneficiary may better be able to incur unrealized appreciation or deduct unrealized loss. If the beneficiary is and will continue to be in a lower tax bracket, then distribution of unrealized appreciation may be preferable (for example, to a minor who will not sell the appreciated property until the minor is free of the so-called kiddie-tax).

(b) If the fiduciary has capital losses, the fiduciary may want to make an election to recognize gain to offset such losses.

(c) What is the effect of the election on the estate's (or trust's) and beneficiary's alternative minimum tax situation?

(d) If appreciated property is transferred as part of a trapping distribution, *see infra*, the executor may have to make the election to ensure that the maximum amount of DNI is carried out. Also, an election, by increasing the amount of DNI that can be carried out to the beneficiaries, can reduce any undistributed net income.

(e) If unrealized capital loss property is transferred and the trust makes the 643(e)(3) election, any loss would be disallowed under section 267(b)(6) (the "related party" doctrine). Although the distributee could use the previously disallowed loss to offset gain on a subsequent sale, § 267(d), this allowance is beneficial only if the asset is sold at a gain. Thus, prior to transferring capital loss property, the trustee should determine who should take advantage of the loss. If the trust can make the best use of the loss, the trustee should sell the asset and incur the loss for the benefit of the trust. If, however, the distributee can make best use of the loss, it is possible to preserve the loss for use by

the distributee by simply distributing the asset in kind and not making the section 643(e) election.

(f) The appreciated assets could be distributed from a trust or estate to a dying beneficiary in order to generate a section 1014 tax-free step up in basis.

(g) The section 643(e)(3) election applies to all distributions in a taxable year. § 643(e)(3)(b). However, the executor or trustee could sell certain property to effect gains or losses and, in addition, make property distributions without making the section 643(e)(3) election when the fiduciary wants the beneficiary to be able to recognize gain or loss on select assets.

(h) Recognition by the estate or trust of the gain on distributions of passive assets would permit an offset for suspended losses. What loss will be recognized by the disposition of the entire interest in a passive activity by an estate or by a trust (consider section 267(b))?

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