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Dying with the "Living" (or "Revocable") Trust: Federal Tax Consequences of Testamentary Dispositions Compared

C. Douglas Miller and R. Alan Rainey***

I. Introduction

Technically, a "living" trust is any trust created during the lifetime of the person, known as the "grantor," who creates it. Similarly, a "revocable" trust is any trust over which someone has direct or indirect power to revoke the declaration of or transfer in trust. In this Article, however, the term "living" or "revocable" trust refers to its popular meaning[1] as a trust that the sole grantor funds[2] with his separate property[3] and that is expressly amendable and revocable by that grantor acting alone. Furthermore, the trust assets are payable to the grantor upon revocation, the trust income is payable to the grantor for life, and the trust becomes irrevocable

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1. "The 'living trust' in the literature of estate planning usually refers to a trust which is revocable by the settlor, acting alone." D. Westfall, Estate Planning Problems 42 (2d ed. 1982).

2. Frequently revocable trusts remain essentially unfunded until the death of the grantor, at which time the trustee receives life insurance proceeds or other death benefits, such as those payable under employee benefit plans.

3. This Article does not discuss the important tax considerations raised when the grantor transfers community property to a revocable trust. Such a transfer raises a number of legal issues. For example, has a conversion of the community property into the separate property of the grantor spouse occurred? Does the death of the first spouse affect the basis in the property? To what extent is the trust revocable by the surviving spouse? If irrevocable, has the surviving spouse made a gift for gift tax purposes? If revocable, is all of the property included in the spouse's gross estate for estate tax purposes? For discussion of these issues, see generally Johanson, *Revocable Trusts and Community Property: The Substantive Problems*, 47 Tex. L. Rev. 537 (1969); Johanson, *Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems*, 47 Tex. L. Rev. 1247 (1969).

upon the grantor's death, at which time its provisions for the eventual distribution of trust property to designated beneficiaries become effective.

The revocable trust has become an important estate planning device, and one that practitioners increasingly regard as a viable alternative to the will as the principal dispositive instrument in the estate plan.[4] Indeed, practitioners perceive the revocable trust as an alternative that has significant lifetime[5] and postdeath advantages.[6] The perceived advantages of the revocable trust, coupled with the further perception that its use has no important federal tax consequences when compared to the alternative of a testamentary disposition,[7] contribute to its popularity and frequency of use.

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4. Courts have considered challenges to the validity of the revocable trust as a testamentary disposition in cases in which the grantor failed to comply with the governing statute of wills. These challenges have been unsuccessful when a formal trust instrument existed and created interests in persons other than the grantor, such as the ultimate or remainder beneficiary. *E.g.*, National Shawmut Bank v. Joy, 315 Mass. 457, 53 N.E.2d 113 (1944). *See generally* RESTATEMENT (SECOND) OF TRUSTS § 57 (1959). Even when a formal trust instrument exists, ordinarily a will—sometimes referred to as a "backup" and more commonly referred to as a "pour-over" will—also exists to dispose of property or claims not subject to the trust at the grantor's death. The will typically provides for a gift of the residuary estate to the trustee of the revocable trust. The widespread adoption of the UNIFORM TESTAMENTARY ADDITIONS TO TRUST ACT, 8 U.L.A. 125 (1983) (included in the Uniform Probate Code as § 2-511), furthered the use of pour-over wills. Previously they were valid in some jurisdictions under the doctrines of incorporation by reference, *see, e.g.*, Second Bank-Stato St. Trust Co. v. Pinion, 341 Mass. 366, 170 N.E.2d 350 (1960), and independent legal significance. *See, e.g.*, Old Colony Trust Co. v. Cleveland, 291 Mass. 380, 196 N.E. 920 (1935).

5. The principal lifetime advantages of a revocable trust are: (1) provision for experienced or professional management of property when the grantor is not also the sole trustee; (2) avoidance of gnardianship or conservatorship proceedings in the event of the grantor's subsequent physical or mental disability or diminisbed capacity; and (3) choice of that jurisdiction's laws under which to administer and interpret the trust.

6. The principal postdeath advantage of a revocable trust is avoidance of probato administration of trust assets. Such avoidance may: (1) eliminate delays in distribution of property to heirs; (2) reduce or eliminate costs associated with probate administration; (3) assure a degree of privacy by avoiding proceedings of public record; (4) avoid burdensome and expensive state probate procedure requirements, including continuing supervision of testamentary trusts; (5) provide a nonprobate receptacle for items payable by reason of the grantor's death, such as life insurance and other death benefits, and thus perhaps avoid state death taxation or creditor access to such funds; and (6) eliminate or reduce claims of a surviving spouse or of crediters generally.

For a discussion of these "advantages," including whether they indeed are advantages, see, for example, Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108 (1960); Moore, *The Advantages of Probate*, INST. ON EST. PLAN. ¶ 400 (1976).

7. Creation of a living revocable trust is an estate planning technique taken in general for other than tax reasons. The action has almost no immediate tax consequences, and is generally neutral as to taxes for the long run. The income is taxed to the donor during his lifetime, inasmuch as he has the power to revoke. Nor are any assets trans-

The purpose of this Article is to examine the federal tax consequences of the revocable trust to the grantor and to his estate. Principally due to the grantor's power to revoke the trust and revest the trust assets in himself the federal tax consequences to the grantor are in effect, if not in cause, insignificant. The perception that *creation* of a revocable trust has no federal tax consequences, therefore, is at least to that extent essentially correct, and the discussion herein is merely a summary review of the tax consequences to the grantor upon the trust's creation and during its administration. Perhaps surprisingly, however, the federal tax consequences to the estate can be significant, and the perception is to that extent incorrect. These latter consequences occur with respect to both estate and income taxes, but primarily with respect to income tax. In sum, whether the decedent implements his controlling dispository directions through a will operating upon the probate estate or through a revocable trust operating upon its corpus will have significant federal tax consequences.[8]

II. Federal Tax Consequences upon Creation and During the Lifetime of the Grantor

The possibility exists for federal tax consequences to arise upon the transfer of property to a revocable trust—depending for example, on whether the grantor has made a transfer of property by gift—and during the lifetime administration of the revocable trust—depending, for example, on to whom items of trust income, deduction, and credit are attributable in computing taxable income.[9] This section of the Article discusses these and other related

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> ferred to the trust removed from the donor's gross estate for federal estate tax purposes. The power to revoke and also the retained life estate require this result. Finally, there has been no taxable gift, again because of the retained power of revocation, there having been no termination of the donor's dominion and control. While on the donor's death the trust can serve as the vehicle for division into marital and residue trusts, minimizing estate taxes on the estate of the surviving spouse, such a function could be accomplished as well by a testamentary trust, and is not distinctive to the revocable living trust.

Report, *The Revocable Living Trust as an Estate Planning Tool,* 7 Real Prop., Prob. & Tr. J. 223 (1972).

8. The general topic has been the subject of prior editorial scrutiny. For the most notable efforts, see Covey, *The Advantages and Disadvantages of the Revocable Trust in Estate Planning,* 26 Inst. on Fed. Tax'n 1379 (1968); Desmond, *Revocable Trust After Death of Grantor,* 116 Trs. & Ests. 218 (1977); Fleming, *Taxation of Income of Grantor Trusts After Death of Grantor and Before Implementation of Successor Trusts or Shares,* 63 Ill. B.J. 78 (1974); Ufford, *Income Taxation of the Funded Revocable Trust After the Death of the Grantor,* 30 Tax Law. 37 (1976). *See also* Moore, *supra* note 6.

9. The proper tax treatment of the cost associated with the creation and lifetime ad-

issues in the context of classification of tax. The discussion for now covers only the gift and income tax effects since they are the only federal taxes potentially imposed during the lifetime of the grantor.[10]

A. *Federal Gift Tax*

The transfer of property by the grantor to the revocable trust upon or subsequent to its creation has no gift tax consequence. This result is due to the grantor's retention of the power of revocation; the legal rationale is that any "gift" to the ultimate or remainder beneficiaries remains "incomplete."[11] The Treasury Regulations[12] long and properly have provided that a gift is complete only as to any interest in property that the donor has "so parted with dominion and control as to leave in him no power to revest the beneficial title to the property in himself."[13] This administrative interpretation of the gift tax statute is entirely consistent with an early expression of the same view by the United States Supreme Court in *Burnet v. Guggenheim*,[14] in which the Court, in construing the gift tax statute, stated that "[t]he statute is not aimed at every transfer of the legal title without consideration . . . [such as] would be [true] if the trustees were to hold for the use of the grantor."[15]

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ministration of the revocable trust has federal tax consequences that may represent one difference in the immediate tax consequences of planning for the disposition of property through the revocable trust vehicle rather than by will. The cost of preparing a will is a personal expense, the deductibility of which is proscribed by I.R.C. § 262. *See* Estate of Pennell, 4 B.T.A. 1039 (1926). The cost of establishing a revocable trust, on the other hand, may be deductible under I.R.C. § 212(2) as expense paid or incurred "for the management, conservation or maintenance of property held for the production of income." *See* Sidney Merians, 60 T.C. 187 (1973) (concurring opinions of Scott, Fay, and Sterrett, JJ.); Nancy Reynolds Bagley, 8 T.C. 130 (1947). Of course, trustees' commissions during administration of the revocable trust are deductible under IRC § 212(2) except to the extent such fees are allocable to the production of, or to property held for the production of, income that is not includible in gross income. I.R.C. § 265 (1982); Treas. Reg. § 1.212-1(a)(2) (1960). In either situation, the portion of the cost allocable to tax advice may he deductible under IRC § 212(3) as expenses paid or incurred "in connection with the determination, collection or refund of any tax." *See* Sidney Merians, 60 T.C. 187 (1973).

10. The Excise Tax Reduction Act of 1965 § 401, 26 U.S.C. § 4041 (1982), repealed the federal documentary stamp tax imposed on transfers of corporate capital stock and certificates of indebtedness. Of course, the transfer of securities to a revocable trust may occasion state transfer taxes.

11. Treas. Reg. § 25.2511-2(b), (c), T.D. 7910, 1983-2 C.B.____

12. *Id.*

13. *Id.* § 25.2511-2(c); *see* Rev. Rul. 54-537, 1954-2 C.B. 316.

14. 288 U.S. 280 (1933).

15. *Id.* at 282.

If the grantor's power of revocation is released or otherwise terminates during his or her lifetime, then necessarily the gifts to the ultimate beneficiaries are complete.[16] Accordingly, a completed gift will occur at the time and to the extent that trust income or principal is actually paid to someone other than the grantor since the grantor will have relinquished or terminated his power to revoke over that income or principal.[17]

B. *Federal Income Tax*

With two potentially significant exceptions, which arise in the context of funding the revocable trust with certain stocks and stock options,[18] the transfer of property by the grantor to the revocable trust will have no income tax consequence to the grantor. This is due both to the grantor's power to revoke the trust and revest the trust assets in himself[19] and to the grantor's retention of trust income.[20] The transfer does not constitute a sale or other taxable disposition of property,[21] and trust income, including capital gains or other income allocable to the corpus, remains fully taxable to the grantor, regardless of whether the income is distributed to

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16. Estate of Sanford v. Commissioner, 308 U.S. 39, *reh'g denied*, 308 U.S. 637 (1939); Burnet v. Guggenheim, 288 U.S. 280 (1933).

17. *See* Treas. Reg. § 25.2511-2(f) (1958).

18. *See infra* text accompanying notes 24-29.

19. I.R.C. § 676 (1982); Treas. Reg. § 1.676(a)-1 (1960). I.R.C. § 676 treats the grantor as the owner of any portion of a trust in which the grantor, a nonadverse party, or both have the power to revest in the grantor title to such portion.

20. I.R.C. § 677 (1982); Treas. Reg. § 1.677(a)-1 (1960). I.R.C. § 677 treats the grantor as the owner of any portion of the trust whose income may be distributed, held, or accumulated for future distribution to the grantor or the grantor's spouse without the approval or consent of any adverse party.

21. The transfer is not a sale or other disposition of property because tbe grantor does not convert the property into cash or exchange it for other property differing materially either in kind or extent upon transfering the property to a revocable trust. Treas. Reg § 1.1001-1(a), (d), T.D. 7213, 1972-2 C.B. 482. Accordingly, it is not necessary to except statutorily such transfers from the general rule of income recognition, although tbe assumption underlying the statutory exceptions is applicable—the "new" property is substantially a continuation of the "old" investment unliquidated. *See* Treas. Reg. § 1.1002-1(c) (1960).

Consistent with this premise, the Internal Revenue Service (IRS) has ruled that if a trust that owns a residence is one under which the Code treats the grantor-occupant as the "owner" of the trust for income tax purposes, then the occupant is the taxpayer for purposes of I.R.C. § 1034. That Code section provides rules for the nonrecognition of gain in certain cases in which the taxpayer sells one residence and, within specified time limits, buys or builds and uses another as his principal residence. Rev. Rul. 66-159, 1966-1 C.B. 162. Similarly, the IRS also has ruled that the transfer of an installment obligation to a revocable trust is not a "disposition" resulting in gain or loss under I.R.C. § 453. Rev. Rul. 74-613, 1974-2 C.B. 153.

the grantor or other distributee or is accumulated by the trustee.[22] Paradoxically, the statutory scheme that taxes the grantor is less confusing than the procedure by which the Treasury implements that scheme.[23]

1. Section 1244 Stock

Internal Revenue Code (I.R.C.) section 1244 provides that, subject to certain conditions and limitations, losses to an individual on the sale or exchange of "Section 1244 stock" issued to such individual shall be treated as "ordinary" losses.[24] The statute provides that the term "individual" does not include a trust,[25] and the Treasury Regulations state that "[a] corporation, *trust*, or estate is not entitled to ordinary loss treatment under section 1244, regardless of how the stock was acquired."[26] Accordingly, the transfer of section 1244 stock to a revocable trust causes the stock to lose its section 1244 status, with the result that any loss subsequently realized is not deductible as an ordinary loss under that section.

2. Statutory Stock Option and Stock Purchase Plans

Statutory stock option and stock purchase plans[27] are compensatory devices that confer certain tax advantages upon employees

22. I.R.C. §§ 671-678 (1982).

23. Procedurally, the IRS requires the trustee of a revocable trust that state law recognizes as a trust to obtain an employer identification number no later than the granter's first taxable year in which the trust receives trust income. Rev. Rul. 63-178, 1963-2 C.B. 609; *see* Treas. Reg. § 301.6109-1, T.D. 7670, 1980-1 C.B. 159. Treas. Reg. § 1.6109-1, T.D. 7306, 1974-1 C.B. 335. The trustee should prepare and file a skeletal fiduciary income tax return (Form 1041), but he should not report items of income, deduction, and credit which, although attributable to any portion of the trust, are treated as owned by the grantor. Rather, he should list these items on a separate statement attached to the return. This separate statement should include both the employer identification number of the trust and the account number of the individual grantor. Rev Rul. 63-228, 1963-2 C.B. 229; *see* Treas. Reg. § 1.671-4, T.D. 7796, 1981-1982 C.B. 141.

With respect to revocable trusts created on or after January 1, 1981, if the grantor is also the sole trustee or a cotrustee and the Code treats all items of income, deduction, and credit as owned by him, the IRS will not require the granter-trustee either to obtain an employer identification number for the trust or to file a Form 1041; instead, the granter-trustee may include these items in his individual return, with proper notation as to nature and source. A procedure exists whereby trustees can make revocable trusts created before January 1, 1981, subject to these rules. *See* Treas. Reg. § 1.671-4 (1960); *id.* § 1.6012-3, T.D. 7838, 1982-2 C.B. 357; *id.* § 301.6109-1, T.D. 7670, 1980-1 C.B. 159.

24. I.R.C. § 1244 (1982); Treas. Reg. § 1.1244(a)-1 (1960).

25. I.R.C. § 1244(d)(4) (1982).

26. Treas. Reg. § 1.1244(a)-1(b) (1960) (emphasis added).

27. I.R.C. §§ 421-425 (1982). I.R.C. § 422 concerns qualified stock options; § 422A concerns incentive stock options; § 423 addresses employee stock purchase plans; and § 424

who acquire their employer's stock pursuant to such stock option or stock purchase plans. An employee who makes a disqualifying disposition by failing to meet any of the holding period requirements[28] loses these tax benefits. Since the Code defines the term "disposition" as including "a transfer of legal title,"[29] a transfer of such an option, or a transfer of stock acquired by the exercise of such an option or pursuant to such a plan, to a revocable trust during the applicable holding period will result in the elimination of the employee's tax benefits.

3. Other "Tax Sensitive" Assets

A grantor may transfer other "tax sensitive" assets to a revocable trust without income tax consequence. These tax sensitive assets include: Installment obligations;[30] noninterest bearing obligations issued at a discount, such as series "E" bonds, or "H" bonds acquired in a tax-free exchange;[31] the grantor's "principal residence";[32] and "small business corporation" (Subchapter S) stock.[33]

III. Federal Tax Consequences upon and After the Death of the Grantor

Different possibilities of tax consequence occur upon the death of the grantor of a revocable trust and during postdeath administration of the revocable trust and the grantor's probate estate. Legal issues that the death of the grantor raises include whether the grantor's gross estate includes the trust assets, and whether other estate tax consequences flow from the grantor's choice of dispositive instrument. Legal issues raised during postdeath administration concern whether the income tax consequences differ depending upon which entity—the estate or the trust—is involved in a particular transaction, and, if so, the significance of the differences. This Article again addresses these and other questions in the context of classification of tax.

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deals with restricted stock options.

28. I.R.C. §§ 422(a)(1), 423(a)(1), 424(a)(1) (1982).

29. I.R.C. § 425(c)(1) (1982); Treas. Reg. § 1.425-1(c) (1966).

30. *See supra* note 21.

31. I.R.C. §§ 454(a), 454(c), 1037 (1982); Rev. Rul. 58-2, 1958-1 C.B. 236; IRS Letter Ruling 7729003.

32. *See supra* note 21.

33. I.R.C. § 1361(c)(2)(A)(i) (1982). *See infra* notes 105-06 and accompanying text.

A. Estate Tax

The value of property held in a revocable trust is includible in the grantor's gross estate for estate tax purposes. This result is due to the grantor's retained right to the income from the trust property,[34] the grantor's right to designate the beneficiaries of the trust property and income by amending the trust,[35] and the grantor's power to amend or revoke the trust.[36] The trust property will be included in the grantor's gross estate at its fair market value at the date of the grantor's death[37] unless the trustee elects alternate[38] or qualified use[39] valuation.[40] Thus, at first blush, the choice of a revocable trust instead of a will as the principal dispositive instrument in the grantor's estate plan appears inconsequential for estate tax purposes. Upon closer examination, however, the possibility of some adverse tax consequence is apparent.[41]

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34. I.R.C. § 2036(a)(1) (1982); Treas. Reg. § 20.2036-1(a)(i), T.D. 6501, 1960-2 C.B. 271.

35. I.R.C. § 2036(a)(2); Treas. Reg. § 20.2036-1(a)(ii) (1982).

36. I.R.C. § 2038(a)(2) (1982); Treas. Reg. § 20.2038-1(a), T.D. 6600, 1962-1 C.B. 164.

37. I.R.C. § 2031(a) (1982).

38. *Id.* § 2032(a) (1982).

39. *Id.* § 2032A (1982).

40. For income tax purposes, the Code deems the trustee, or other person acquiring trust property, as acquiring the trust property from the decedent, and the basis will he the date-of-death fair market, alternate, or qualified use value. I.R.C. §§ 1014(a), 1014(b)(2), (3), (9) (1982). As a result, the "constructive" more-than-one-year holding period applies to sales or other dispositions within one year after the grantor's death. I.R.C. § 1223(11) (1982).

41. This Article generally ignores differences that typically are without tax consequence. For example, I.R.C. § 2053 authorizes a deduction from the value of the gross estate for funeral expenses, administration expenses, claims against the estate, and certain indebtedness. The 1939 Code limited the *total allowance* of such deductions to the value of property included in the gross estate and subject to claims under state law. I.R.C. § 812(b) (1939). To the extent that property in a revocable *inter vivos* trust was not subject to claims and comprised most or a significant part of the gross estate, the potential existed for the loss of these estate tax deductions. I.R.C. § 2053(c)(2) lifted that limitation to the extent that the executor paid such expenses before timely filing the estate tax return. I.R.C. § 2053(c)(2) (1982); Treas. Reg. § 20.2053-1(c), T.D. 6826, 1965-2 C.B. 367. Moreover, the 1939 Code did not allow the deduction of expenses incurred in *administering* property not subject to claims. I.R.C. § 812(b) (1939). I.R.C. § 2053(b) now allows the deduction of such expenses that the executor pays before the expiration of the I.R.C. § 6501 period of limitation for assessment. I.R.C. § 2053(b) (1982); Treas. Reg. § 20.2053-8(a)(1), (2) (1958). Administration expenses include executor's commissions, attorneys' fees, and other expenses. Treas. Reg. § 20.2053-3(b), (c), (d) (1954). Commissions and expenses of a trustee performing services normally performed by an executor are deductible expenses of administration, but subject to the foregoing limitation if the trustee performs the services with respect to property not subject to claims. Treas. Reg. §§ 20.2053-3(b)(3), -8(a)(1), -8(a)(2), -8(c) (1958).

1. Alternate Valuation

I.R.C. section 2032(a) permits an executor to elect to determine the value of a decedent's gross estate by valuing the property as of the date six months after death, except for property distributed, sold, exchanged, or otherwise disposed of within that six-month period, which is valued as of the date of distribution, sale, exchange, or disposition.[42] This advantageous method of valuation is potentially applicable to "all the property included in the gross estate"[43] and, therefore, to property held in a revocable trust. If, however, the revocable trust provides, as such trusts commonly do, for the division of trust property into separate trusts upon the death of the grantor, the division will constitute a "distribution" for purposes of I.R.C. section 2032(a)(1).[44] To the extent that the terms of the trust require the division into separate trusts upon the death of the grantor, the distribution will occur at the grantor's death, thus neutralizing the benefits of the alternate valuation method as to the property held in the revocable trust.[45]

2. Inclusion of Amounts Receivable by the Executor

Proceeds from those policies on the life of the decedent with respect to which the decedent did not possess any incidents of ownership are includible in his gross estate only to the extent "receivable by the executor."[46] Futhermore, the Code excludes up to $100,000 in value[47] of an annuity or other payment[48] from a qualified employee benefit plan (hereinafter "employee benefit annuity") from the gross estate to the extent that such value is attributable to employer contributions and is receivable "by any beneficiary (other than the executor)."[49] A similar rule applies to exclude up to $100,000 in value—when aggregated with the amounts excluded under the employee benefit annuity exclu-

42. I.R.C. § 2032(a)(1), (2) (1982).
43. I.R.C. § 2032(a) (1982).
44. Rev. Rul. 73-97, 1973-1 C.B. 404; *see* Treas. Reg. § 20.2032-1(c)(2), T.D. 7238, 1973-1 C.B. 544. See *infra* note 63 for other consequences of "distribution" status.
45. A provision in the trust instrument requiring a postponement of the division until a date six months after the grantor's death should solve this problem. Moreover, if the trust requires a division into "parts," as distinguished from "separate trusts," the IRS may not consider the division a distribution. *Compare* Rev. Rul. 57-495, 1957-2 C.B. 616, *with* Rev. Rul. 73-97, 1973-1 C.B. 404.
46. I.R.C. § 2042(1) (1982).
47. *Id.* § 2039(g) (1982).
48. *Id.* § 2039(f) (1982).
49. *Id.* § 2039(c) (1982).

sion—of an annuity under an individual retirement account, individual retirement annuity, or retirement bond (hereinafter "individual retirement account") receivable "by any beneficiary (other than the executor)."[50]

For purposes of determining inclusion in or exclusion from the gross estate of the value of these property interests, the Treasury Regulations provide that an item is deemed receivable by the executor if it is "received by or for the benefit of the estate."[51] The Treasury Regulations further provide that an item is receivable for the benefit of the estate, and thus by the executor, if payable to a beneficiary other than the executor but subject to a legal obligation "to pay taxes, debts, or other charges enforceable against the estate."[52]

A revocable trust commonly directs or otherwise legally obligates the trustee to pay taxes, debts, or other charges against the estate, and makes the insurance proceeds, employee benefit annuity, or individual retirement annuity payable to the trust. In such a situation, the amounts are deemed receivable by the executor and, therefore, included in the gross estate even though the ultimate beneficiary is an individual or trust named in the instrument.[53] On the other hand, if the revocable trust merely authorizes the trustee to pay taxes, debts, or other charges against the estate, and controlling state law does not impose that obligation on the trustee, then such amounts should not be deemed receivable by the executor, although this result is not entirely free from doubt.[54] If the revocable trust prohibits the trustee from using such amounts to pay taxes, debts, or other charges against the estate, then such amounts will not be deemed receivable by the executor,[55] even if the revocable trust authorizes the trustees to lend funds to and purchase property from the estate.[56]

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50. *Id.* § 2039(e) (West Supp. 1984).

51. Treas. Reg. § 20.2039-2(b)(5), T.D. 7623, 1979-1 C.B. 66; *id.* § 20.2042-1(a), T.D. 7761, 1981-1 C.B. 459.

52. Treas. Reg. § 20.2042-1(b)(1).

53. *See, e.g.*, Estate of J.S. Logan, 23 B.T.A. 236 (1931), *acq.*, 7-7-1 C.B. 279.

54. *See* Old Colony Trust, 39 B.T.A. 871 (1939) (insurance not receivable by the executor when payable to an *inter vivos* trust that *authorized* the trustee to pay taxes and debts of the insured's estate; code provision exempted from the gross estate $40,000 of insurance proceeds on the decedent's life if not receivable by the insured's executor).

55. Rev. Rul. 73-404, 1973-2 C.B. 319. In Rev. Rul. 77-157, 77-1 C.B. 279, the Treasury stated that such a prohibition is not to achieve exemption under I.R.C. § 2039(c), but that the estate will lose the exemption if the probate estate is insufficient to pay its taxes, debts, or other charges.

56. *See* Estate of Salsbury, 34 T.C.M. (CCH) 1441, 1455 (1975) (qualified retirement

3. "Flower" Bonds

Certain issues of United States Treasury bonds, commonly referred to as "flower" bonds, are redeemable at par—together with accrued interest—in an amount not to exceed the estate taxes for the purpose of applying the proceeds to the payment of those taxes.[57] To be eligible for such redemption, the bonds must have been owned by the decedent at the time of his death and, therefore, included in his gross estate.[58] If the trustee of a revocable trust holds the "flower" bonds, then the trustee may redeem them at par to pay estate taxes only if (1) the trust terminates in favor of the estate, (2) the trustee is required to pay the estate taxes under the terms of the trust instrument, or (3) the debts of the estate, including costs of administration and death taxes, exceed the assets of the probate estate.[59] Accordingly, if the grantor transferred the bonds to a revocable trust that does not comply with one of these requirements,[60] no assurances can be made that the redemption-at-par privilege will be available at the grantor's death.

B. *Federal Income Tax*

1. In General

Both the revocable trust and the estate become new and independent taxpayers upon the death of the grantor-decedent.[61] Both

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benefits paid to a revocable *inter vivos* trust that permitted the trustees to lend funds to and purchase property from the estate; citing Old Colony Trust, 39 B.T.A. 871 (1939), with apparent approval). If the estate is insufficient to pay its taxes, debts, or other charges, the IRS likely will characterize loans to it as distributions, thus affecting the status of amounts used to make such loans. *See* Rev. Rul. 77-157, 77-1 C. B. 279.

57. Congress repealed the statutory authority, former I.R.C. § 6312, in 1971, but only with respect to obligations issued after March 3, 1971; accordingly, outstanding issues of United States Treasury bonds exists that are eligible for redemption at par.

58. 31 C.F.R. § 306.28 (1983). For a brief, general discussion, see *Estate Planning: Flower Bonds in Trust*, 29 TAX LAW. 618 (1976).

59. 31 C.F.R. § 306.28 (1983).

60. Since a provision terminating the trust in favor of the estate would result in the loss of many of the nontax advantages of the revocable trust, the trust instrument should direct the trustee to tender in redemption for payment of estate taxes any eligible United States Treasury bonds held in the trust. The effect of such a direction on the issues, discussed *supra* notes 50-56 and accompanying text, is open to question.

61. The first taxable period of an estate begins on the day following death. Treas. Reg. § 1.443-1(a)(2), T.D. 7767, 1981-1 C.B. 171. The revocable trust is a "grantor trust" during the lifetime of the grantor, and the Code treats the grantor as directly having received the income and requires the grantor to report the income for the grantor's taxable year that the trust realizes such items. Treas. Reg. § 1.671-3(a)(1), T.D. 6989, 1969-1 C.B. 168. Under amendments to Treasury Regulations §§ 1.671-4, 1.6012-3, and 301.6109-1, the IRS does not require Form 1041 (Income Tax Return for Trusts and Estates) when the same individual,

compute taxable income "in the same manner as in the case of an individual, *except as otherwise provided in this part.* The tax shall be computed on such taxable income and shall be paid by the fiduciary."[62]

In order to implement the congressional policy of imposing only a single tax on such income, Congress created a "conduit" system of taxation that generally taxes estates and trusts only on income not currently taxable to a beneficiary. Congress created the conduit system by allowing a deduction to estates and trusts for distributions to beneficiaries[63] to the extent of the estate's or

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other than an estate or trust, is both granter and trustee or cotrustee. The IRS treats that individual as the owner of all trust assets by reason of a power of revocation under I.R.C. § 676. The IRS also exempts such grantor trusts from the requirements of obtaining a separate employer identification number; instead, the IRS requires the grantor to furnish his social security number. Upon the death of the granter, however, the trust becomes irrevocable and, as in the case of an estate, a new taxpayer comes into existence. Rev. Rul. 57-51, 1957-1 C.B. 171; *see* Ufford, *supra* note 8. The IRS does not attribute the trust's income, deduction, and credit items to the grantor's estate, Rev. Rul. 75-267, 1975-2 C.B. 255, since the trust and estate are separate taxable entities.

62. I.R.C. § 641(b) (1982) (emphasis added). I.R.C. § 1(e) imposes the tax. *See id.* § 641(a). Although the Code taxes trusts and estates in a manner essentially equivalent to individuals, it requires certain adjustments to taxable income. *Id.* § 642. Furthermore, certain tax computation elections are not available to trusts or estates. *See, e.g., id.* §§ 1301-1304 (1982) (income averaging); *id.* § 1348 (maximum tax) (repealed for taxable years beginning after December 31, 1981). As new taxpayers, both the estate and the trust must select a taxable year, which may be a calendar year or a fiscal year of twelve months or less. *Id.* §§ 441(b), (d), (e), 443(a)(2). The IRS does not require annualization of reported income for short first years. Treas. Reg. § 1.443-1(a)(2) (1960). The executor selects a tax year by filing the estate's first income tax return for the period ending on the last day of the year selected. *Id.* § 1.441-1(b)(3) (1960). The executor must file the initial return within three and one-half months of the close of the year selected. I.R.C. § 6072 (1982). As new taxpayers, both the estate and the trust are able to adopt an accounting method that differs from the decedent's accounting method as long as the method clearly reflects income. *Id.* § 446(b); Treas. Reg. § 1.446-1(a)(2), T.D. 7767, 1981-1 C.B. 171. Securing the Commissioner's approval under I.R.C. § 446(c) should not be required. Similarly no I.R.C. § 481 adjustment should be available to the estate or trust when changing from the decedent's method to the estate's or trust's new method. *See* Biewer v. Commissioner, 341 F.2d 394 (6th Cir. 1965), *aff'g* 41 T.C. 191 (1963). In certain circumstances the choice of accounting methods is not flexible. For instance, if the decedent's business uses inventories and the estate or trust continues the business, the estate or trust must use the accrual method. *Biewer*, 341 F.2d at 397-98. Also, I.R.C. § 691(b) by its terms permits deductions in respect of a decedent only "when paid" regardless of the accounting method otherwise employed.

63. The deductibility of a transfer of property by an estate or trust depends upon whether such item transferred was either (1) an amount of fiduciary accounting income of the trust or estate that the Code required the trust or estate to distribute currently, or (2) any other amount that the trust or estate properly paid or credited, or that the Code required the trust or estate to distributed. I.R.C. §§ 651(a), 661(a) (1982). Payments or transfers not so described are not distributions and, hence, not deductible. The most notable nondeductible transfers are payments or transfers that meet the specific bequest or gift rule of I.R.C. § 663(a)(1). I.R.C. § 663(a)(1) applies to a gift or bequest of a specific sum of

trust's distributable net income (DNI) for the current year.[64] The Code does not trace the source of distributions, and, therefore, all distributions of fiduciary accounting income or principal, including distributions of property in kind, are deductible by the estate or trust in computing taxable income. Corresponding provisions provide that the DNI for which a deduction is allowed to the estate or trust is the amount that the beneficiary must include in his gross income.[65] The "tax character" of the amounts realized by the estate or trust flows through to the beneficiary.[66] In general terms, then, and at the risk of oversimplification, under I.R.C. Subchapter J, trusts and estates are essentially "conduits" through which the

money or specific property that the grantor pays or credits in three or fewer installments. The Treasury Regulations deem bequests under a will that does not specify a time of payment as required to be paid in single installments. Treas. Reg. § 1.663(a)-1(c)(iii) (1960). A "marital deduction formula pecuniary bequest" does not fall within the exception as a bequest of a specific sum of money, and, hence, will qualify as a distribution deduction. *Id.* § 1.663(a)-(1)(b); *see also* Rev. Rul. 72-295, 1972-1 C.B. 197. The distribution rules also do not apply to money or property passing by operation of law outside of the estate or trust directly to the owner, heir, legatee, or devisee. *See* Treas. Reg. § 1.663(a)-(1)(c)(1)(ii) (1960). For instance, payments to a creditor *qua* creditor do not constitute a distribution, even if the creditor is also a beneficiary. *See, e.g.*, Mariani v. Commissioner, 54 T.C. 135 (1970); Early v. Commissioner, 52 T.C. 560 (1969), *rev'd*, 445 F.2d 166 (5th Cir.), *cert. denied*, 404 U.S. 855 (1971). Nor does the term encompass dower or statutory rights in lieu of dower. Rev. Rul. 71-167, 1971-1 C.B. 163, *modifying* Rev. Rul. 64-101, 1964-1 C.B. 77. Payments to widows for support allowances, whether from income or corpus, however, are estato distributions. Rev. Proc. 73-4, 1973-1 C.B. 751; *see also* Rev. Rul. 75-124, 1975-1 C.B. 183 (payments of widows' and dependents' support allowances are dedutible as distributions even though local law considers such payments debts). The distribution provisions do not include life insurance proceeds payable to the decedent's estate if, as under the statutes of some states, such proceeds inure directly to the surviving spouse and children and are free from creditors' claims. Estate of Flick v. Commissioner, 166 F.2d 733, 737 (5th Cir. 1948); New York Life Ins. Co. v. Valz, 141 F.2d 1014 (5th Cir. 1944); *see, e.g.*, FLA. STAT. § 222.12 (1983).

64. Distributable net income (DNI) is the taxable income of the trust or estate with certain modifications. I.R.C. § 643(a) (1982). The most notable modification is that the Code excludes capital gains from DNI, except in certain circumstances. *Id.* § 643(a)(3). When the Code excludes capital gains from DNI, distributions to beneficiaries cannot generate a deduction to offset the capital gains. Thus, unless distributions attract DNI that includes capital gains, the trust or estate will pay on the capital gains. This rule's rationale assumes that capital gains generally are attributable to principal items and, therefore, generally are not distributable to income beneficiaries. Other significant modifications include ignoring the dividend exclusion, *see id.* § 643(a)(7), including tax exempt interest, *see id.* § 643(a)(5), and ignoring amounts qualifying for a charitable deduction under I.R.C. § 647(c). *See id.* § 663(a)(2); Treas. Reg. § 1.663(a)-2 (1960); *see also* Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1108 (1973); Rev. Rul. 68-667, 1968-2 C.B. 289.

65. I.R.C. §§ 652, 662 (1982). Amounts distributed in excess of DNI are tax free. *See id.* § 102(a). An exception to this tax free treatment would be a distribution from a trust that constitutes an accumulation distribution of undistributed net income for a preceeding taxable year. This exception is codified in the Code's "throwback" rules. *See id.* §§ 665-668. The throwback rules do not apply to estates. *See infra* notes 115-22 and accompanying text.

66. I.R.C. §§ 652(b), 662(b) (1982); Treas. Reg. § 1.643(a)-0 (1960).

income tax liability for the taxable income that the trust or estate earned is allocated between the beneficiaries on the one hand and the estate or trust on the other hand, depending on whether the trustee distributed amounts to the beneficiaries or retained them in the trust or estate during the current year.[67]

2. Accumulation of Income During Administration

An executor may seek to minimize the total income tax burden on the taxable income earned during the interim period of estate administration by engaging in postmortem planning.[68] Because an estate is a separate taxable entity, postmortem income tax planning often necessitates continuing the existence of the estate as a separate taxable entity for as long as possible.[69] If the executor accumulates some or all of the income earned on estate assets and the Code thus taxes that income to the estate, the estate and beneficiaries may pay a lesser aggregate tax than they would if the executor distributed all of the income to the beneficiaries, who would have to report it in their individual income tax returns.[70]

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67. For a thorough discussion of this complex area of taxation, see M. FERGUSON, J. FREELAND, & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES (1970); D. KAHN & E. COLSON, FEDERAL TAXATION OF ESTATES, GIFTS AND TRUSTS (2nd ed. 1975).

68. *See* Giles, *The Application of Certain Rules of Federal Income Taxation: Bracket Splitting, Multiple Trusts, Trapping Distributions, and Basis Adjustments*, 37 INST. ON FED. TAX'N ch. 40 (1979); Walsh, *Postmortem Estate Planning*, 37 INST. ON FED. TAX'N ch. 44 (1979).

69. The Treasury Regulations deem an estate terminated when the executor has distributed all assets except for a reasonable good faith reserve for unascertainable or contingent liabilities (not including claims by a beneficiary). Treas. Reg. § 1.641(b)-3(a) (1960). If the executor unreasonably prolongs the administration of the estate beyond a reasonable period for performance of all duties of administration, the Commissioner may treat the estato as terminated. *Id.* Courts have disregarded for federal tax purposes capricious delay in closing an estato. Old Va. Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966); Chick v. Commissioner, 166 F.2d 337 (1st Cir.), *cert. denied*, 334 U.S. 845 (1948); Manufacturers' Hanover Trust Co. v. United States, 410 F.2d 767 (Ct. Cl. 1969); Rev. Rul. 66-266, 1966-2 C.B. 356. Reasonable grounds for continuation of an estate have prevented termination. *See* Wylie v. Unitod States, 281 F. Supp. 180 (N.D. Tex. 1968)(litigation of nominal claims for eight years); McCauley v. United States, 193 F. Supp. 938 (E.D. Ark.), *appeal dismissed*, 295 F.2d 511 (8th Cir. 1961) (prosecution of tax refund); Carsen v. United States, 317 F.2d 370 (Ct. Cl. 1963) (trustee used income to pay claims for 18 years rather than selling valuable assets); Rev. Rul. 76-23, 1976-1 C.B. 264 (payment of estate tax in ten annual installments under old I.R.C. § 6166 for purposes of retaining Subchapter S status).

70. The rates applicable to trusts and estates are found in I.R.C. § 1(e), introduced by the Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126 (1977). These rates are higher than the rates for individuals. When income earned and accumulated by the estate will be substantially less than the tetal income of the beneficiaries if such income were distributed, however, accumulation and payment of the income tax by the estate may still result in tax savings. The ability to accumulate estate income depends on the

Permanent tax savings result since the executor later can distribute the accumulated income to high bracket beneficiaries without additional tax cost.[71]

The trustee of a revocable trust also may seek to utilize the revocable trust as a separate taxable entity. The ability of the trustee of a revocable trust to accumulate income at the trust's lower bracket during the interim period of administration depends on whether, and for how long, the trust continues as a taxable entity, and, if the trust is continuing, whether the trust instrument gives the trustee the power to accumulate income or instead requires him to distribute the income.

(a) Continuance of the Trust as a Tax Entity

Distribution requirements in revocable trust instruments can create uncertainty concerning the continuance of the trust as a tax entity. Often, the trust instrument provides either for a "distribution" of trust assets to the ultimate beneficiaries "upon the grantor's death" or "immediately upon receipt of the assets from the estate," or for an immediate "division" of the trust principal among those beneficiaries. In such situations an implication may arise that the grantor's death has terminated the revocable trust. If the revocable trust has terminated, the Treasury Regulations require the ultimate beneficiaries of the revocable trust, whether individuals or subsidiary trusts, and not the revocable trust itself, to

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lack of a directive contained in the will or a provision of state law that requires the executor to distribute income currently to the beneficiaries of the estate during administration. *See generally* M. FERGUSON, J. FREELAND, & R. STEPHENS, *supra* noto 67, at 407-26. A directive in the will to distribute the income of the estate currently during administration may be ineffective to compel immediate distribution. *See* Smith's Estate v. Commissioner, 168 F.2d 431 (6th Cir. 1948); *see also* FLA. STAT. § 733.801 (1983) (no personal representative of an estate shall be required to pay any amount to any beneficiary until five months after granting of letters). Occasionally, all or a part of an estate's income may be currently distributable. In such situations, the Code requires the executor to deduct the income from the estate, *see, e.g.*, United States v. James, 333 F.2d 748 (9th Cir.), *cert. denied*, 379 U.S. 932 (1964) (court ordered the estate to pay a widow's allowance from the income of the estate); *see also* Hibernia Nat'l Bank v. Donnelly, 121 F. Supp 179 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954) (under Louisiana law, dividends accruing on corporate stocks that are the subject of a bequest belong to the specific legatee when the estate earns such dividends). Generally, however, in contrast to the *Donnelly* decision, income accruing on specific property that itself is the subject of a special bequest belongs to the beneficiary only ultimately, and the IRS does not require the estate to make the distribution currently. In such situations, the IRS does not require the estate to deduct currently the amount nltimately payable to the beneficiary until the year actually distributed, subject to the DNI calculations for the year of distribution. *See generally* Treas. Reg. §§ 1.661(b)-1, 1.662(b)-1 (1960).

71. *See infra* notes 115-22 and accompanying text.

include in gross income the amount of income currently realized by the trust: "If a trust . . . is considered terminated under this section for Federal income tax purposes . . . the gross income, deductions and credits of the trust are, subsequent to the termination, considered the gross income, deductions and credits of the person or persons succeeding to the property of the . . . trust."[72]

Recognizing that the issue of termination ought not be determined solely by reason of trust provisions requiring "immediate" distribution or division upon the grantor's death, the Treasury Regulations provide:

> Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust.[73]

Timing the termination of an estate or trust to the advantage of the interested parties is a complex tax planning transaction;[74] loss of the opportunity to engage in such planning due to a premature, and perhaps unknown, termination of the revocable trust is a serious matter.[75] Accordingly, revocable trust instruments ordina-

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72. Treas. Reg. § 1.641(b)-3(d) (1960).

73. *Id.* § 1.641(b)-3(b).

74. A judicious choice of the termination date can prevent "bunching" of trust income in the beneficiaries' returns. The DNI attracted by distributions to beneficiaries is includible by the beneficiary for any taxable year or years of the trust or estate ending *within* or with the beneficiary's taxable year. I.R.C. § 662(c) (1982). Upon termination of an estate or trust, the taxable year is closed. *Id.* § 441(b)(3). In those years in which the interim trust or estate continues, the beneficiaries only have to include amounts in their gross income attributable to one estate or trust taxable year. In the year of estate or trust termination, however, two trust or estate taxable years may end within the beneficiary's taxable year, resulting in as much as twenty-three months of fiscal year estate or trust DNI bunched into one of the beneficiary's taxable years. *Id.* § 662(c); *see* Schemberg v. United States, 365 F.2d 70 (7th Cir. 1966); *see also* Rev. Rul. 71-180, 1971-1 C.B. 205. Timing of the termination date is also critical in the "pass-through" of excess estate or trust deductions to beneficiaries. *See* I.R.C. § 642(h) (1982); *see also* Westphal v. Commissioner, 37 T.C. 340 (1961). *See generally* M. FERGUSON, J. FREELAND, & R. STEPHENS, *supra* note 67.

75. As a practical matter, an accurate physical division or distribution of the revocable trust assets usually is not possible immediately after the grantor's death, especially when revocable trust beneficiaries are subsidiary trusts, such as a marital deduction trust, whose size is determined by a formula. Certain elections available to the fiduciaries can affect the

rily should provide for the continued existence of the trust during the "interim" phase.[76] Trust provisions requiring distribution or

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relative size of shares; among them the most notable is the election to utilize administration expenses as income tax deductions rather than as estate tax deductions. *See* Treas. Reg. § 642(g) (1982). *See generally* R. Covey, The Marital Deduction and the Use of Formula Provisions (2d ed. 1978). Also, when the revocable trust assets may be subject to a call by the estate for payment of debts, claims, and taxes of the decedent, the ultimate size of distributions may not be immediately ascertainable. Accordingly, a premature termination of the interim trust would result in income earned by trust assets during the administration phase being autematically includible in the returns of the beneficiaries, thus requiring the beneficiaries to report such income in their own returns for a period in which they may not have received dollars or property with which to pay the income tax liability. Moreover, if the trustee later distributes trust assets in percentages that differ from earlier estimates used to report the income by the beneficiaries, then tax deficiencies for some beneficiaries and tax refimds for others will result. *See* I.R.C. §§ 6211, 6401, 6501, and 6511 (1982). A premature termination of the interim trust could result in other serious adverse collateral tax consequences. When the trustee actually divides trust assets into shares and distributes them soon after the grantor's death, the asset values may become fixed for purposes of estate tax on the distribution date without regard to the alternate valuation date. *See id.* § 2032; Rev. Rul. 73-97, 1973-1 C.B. 404. *But see* Rev. Rul. 57-495, 1957-2 C.B. 616 (when the trustee is merely dividing property among separate shares no such disposition occurs under I.R.C. § 2032). *See generally* Moore, *supra* note 6, ¶¶ 400-401. Also, when one or more of the beneficiaries of the terminated revocable trust is a subsidiary trust that by its terms requires the trustee to distribute currently the income that the trust receives—for instance, a power of appointment marital deduction trust—the postmortem option to utilize administrative expenses as income tax, rather than estate tax, deductions may be partially lost. This would occur if one share or subsidiary trust—for instance, a residuary trust—and not another—for instance, the marital—were to pay all administrative expenses. If income earned on the trust assets is immediately divisible between the subsidiary trusts according to their relative sizes, the risk increases that administrative expenses will exceed taxable income allocated to the particular subsidiary trust. There is no carryover of excess administrative expenses, and to the extent not allowed against the current year's income, they are wasted for income tax purposes. The estate could claim the excess deductions on its estate tax return. To be deductible on the estate tax return, however, the executor must pay the expenses within three years from the filing of the estate tax return if the trust property is not subject to probate claims. Treas. Reg. §§ 20.2053-1, 20.2053-8 (1958). Trustee commissions may not be deductible on the estate tax return even if the trust property is subject to claims, unless and to the extent that a trustee is "in fact performing services with respect to property subject to claims which would normally be performed by an executor." *Id.* § 20.2053-3(b)(3).

76. The trust instrument could provide:

> As soon as is conveniently possible after Grantor's death, but subject to proper provisions being made for all of the obligations, payments, and distributions described above (relating to special duties of the Trustee arising upon Grantor's death), then
>
> (i) all of the property of the original Trust Estate hereunder, both income and principal,
>
> (ii) all insurance policies and proceeds and other benefits of any kind to the extent receivable by the Trustee of the original Trust hereunder, and
>
> (iii) all properties which are receivable by such Trustee under the provisions of Grantor's last will and testament, Grantor's revocable trust(s), or by the exercise of any power of appointment,
>
> shall be disposed of in the following manner:

division "upon the grantor's death" or "immediately upon receipt of the assets from the estate" should not be construed as causing termination, but rather as serving to establish a point in time for measuring the relative shares of the different beneficiaries. Nonetheless, as a precautionary measure, provision for the trust's continuance would be wise.

(b) Whether Trust Income Can Be Accumulated

The determination of whether the trustee can accumulate trust income or must distribute it currently depends

> upon the terms of the trust instrument and the applicable local law . . . . [If a trust cannot accumulate income] the fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year.[77]

If the revocable trust requires the trustee to distribute all income currently, then the utility of the trust as a separately taxed accumulation vehicle diminishes. The central test for determining whether a trustee has a duty to distribute income currently is whether the beneficiary has the present right to compel immediate distribution.[78] This test is distinct from the issue of whether the beneficiary has the ultimate right to receive the income, or whether he actually receives the income. If the trustee has a duty to distribute the trust income currently, the beneficiary of the trust must include in gross income for the taxable year the amount of income that the trust instrument requires to be distributed currently, whether or not the trustee distributes the income.[79]

The lack of a specific provision requiring current distribution of income is not conclusive if a duty otherwise exists. State law, however, generally specifies that an executor of an estate does not have a duty to distribute estate income currently,[80] and serious doubt exists on the question of whether a will can effectively require distribution of estate income prior to satisfaction of claims.[81]

(i) . . .; and
(ii) . . .;

and when all of the properties of the original Trust hereunder have been thus disposed of, it shall be deemed terminated.

77. Treas. Reg. § 1.651(a)-2(a) (1960).

78. Freuler v. Helvering, 291 U.S. 35, 42 (1934).

79. I.R.C. §§ 652(a), 662(a)(2)(A) (1982).

80. *See, e.g.*, Fla. Stat. Ann. § 733.801 (West 1976).

81. *See, e.g.*, Smith's Estate v. Commissioner, 168 F.2d 431 (6th Cir. 1948); *see also supra* note 132. One rationale is that such distributions could result in imposition of personal liability for "debts" (taxes) that the decedent owes the United States. *See* 31 U.S.C.

The Treasury Regulations acknowledge these limitations on the executor's power to distribute income in their framework for determining whether an interest in property passing from a decedent to his surviving spouse is a deductible interest for purposes of the estate tax marital deduction.[82]

The legal basis for the proposition that the beneficiaries of an estate do not have a present right to estate income is of dubious import on whether the trustee of a revocable trust that is silent on the issue has discretion to accumulate trust income.[83] Nevertheless, when the trustee of a revocable trust has a duty to perform "executor-like" tasks—for example, paying funeral expenses, attorneys' fees, appraisers' fees, debts, and taxes—the estate analogy conceivably applies, in which event the trustee of the revocable trust essentially has the power to accumulate income.

Little authority exists concerning whether states will analogize between the estate executor and the trustee with "executor-like" tasks and accordingly grant the trustee the power to accumulate income. The issue rarely arises other than in a federal income tax setting, although it has arisen with mixed results in cases in which a state statute prohibited accumulation of income[84] and in cases in which creditors attempted to levy on the beneficiaries' rights to income after a terminating event but prior to the final accounting.[85] The United States Court of Appeals for the Second Circuit's decision in *Commissioner v. First Trust & Deposit Co.*[86] supports the

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3713 (1982); Treas. Reg. §§ 20.2002-1, 1.641(b)-2(a), T.D. 6580, 1961-2 C.B. 123; *see also* Miller, *The Fiduciary's Personal Liability for Deficiencies in Federal Income, Gift and Estate Taxes of a Decedent or Decedent's Estate*, 11 GONZ. L. REV. 431 (1976).

82. *See* Treas. Reg. § 20.2056(b)-5(f)(9) (1958) (the interest does not fail to satisfy the conditions of deductibility because the law does not entitle the spouse to income from estate assets for the period before distribution unless a court authorizes a delay beyond the period reasonably required for administration). Revenue Ruling 76-446, 1976-2 C.B. 295, indicates that the result may be different if the marital deduction bequest is contained in a revocable trust, unless the payment of income is "delayed because of the trust's interrelation with the administration of the settlor's probate estate." *See* R. COVEY, *supra* note 75, at 140-41.

83. The Code limits a trustee's potential personal liability for "debts" the decedent owed the United States to the value of the trust property at the grantor's death. I.R.C. § 6324(a)(2) (1982).

84. *See, e.g.*, Bryant v. Commissioner, 14 T.C. 127, *aff'd*, 185 F.2d 517 (4th Cir. 1950).

85. *See, e.g.*, Derring v. Pierce, 149 A.D. 10, 133 N.Y.S. 582 (1912) (a creditor of a remainderman may not levy execution upon the trust property after the terminating event but before the trustee accounts).

86. 41 B.T.A. 107 (1940), *aff'd*, 118 F.2d 449 (2d Cir. 1941). For a discussion of this case, see Covey, *supra* note 8, at 1395-1396; Fleming, *supra* note 8, at 82; Ufford, *supra* note 8, at 43-44. The *First Trust & Deposit* case, which dealt with the uncertain amounts of distributions, is distinguishable from those situations in which the beneficiaries' identities are not certain. The inability to ascertain the beneficiaries' identities does not preclude the

proposition that the trustee of a revocable trust has the power to accumulate income and, therefore, supports the corollary that for income tax purposes the trust income is not currently distributable. In *First Trust & Deposit Co.*, the trust instrument provided that upon the grantor's death the trustee was to pay income to the grantor's wife, for life, and upon her death the trustee was to distribute the principal equally among the children. The trust required the trustee to pay all estate taxes due on account of the grantor's death. When the grantor and his wife died in a common disaster, the trustee collected the insurance and paid the estate taxes over a five-year period of administration. The trustee accumulated income during this period. The IRS brought an action against the beneficiaries requiring them to include the trust income in their individual returns even though the trustee had not distributed the income to them. In holding that the income that the trustee collected for the years in question was taxable to the trust and not to the beneficiaries, the Second Circuit placed great emphasis on the "executor-like" duties imposed on the trustee:

> Under the terms of the trust deed the gift to the children, which became vested on the death of their parents, was subject to the payment of taxes, commissions and expenses incident to the winding up of the trust. There was no duty on the part of the fiduciary to make periodical distributions of current income to the children and distribution of either income or principal could only be compelled after an accounting . . . . [We previously have said] that "income to be distributed currently" is income directed by a will or deed to be currently distributed and that the words presuppose a periodic duty on the part of the trustee. The situation here resembles that of an estate in the course of administration where the income pending settlement is returnable by the executor, and is not regarded as the income of the legatees or next of kin . . . . Until completion by the trustee of its duties the income was that of the trust and not of the remaindermen and taxable to the trustee accordingly.[87]

(c) Resolving the Issue

If empowering the trustee of a revocable trust to accumulate income during the "estate administration" period is desirable, and it ordinarily would seem to be, the trust instrument should clearly so provide. A variety of methods could accomplish this result, but one method would be to provide for the existence of an "interim" trust for the "estate administration" period. The trust instrument would not require current distribution of income from this trust,

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trust from distributing income. United States v. Higginson, 238 F.2d 439 (1st Cir. 1956); Rev. Rul. 62-147, 1962-2 C.B. 151. *But see* Estate of Bruchmann, 53 T.C. 403 (1969).

87. *First Trust & Deposit Co.*, 118 F.2d at 452.

but rather would authorize discretionary distributions to fund any subsidiary trusts and interim distributions to other trust beneficiaries. Given such a trust instrument, the postmortem income tax planning opportunities available to the estate clearly should be available to the revocable trust.

3. Other Income Tax Differences Between the Estate and the Revocable Trust During Administration

The questionable availability of the revocable trust as a separate tax entity having the ability to accumulate income is not the only potential point of departure in the comparison between the revocable trust and the estate during the "estate administration" period, although it is a significant one. Other significant issues and differences exist, the most important of which this Article now addresses.

(a) Personal Exemption

The Internal Revenue Code allows an estate a personal exemption, in lieu of the personal exemptions provided by I.R.C. section 151, of $600 in computing taxable income.[88] The Code, however, limits the revocable trust either to a deduction of $100 if it is a "complex" trust—that is, one that can accumulate income or distribute corpus—or to a $300 deduction if it is a "simple" trust—that is, all of its income is required to be distributed currently.[89]

(b) Installment Payments of Income Taxes

An estate may pay its income tax in four equal installments without interest;[90] accordingly, the estate can invest the deferred taxes during the deferral period and thereby create additional wealth. This opportunity is unavailable to the revocable trust, which must pay its tax with the return.[91]

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88. I.R.C. § 642(b) (1982).

89. *Id.*

90. *Id.* § 6152(a) (1982).

91. *Id.* § 6151 (1982). The Code does not subject the estate or the trust to the estimated tax provisions.

(c) Depreciation

I.R.C. section 167 allows as a deduction for income tax purposes a "reasonable allowance" for depreciation.[92] I.R.C. section 642 allows the deduction for depreciation to an estate or trust only to the extent not allowable to estate or trust beneficiaries under section 167(h).[93] With respect to estates and beneficiaries of estates the Code allocates the depreciation deduction on the basis of income of the estate allocable to each beneficiary.[94] With respect to trusts the rule is quite different. The Code first allocates the depreciation deduction to the trustee to the extent the trust document requires the trustee to retain a reserve for depreciation out of income or to the extent the trustee actually retains for such purposes where state law or the trust document permits the retention of such a reserve. The Code allocates any remaining depreciation among the trust and trust beneficiaries in proportion to the amount of income in excess of the reserve allocated to each.[95] Thus, when a will or trust requires or permits the executor or trustee to set aside a reserve for depreciation out of income, the allocation of the depreciation deduction for income tax purposes will depend on whether the estate or a revocable trust is the relevant entity.

(d) Charitable Deduction

Under I.R.C. section 642(c) an estate may deduct amounts permanently set aside for charity.[96] Trusts may take a deduction only for amounts actually paid to charity; no provision exists for a permanent "set aside" deduction.[97]

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92. In the case of "recovery property" within the meaning of I.R.C. § 168 (Accelerated Cost Recovery System), the deduction allowed by I.R.C. § 168 is a reasonable allowance under § 167.

93. I.R.C. § 642(e) (1982).

94. The term "income" appearing in § 167(h) probably means fiduciary accounting income within the meaning of I.R.C. § 643(b). Rules similar to the depreciation rules apply for the depletion allowance. *See* I.R.C. § 611(b) (1982).

95. *Id.* § 167(h) (1982); Treas. Reg. § 1.167(h)-1(c) (1960) (estates); Treas. Reg. § 1.167(h)-1(b) (1960) (trusts).

96. I.R.C. § 642(c)(2) (1982); Treas. Reg. § 1.642-(c)(2) T.D. 7387, 1975-2 C.B. 244. The deduction is in lieu of the charitable deduction under I.R.C. § 170(a).

97. The trustee, however, may elect the deduction for a taxable year when the actual payment occurs in the following taxable year. I.R.C. § 642(c)(1) (1982).

(e) Charitable Remainder Trusts

A revocable trust may establish a charitable remainder trust upon completion of the "estate administration" period. For charitable remainder annuity or unitrust status, with its attendant exemption from income tax and qualification for the estate tax charitable deduction, the trust instrument specifically must create a new trust rather than merely continue the old.[98] The Code does not impose a similar requirement for charitable remainder trusts created under a will.

(f) Recognition of Losses

I.R.C. section 267 disallows an otherwise deductible loss arising out of a sale or exchange transaction between a revocable trust and a beneficiary of such trust.[99] This rule of disallowance does not apply to transactions between an estate and its beneficiaries.[100] Postmortem in-kind funding distributions in satisfaction of a fixed obligation can result in realization of gain or loss to the trust or estate.[101] A loss realized by a revocable trust making an in-kind distribution, however, would be disallowed as a deduction, whereas any such loss realized by an estate would be allowed.[102]

(g) Subchapter S

When a decedent dies owning stock of a Subchapter S corporation, his estate may continue to hold the stock without termination of Subchapter S status during the probato period.[103] Upon termination of the estate, the beneficiaries receiving the Subchapter S stock must be qualified shareholders for the election to continue.[104]

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98. Treas. Reg. § 1.664-1(a)(4); *id.* § 1.664-1(a)(6); *see, e.g.,* Rev. Rul. 72-395, 1972-2 C.B. 340.

99. I.R.C. § 267 (1982).

100. *Id.*

101. *See* Treas. Reg. § 1.1014-4(a)(3) (1960); Rev. Rul. 60-87, 1960-1 C.B. 286; Rev. Rul. 56-270, 1956-1 C.B. 325.

102. When I.R.C. § 267 disallows a loss, subsequent gain realized by the taxpayer on sale of the asset may go unrecognized to the extent of the previously disallowed loss. *See* I.R.C. § 267(d) (1982).

103. *Id.* § 1361(b)(1)(B) (1982).

104. The permissible shareholders include:

(i) resident aliens or United States citizen individuals, I.R.C. § 1361(b); or

(ii) trusts, but ouly for 60 days, I.R.C. § 1361(c)(2)(A)

(iii) unless any such trust is either

(a) described in I.R.C. § 1361(c)(2)(A)(ii) (but only for a maximum two year period following such grantor's death); or

(b) a qualified Subschapter S trust described in I.R.C. § 1361(d).

A grantor may fund a revocable trust with Subchapter S stock during his life,[105] but the trustee must distribute that stock to a permissible shareholder within two years following the grantor's death.[106] When distribution of Subchapter S stock is not desirable until after the "estate administration" phase, the estate appears to allow more flexibility in Subchapter S stock distributions than does the revocable trust.[107]

(h) Separate Share Rule

The Code treats substantially separate and independent shares of different beneficiaries in a single trust as separate trusts for the purposes of computing DNI,[108] which insulates one beneficiary from taxes on income accumulated for another beneficiary.[109] Separate share treatment is mandatory for trusts,[110] but does not apply to estates.[111] Although this "separate share" rule for trusts ordinarily would be an advantage, and its inapplicability to estates a disadvantage,[112] it may be advantageous in certain situations for an estate or trust to make non-pro rata distributions, and thus give low bracket taxpayers such as subsidiary trusts a greater portion of the trust income. The separate share rule, however, effectively prohibits a revocable trust from making such distributions.[113]

(i) Sixty-Five Day Rule

A trustee may elect to treat distributions within the first sixty-five days of a taxable year as occurring during the preceeding taxable year.[114] This advantageous "look back" rule is available to a revocable trust, but is not available to estates.

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105. I.R.C. § 1361(c)(2)(A)(i) (1982).

106. *Id.* § 1361(c)(2)(A)(ii). If the entire corpus is not included in the grantor's gross estate the trustee must distribute the stock within 60 days—not within two years.

107. Although a shareholder's estato is a qualified "S" shareholder, it may not hold the stock indefinitely. Once the estate has performed its ordinary duties, it may be terminated for federal income tax purposes, regardless of whether probate continues under local law. *See* Old Va. Brick Co. v. Commissioner, 367 F.2d 267 (4th Cir. 1966).

108. I.R.C. § 663(c) (1982); Treas. Reg. § 1.663(c)-3, T.d. 7633, 1979-2 C.B. 247.

109. Treas. Reg. § 1.663(c)-1(a) (1960).

110. *Id.* § 1.663(c)-1(d).

111. *Id.* § 1.663(c)-3(f).

112. *Cf.* Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied*, 414 U.S. 820 (1973).

113. *See infra* notes 126-37 and accompanying text.

114. I.R.C. § 663(b) (1982).

(j) Throwback Rules

Generally, amounts that an estate or trust distributes in excess of its DNI are not includible in the gross income of the estate or trust beneficiary.[115] To foreclose the tax avoidance opportunities this rule could present, Congress created a statutory scheme—the so-called "throwback" rules—that does tax certain amounts distributed in excess of DNI.[116] The throwback rules are not applicable to estates,[117] nor are they applicable, generally, to a trust in a year in which it is a simple trust.[118] A revocable trust that does not require distribution of all of its income currently is not a simple trust and, therefore, is subject to the throwback rules.

In theory, the throwback rules tax the beneficiary of a trust that accumulates income as if the beneficiary received the income in the year the trust earned and accumulated it.[119] In operation, such rules would require inclusion of the accumulated income in

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115. *See id.* § 662(a) (1982); *id.* § 102(b) (1982).

116. I.R.C. §§ 665-668 (1982).

117. Treas. Reg. § 1.665(a)-0A(d) (1972). During the debates on the 1954 Code, which first introduced the throwback rules into the trust income taxation scheme, a Senate Report noted:

> In spite of the "65-day and 12-month rules" of existing law, it is still possible to shift the tax burden in part from a beneficiary to a trust. For example, if the distribution of trust income for one year is deferred to a date more than 65 days after the beginning of the following year, and the trust income for the following year is distributed within the first 65 days after the end of that year, the beneficiary is taxable to the extent of the trust income for the second year only, even though he received all the income for both years. The purpose of the "throwback rule" is to close this tax-avoidance loophole in the existing law.
>
> To meet this and similar situations, distributions by a trust in excess of its distributable net income for the current taxable year will be "thrown back" to each of the 5 preceding years in reverse order and will be taxed to the beneficiaries to the extent that the distributable net income of . . . [certain prior] . . . years was not, in fact, distributed.
>
> To prevent double taxation, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess so thrown back. However, the beneficiaries are deemed to have received their share of the tax paid by the trust on this excess. In effect, the beneficiaries, except for the fact that they report the income currently, are placed in the same position as if the trust made the distribution at the time it received the income. . . . [The] throwback provisions . . . [do] not apply to estates or generally to simple trusts.

SENATE REPORT No. 1622, 83rd Cong., 2d Sess. 85 (1954).

Clearly, Congress did not regard estates as presenting significant opportunities for tax avoidance through the use of accumulation distributions; apparently, this reasoning continues since estates remain immune to the throwback rules. The probable basis for this policy decision is the relatively short life of estates. Trusts generally have a longer life span, and, hence, greater potential for tax avoidance through accumulation distributions.

118. Treas. Reg. § 1.665(a)-0A(a)1 (1972).

119. *Id.*

the beneficiary's income for the taxable year during which the trust earned and accumulated it and a recomputation of the resultant tax liability. In practice, however, the throwback rules impose a partial tax on the undistributed net income (UNI) in the year of distribution. The Code requires the trustee to compute the partial tax at the beneficiaries' rates using a special five year average arrangement. From a tax planning perspective, if the throwback tax liability incurred upon a subsequent distribution does not exceed the tax liability otherwise incurred on a current distribution by more than the net after-tax benefit from the accumulation of earnings on the amount of the deferred tax, then the tax planner will achieve an economic advantage. Often, however, an economic disadvantage will result, due to higher marginal tax rates applicable to the beneficiary's taxable income in the distribution year.

Not all distributions from a revocable trust are subject to a throwback tax. Without triggering a throwback tax, a revocable trust can: accumulate and subsequently distribute capital gains;[120] distribute what otherwise would be UNI, if the accumulation occurred prior to the twenty-first birthday of the beneficiary;[121] distribute current fiduciary accounting income, as defined in I.R.C. section 643(b), even if the income is in excess of current DNI;[122] and distribute to a subsidiary trust that, prior to the distribution, was not in existence.[123]

Due to the complexity and potentially significant tax consequences of the throwback rules, the tax planner must consider

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120. I.R.C. § 643(a)(1) generally excludes capital gains from DNI.

121. I.R.C. § 665(b) (1982).

122. The Tax Reform Act of 1976 introduced an exception to the unlimited throwback rule by providing that if "amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year." Tax Reform Act of 1976 § 701(b), (c), I.R.C. § 665(b) (1982) (effective for tax years commencing after December 31, 1975). Apparently, distributions may include amounts which otherwise would effect an accumulation distribution but for the fact that the distribution does not exceed trust income. *See* I.R.C. § 643(b) (1982) (fiduciary accounting income or trust income). Clearly principal distributions or distributions of income accumulated from prior years pass out to the beneficiaries without triggering a throwback distribution if the distributions fall within this exception. *See generally* Hirshson, *Accumulation Trusts and the Tax Reform Act of 1976*, 1 REV. TAX'N INDIVIDUALS 291 (1977); Link & Wahoshe, *Taxation of Distributions from Accumulation Trusts: The Impact of the Tax Reform Act of 1976*, 52 NOTRE DAME LAW. 611 (1977); Zaritsky, *The New Accumulation Trust Rules of the Tax Reform Act of 1976*, 54 TAXES 676 (1976). As with all distributions by a trust, the trustee may consider any amount paid or credited by the trust within 65 days of the close of its taxable year as properly paid or credited at the close of such taxable year. I.R.C. § 663(b) (1982). *See supra* note 114 and accompanying text.

123. *See* I.R.C. § 666(a) (1982) (no preceeding taxable years).

their inapplicability to estates as giving disposition by will an important advantage over disposition by revocable trust.

(k) Trapping Distributions

(1) Distributions in General

The very complexity of Internal Revenue Code Subchapter J permits a fiduciary who understands it to realize the advantages and minimize the disadvantages resulting from estate or trust distributions. For example, an executor or trustee who considers the effect of the selection of taxable years for the different taxpayers[124] doubtless will select staggered taxable years—fiscal years ending on the last day of different calendar months. Selecting staggered taxable years will permit the fiduciary to make distributions from an estate or trust through one or more intermediary trusts to the ultimate beneficiary. The tax on these distributions either will not be payable by the beneficiary,[125] or if payable by the beneficiary, will not be payable for several years.[126] The timing of distributions

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124. The estate and trust, and any subsidiary trusts, each may elect a fiscal or calendar year without approval of the Commissioner. I.R.C. §§ 442-443 (1982). The first year may be less than twelve months, and its selection is made by filing the first return. Treas. Reg. § 1.441-1(b)(3), T.D. 7767, 1981-1 C.B. 478.

125. This opportunity arises in distributions during the first taxable year. For example, assume an estate tbat has a July 31 date as its end of fiscal year makes its initial funding distribution on May 30, 1984, to an interim revocable trust having a June 30 year-end date. Assume that the distribution carries out a substantial amount of DNI from the estate. The interim trust will have no DNI for its first fiscal year, ending June 30, 1984. Accordingly, it can distribute the property to the beneficiary prior to June 30, 1984—or within the 65 day period established by I.R.C. § 643(c)—without the beneficiary having to report it as income. The DNI will be taxable to the trust the following year unless distributions during that year carry out the DNI.

126. A beneficiary reports income from an estate or trust in his taxable year in which or with which the fiscal or calendar year of the estate or trust ends. For example, assume the executor selects a fiscal year ending June 30, 1984, and distributes income to the interim revocable trust on December 31, 1984. Next, assume the interim revocable trust adopts a fiscal year ending on May 31 and distributes the income immediately to the subsidiary trusts. These subsidiary trusts, in turn, adopt fiscal years ending on April 30 and immediately distribute the income to the beneficiaries on December 31, 1984. The income is included in the DNI of the interim trust for its taxable year ending May 31, 1985. The income distributed by that trust to the subsidiary trusts will be included in their DNI for the taxable year ending April 30, 1986. While the beneficiaries receive the distribution on December 31, 1984, the tax payable is due with their return on April 15, 1987.

Countervailing considerations to staggering estate and trust fiscal years, however, do exist. The risk of bunching income from two or more years into a single taxable period on termination is greater with staggered years. *See supra* note 74. Also, a surviving spouse can file a joint return with the deceased in the year of death, I.R.C. § 6013 (1982), and may be able to use the joint return rates for two years thereafter. *Id.* § 2(a). Deferred income distributed to the surviving spouse, therefore, may wind up taxable at higher marginal tax

of appreciated property[127] and of capital gains[128] is similarly consequential.

(2) Trapping Distributions

A trapping distribution is a distribution from an estate or revocable trust to a testamentary or subsidiary trust tbat removes estate or trust income for income tax purposes, but which constitutes principal for trust law purposes, and which, therefore, the subsidiary trust need not distribute. Since the income is not distributed to the income beneficiary, the Code will not currently tax that income to him.[129]

Trapping distributions are possible because one of the principal tenets of Subchapter J is its rejection of a distribution-tracing concept; with significant exception,[130] all distributions of an estate or trust, whether designated as income or principal, are from DNI to the extent of DNI.[131] As previously discussed,[132] the corollary of this rule is that distribution of principal as well of income are deductible by the estate or revocable trust to the extent of DNI, and

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rates than had the income been taxed to the surviving spouse immediately after the decedent's death.

127. If the grantor trust has DNI when it distributes appreciated property, the beneficiary receives a step up in basis to the fair market value of the distributed property to the extent the IRS deems the DNI distributed. Treas. Reg. § 1.661(a)-2(f)(3), T.D. 7287, 1973-2 C.B. 210. If a marital share determined by a pecuniary formula is funded with appreciated property, the distributing estate or trust recognizes gain on the appreciation, limited to the difference between the value of the property for estate tax purposes and its fair market value on the date of distribution. *Id.* § 1.1014-4(a)(3) (1960).

128. The Code does not include capital gains in the trust's DNI, unless they are allocated to income under the trust instrument or unless local law allocates the capital gains to income and the trustee actually distributes tbe income to the beneficiaries. I.R.C. § 643(a)(3) (1982); Treas. Reg. § 1.643(a)-3(a). Since capital gains are no longer subject to throwback, the beneficiaries can avoid tax liability on the trust's capital gains. If the beneficiaries have capital losses or capital loss carryovers that otherwise would expire, however, the grantor trust simply could distribute the capital gains with a designation tbat the distribution represents capital gains of the trust for the current year.

129. *See* Cornfeld, *Trapping Distributions*, 14 INST. ON EST. PLAN. ch. 14 (1980); Giles, *The Application of Certain Rules of Federal Income Taxation: Bracket Splitting, Multiple Trusts, Trapping Distributions and Basis Adjustments*, 37 INST. ON FED. TAX'N ch. 40 (1979).

130. I.R.C. § 663(a)(1) (1982); *see supra* note 63.

131. Certain qualifications to the general statement contained in the text are created by carving out exceptions from the term "distribution" to which the distribution rules of Subchapter J apply. For instance, a distribution does not include a specific bequest or gift of property that the trustee pays, pursuant to the terms of the governing instrument, all at once or in not more than three installments. *See* I.R.C. § 663(b) (1982); *see also id.* § 662(a) (providing for some elements of tracing).

132. *See supra* text accompanying notes 61-67.

distributions of principal as well as of income are includible in the income of the recipientto the extent of the beneficiaries' allocated share of DNI. Accordingly, when income and principal beneficiaries each received distributions in the same year, the Code allocates a portion of the current year's DNI to both income and principal beneficiaries.[133]

Harkness v. United States[134] illustrates the potential for mischief this rule permits. In *Harkness* the decedent's widow was to receive fifty percent of the income of the estate. For the taxable year in question, the executor made distributions to the widow of both principal and income of over $27,467,000. These distributions represented seventy-six percent of the total principal and income distributions to all beneficiaries. Thus, even though her total distributions included only one-half of the estate's current income ($206,000), she was liable for the taxes on seventy-six percent, not fifty percent, of the estate's $826,758 of DNI for the year. This occasioned an income tax liability to her of $188,000.[135] The Court of Claims, in upholding the Commissioner's imposition of this tax liability, stated:

> If discretionary "balancing" payments which include large amounts of corpus are made and accepted, as here, the necessary consequence is to invoke the formula nonetheless, and the taxpayer will not be allowed to "trace" in order to show that the source of part of his receipts was in fact not "distributable

133. I.R.C. § 662(a) (1982). Although the general rule for Subchapter J is to allocate DNI ratably among the recipients of property that attract DNI, this rule is subject to two qualifications when the trustee makes income and principal distributions in the same year. First, when the trustee distributes income and principal from an estate or trust in the same year to different beneficiaries, those beneficiaries to whom the trust requires current income distributions are allocated all DNI to the extent of required distributions. *Id.* § 662(a)(1). All other beneficiaries report any residual DNI on a ratable basis. *Id.* § 662(a)(2). Second, when a trustee distributes income and principal from an estate or trust in the same year to a beneficiary that is a trust, the IRS allows the trust to deduct, in computing its taxable income, amounts that it, in turn, distributes to its beneficiaries up to the amount of its DNI. The trust's DNI will include the DNI originally allocated to it by virtue of distributions from the estate or trust. Thus, if a trust receiving income and principal in the same year distributes that income, then the DNI allocated initially to the trust will be reallocated to the income beneficiaries up to the lower of the trust's DNI or the amounts distributed. When the trustee makes distributions of principal and income to a simple trust from an estate or interim trust during the same taxable year, the result will not be a truly ratable allocation of DNI among the principal and income. Rather, the result will be similar to the "tier one" allocation to current income beneficiaries under I.R.C. § 662. The trustee must consider this factor in making distributions of principal to a subsidiary trust. If the subsidiary trust is to be a significant separate taxpayer for purposes of reporting tax liability, distributions of income from the subsidiary trust will defeat that purpose dollar for dollar by deflecting liability for DNI to its own income beneficiary.

134. 469 F.2d 310 (Ct. Cl. 1972), *cert. denied,* 414 U.S. 820 (1973).

135. The widow's total tax liability including interest was almost $250,000.

net income" but corpus. If the tax consequences of this approach are deemed sufficiently undesirable, there is the other route which can and should be taken. In these circumstances, there is no compulsion to accept an unfair or unrealistic division of "distributable net income."[136]

Due to the throwback rules, trapping distributions by revocable trusts are less advantageous than trapping distributions by an estate. Although the throwback rules generally do not apply to simple trusts—those that must distribute all income currently—they do apply to a simple trust to the extent that it has "outside income."[137] In the case of a trapping distribution from a revocable trust, a simple subsidiary trust has outside income when it receives principal amounts from the revocable trust that attract DNI from the distributing revocable trust. Thus, when a revocable trust makes a trapping distribution, the trapped DNI automatically becomes "outside income," and a later distribution by the subsidiary trust will occasion a throwback tax. Thus, trapping distributions to a simple subsidiary trust from a revocable trust are ladened with the complexities and uncertainties of the throwback rules operating upon a later distribution.[138]

When an estate makes a trapping distribution of principal to a simple trust, the definition of "outside income" is more restrictive. Thus, a throwback calculation will not be required if the simple trust later distributes that principal except to the extent that the trapped DNI included either "income in respect of a decedent" or constituted unrealized accounts receivable assigned to the trust.[139]

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136. *Harkness*, 469 F.2d at 321.

137. The Regulations state that "the term 'outside income' means amounts that are included in the distributable net income of the trust for the year but are not 'income' of the trust as that term is defined in § 1.643(b)-1"—for example, "[d]istributions from another trust that include distributable net income or undistributed net income of such other trust." Treas. Reg. § 1.665(e)-1A(b) (1972); *see* I.R.C. § 643(b) (1982); Treas. Reg. § 1.643(b)-1.

138. *See supra* notes 115-22 and accompanying text.

139. Treas. Reg. § 1.665(e)-1A(b) (1972). *See* I.R.C. § 643(b) (1982); Treas. Reg. § 1.643(b)-1. Except for income in respect of a decedent under § 691 and unrealized accounts receivable assigned to the trust, amounts received from an estate, for which § 661(a) allowed the estate a deduction, are not outside income items. Neither the Code nor the Regulations attempt specific definition of "income in respect of a decedent" (IRD). *See* Treas. Reg. § 1.691(a)-1(b), T.D. 6808, 1965-1 C.B. 257. Cases have referred to the concept in a variety of ways, including: items that would have been taxable as income to the decedent had he lived to receive them, *see, e.g.*, Estate of Davison v. United States, 292 F.2d 937 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961); items "accrued" in broad, not technical, sense at death, *see, e.g.*, Estate of Riegelman v. Commissioner, 253 F.2d 315 (2d Cir. 1958); and items attributable to activities of decedent during his lifetime and not to activities of the estate or beneficiary, *see, e.g.*, Keck v. Commissioner, 49 T.C. 313 (1968), *rev'd*, 415 F.2d 531 (6th Cir. 1969). A legally enforceable right to items by decedent is not a prerequisite. *See* O'Daniel's Estate v. Commissioner, 173 F.2d 966 (2d Cir. 1949). *See generally* M. FERGUSON, J. FREE-

A trapping distribution from an estate to a simple trust that does not include either of the two designated types of "outside income" will not occasion a throwback calculation upon a later distribution from the simple trust. The simple trust, therefore, can become the permanent taxpayer with respect to the accumulated amount of trapped DNI received from the estate. The uncertainties inherent in the throwback contingencies do not affect the estate executor's ability to employ effectively the trapping distribution strategem. The ability of an estate to make trapping distributions results in a clear advantage in comparison to the same distributions made by a revocable trust.[140]

IV. CONCLUSION

The nontax advantages of the revocable trust doubtlessly justify its popularity as an estate planning technique. Perhaps in part due to the realization that these advantages are not tax-related, estate planners popularly perceive the revocable trust as essentially "neutral" from a tax perspective, upon establishment and during administration for the periods prior to and following the grantor's death. Under this perception, the revocable trust seems to be an innocuous alternative to disposition by will.

The purpose of this Article has been to examine this percep-

LAND, & R. STEPHENS, *supra* note 67, ch. 4. The Code taxes IRD upon receipt by the estate or other beneficiary unless the recipient transfers the right to IRD prior to the receipt. I.R.C. § 691(a)(2) (1982). The income retains the same character in recipient's hands that it had in decedent's hands. *Id.* § 691(a)(3); Rev. Rul. 64-150, 1964-1 C.B. 448 (sick pay). The Code allows the recipient income tax deductions for estate tax attributable to IRD. IRD does not receive new basis at death. I.R.C. § 1014(c) (1982).

140. When the estate planner makes a decision to utilize a revocable trust as the primary dispositive instrument, the planner may avoid the disadvantage regarding trapping distributions by the interim revocable trust to its subsidiary trusts by first "pouring up" income into the probate estate. If the estate planner does this, the distribution from the trust to the estate could permit the use of the estate as a separate taxable entity and could "cleanse" the income so distributed of its throwback taint. No judicial authority exists that clarifies whether a "pour-up" distribution from a revocable trust to an estate carries DNI from the trust to the estate. In order for a "pour-up" to carry out DNI to the estate, a "distribution" must occur. Not all transfers, of course, are "distributions." A transfer of property from the revocable trust to tbe estate in response to the exercise of a power by the executor to demand assets for payment of taxes, debts, and administration expenses is probably not a "distribution" and, therefore, would not carry out DNI. The demand right, however, could make the estate subject to income tax liability for the interim trust's taxable income, including capital gains, under the grantor trust income tax rules of § 678, resulting in a similar "cleansing" of the trust's income. If, however, transfers are made as a result of the exercise of the trustee's discretion to sprinkle income among certain beneficiaries including the estate, the IRS should view the estate as a beneficiary of the trust, receiving income distributions that transfer DNI to the estate.

tion. Having done so, it is apparent that the perception is at once both correct and incorrect. With few significant exceptions, a transfer of property to a revocable trust yields, during the grantor's lifetime, only subtle differences in tax consequences from those that would have resulted had the grantor retained individual ownership of the trust property. During the period following the grantor's death, however, many significant differences exist between the results obtainable had the trust not been established and the tax results stemming from disposition through revocable trust. The use of the revocable trust as the principal dispositive instrument in the estate plan based upon the assumption that the tax consequences do not differ materially from those obtainable through testamentary disposition is inappropriate, for the assumption is erroneous and the consequences are potentially serious.

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