

The Intersection of Income In Respect of a Decedent, The Separate Share Rule and Making Charitable Bequests – Be Sure To Look All Ways Before Crossing

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INTRODUCTION

Post-mortem income tax planning relies on a number of concepts, including income in respect of a decedent, the separate share rule and the charitable deduction allowable to an estate for fiduciary income tax purposes. In addition, effective post-mortem income tax planning is often dependent on planning actions and documents executed by the decedent during his or her lifetime. This article will review an estate planning situation in which these separate principals converged and discuss the planning steps taken to best effectuate the client's testamentary intent in a tax-advantaged manner.

OVERVIEW OF INCOME TAXATION OF ESTATES

A brief introduction as to how an estate's income is subject to taxation is appropriate to understand the tax implications planned for in this article. Subchapter J of the Internal Revenue Code ("IRC" or "Code") governs the income taxation of trusts and estates. Subchapter J draws from various income tax concepts in providing the income tax rules for trusts and estates.²

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² In most respects, Subchapter J imposes similar rules on the income taxation of estates and trusts. However, as this is a review of a plan for post-mortem fiduciary income tax savings, the article will usually refer to the income tax rules as they apply to the income taxation of estates.

Subchapter J indicates that the general rules of the Code apply to the income taxation of an estate unless Subchapter J specifically provides otherwise. As a result, the income taxation of an estate starts with the basic concepts of income, reduced by deductions and exemptions, to calculate the estate's tentative taxable income to which any available credits are applied to determine the estate's income tax liability.

One of the primary distinctions between income taxation of an individual and income taxation of an estate is the availability to an estate of a deduction for income distributions made during the estate's fiscal year frequently referred to as a distribution deduction.³ The purpose of the distribution deduction is to allow an estate to distribute its income, and the corresponding income tax liability, to the beneficiaries of the estate.⁴ The result of the distribution deduction is to tax the income of an estate as a hybrid; to the extent that an estate distributes its income to its beneficiaries, it is merely a pass-through entity for income tax purposes similar to a partnership.⁵ However, to the extent that an estate does not distribute its income to its beneficiaries, there is no distribution deduction available and the estate will be its own taxpayer and must calculate and satisfy its own income tax liability.

³ Another difference between an estate and an individual taxpayer is that an estate is permitted to elect a fiscal year where an individual cannot. An important distinction between the income taxation of trusts and the income taxation of estates is that most trusts cannot elect a fiscal year and must use a calendar year similar to an individual. See IRC Section 644.

⁴ It should be noted that the distribution deduction is not elective.

⁵ As with a partnership, an estate will still be required to file a fiduciary income tax return (Form 1041) if its gross income exceeds the exemption amount of \$600, even if all of its income has passed through to the beneficiaries. The Form 1041 will include Schedules K-1 issued to the beneficiaries to provide them with the income tax consequences of the distributions which they have received from the estate.

DISTRIBUTABLE NET INCOME

Distributable net income, commonly known as DNI, is defined by Code section 643. Essentially, DNI is the amount of income that can be distributed to the beneficiaries of an estate or trust, and is computed by calculating the taxable income of the entity without considering any deduction for distributions or personal exemption, nor any capital gains or losses.

DNI is a key concept since it will be the maximum amount that will qualify for the distribution deduction under section 651 or section 661 of the IRC.⁶ This is essential since, as discussed above, the effect of the distribution deduction is that it transfers the income tax consequences from the estate to the beneficiary.

There are certain rules that need to be observed in reporting DNI:

- Under section 663(a), no DNI is carried out of an estate by a distribution of either a specific bequest, or a general legacy that is properly paid in not more than 3 installments;
- DNI is usually carried out of the estate by distributions to residuary beneficiaries. These distributions can be of either “income” or “principal”;⁷ and
- The allocation of DNI among beneficiaries is provided for and discussed fully in the Treasury Regulations (hereinafter “Treas Reg”) promulgated under Section 661.

⁶ Section 651 allows for a distribution deduction for simple trusts (trusts that must distribute all of its income on an annual basis). Section 661 allows for a distribution deduction for complex trusts (all non-simple trusts) and estates.

⁷ In other words, the estate cannot change the tax effect of a distribution by characterizing it as a principal distribution, as opposed to an income distribution.

SEPARATE SHARE RULE

The separate share rule will apply if there are substantially separate and independent shares of an estate having more than one beneficiary. “Separate economic interests” exist where the economic interests of the beneficiaries are not interdependent. Some examples of separate shares include:

- A surviving spouse’s elective share if it shares in estate income.⁸ Treas Reg 1.663c-1(a);
- Any formula pecuniary bequest or formula marital deduction provision that shares in the estate’s income, or if it is not entitled to share in income, appreciation, or depreciation, is not required to be paid in more than three installments. Treas Reg 1.663c-4(b);
- A qualified revocable trust under IRC 645 will always be a separate share whether the section 645 election is or is not made. Such trust may itself be divided further into additional separate shares. Treas Reg 1.663c-4(a).

The separate share rule applies to the estates of decedents dying after August 5, 1997. Code Section 663(c). Treas Regs 1.663c(1)-(6) will also apply if the decedent died after December 28, 1999. If separate share treatment is applicable, it is not elective and the separate shares come into existence at the earliest moment that the fiduciary can determine that the separate shares exist.

⁸ If the elective share is not entitled to share in estate income, or in the appreciation or depreciation of value of estate assets, but is determined at the date of death, it is still a separate share. Treas Reg 1.663c-1(a).

The purpose of having the separate share rule apply to estates is to promote fairness in that a beneficiary does not get taxed on another beneficiary's income (i.e., a beneficiary can only be taxed on his pro rata share of estate income). Where there are separate shares, a fiduciary may use any reasonable method of making the allocations, valuations and calculations required by the regulations.⁹ Although deductions and losses are generally allocated on a pro rata basis, deductions and losses are to be allocated separately if they can be identified with a particular share. Treas Reg 1.663c-1(b)(5).

DNI is calculated separately for each separate share, and the estate's gross income is allocated in accordance with the income to which each share is entitled under either state law or the governing instrument. As separate shares are used for purposes of allocating DNI, it is questionable whether a specific bequest can be a qualified separate share since, as discussed above, DNI is usually not allocated to a specific bequest.¹⁰

CHARITABLE DEDUCTION FOR FIDUCIARY INCOME TAX PURPOSES¹¹

As discussed above, an estate is a taxpayer which must report its income and deductions on a timely filed fiduciary income tax return and pay any applicable income tax. Although Code

⁹ Any allocation of income to charity is governed by 642(c), not the separate share or DNI rules. Treas Reg 1.663c-5) Ex. 11

¹⁰ This will be an important point in our planning later in this article.

¹¹ Although this article will focus on the post-mortem income tax planning issues, it is important to recall that there is also a separate charitable deduction permitted for estate tax purposes so long as the bequest meets the requirements of the IRC. As a general rule, a charitable deduction for estate tax purposes will be allowed if the bequest passes to a qualified charitable organization in a qualifying manner. Although this can raise complicated issues, for purposes of this article the charitable deduction for estate tax purposes will be available to the estate as the organization qualifies for the deduction and the bequest is an outright gift.

Section 170 governs the charitable deduction permitted to individuals on their personal income tax returns, Subchapter J supersedes these rules for the charitable deduction available to trusts and estates for use on their fiduciary income tax returns.

It is important to note that an income tax deduction is permitted only if the charitable organization which receives the distribution is a permissible beneficiary under the terms of the governing instrument.¹² Further, the charitable deduction for income tax purposes is only available if the charity is receiving income from the estate. As a typical general legacy to a charitable organization is payable from the principal of the estate¹³, there is no income tax deduction permitted by satisfaction of the bequest.¹⁴

INCOME IN RESPECT OF A DECEDENT

Income in Respect of a Decedent, frequently known as IRD, is income that the decedent was entitled to receive at the time of his death. Some examples of IRD include:

- unpaid salary;
 - retirement plan benefits;
 - dividends that were declared but not paid prior to the decedent's death;
- and

¹² As a charitable organization cannot receive a distribution under the intestacy laws, it is presumed that the decedent's Will is the governing instrument. However, the analysis herein should be equally applicable to situations where the estate plan utilizes a revocable trust with a pourover Will.

¹³ An example of the legacy contemplated is "I leave the sum of Ten Thousand Dollars to Qualifying Charitable Organization".

¹⁴ Of course this bequest may provide a charitable deduction for estate tax purposes as discussed above.

- interest due to the decedent (including accrued interest on U.S. Savings bonds if not reported by the decedent prior to her death).

IRD is governed by Code section 691. Assets which fall within the definition of IRD are both includible in the gross estate for estate tax purposes of the account owner and also constitute taxable income to the recipient.

The growth in popularity and value of Individual Retirement Accounts and similar arrangements has increased the importance of appropriate planning for clients who have assets which will constitute IRD. Often the technique for dealing with assets that will constitute IRD is to plan so that the income can be spread out over as long a period as possible to avoid bunching of income in a particular year and continued tax deferred growth where possible.¹⁵ Another possible use of IRD assets in a tax-advantaged manner is to use such assets to satisfy the client's charitable inclinations since, if properly done, both an estate tax deduction may be available and there will be no income tax consequences.¹⁶

An estate will have to pay income tax on IRD items on the cash basis (i.e., once the income is collected). As a general rule of income tax planning, taxpayers seek to avoid or defer income tax where possible which creates one possible goal of estate administration to avoid accelerating IRD. However, an executor may choose to accelerate IRD as part of a post-mortem

¹⁵ When estate planning for retirement benefits, it is essential to understand the minimum distribution rules which will apply both to the client during their lifetime and the rules that will govern the distributions to the proposed beneficiaries after the death of the client.

¹⁶ If a charity is the designated beneficiary of an IRD asset, the estate will have no income on the collection of the asset as the estate does not receive the income. Further, the charity will not have to pay income tax on the receipt of the IRD item.

tax plan if there are expenses being paid in a particular taxable year that would qualify as deductions and it is in the best interest of the estate to offset these deductions with income.

Often the best planning for minimizing IRD takes place during the estate planning stage before the decedent's death. However, there are certain post-mortem planning opportunities that an estate may use depending on the type of IRD involved. We will quickly review a few techniques:

1. Savings Bonds – An estate can elect to report the accrued interest not previously reported on the decedent's final personal income tax return. This may have the advantage of the interest being taxed at a lower rate, or providing income to utilize deductions and exemptions that might otherwise go unused.
2. Retirement Accounts
 - a. Pre-death: Analyze whether the client may be better served by reducing or foregoing a contribution to a retirement plan, and instead make a gift of the after-tax dollars to the beneficiaries. Additionally, beneficiary designations may be helpful in many instances.
 - b. Post-death – It may be in the interest of the beneficiaries of retirement accounts to withdraw the balances over the period of time allowed by law, as opposed to withdrawing the entire amount immediately after the decedent's death.
3. Disposition of IRD Items at Death – Consider specifically bequeathing IRD items to beneficiaries in lower income tax brackets, or to a tax exempt entity, especially

when the client has charitable desires. It may reduce the overall income tax bite to the estate and its beneficiaries.¹⁷

There are special problems regarding assets which constitute income in respect of a decedent (“IRD”) and the separate share rule. IRD items are allocated among the separate shares that could potentially be funded with the IRD amounts, whether or not such shares would otherwise participate in income.¹⁸ This allocation is made pro rata, based on the relative value of each share.¹⁹ This allocation of IRD could shift income tax liability to trusts otherwise protected from estate tax or GSTT by the use of the decedent’s exemptions. As such, it is suggested that a draftsman consider inserting language to limit the possible recipients of IRD items.

CLIENT SITUATION

The author was retained by an estate planning client with the following characteristics:

- The client has sufficient assets to create estate tax liability under current law;
- Much of the client’s assets were various retirement accounts that will constitute IRD to her estate or its beneficiaries upon her death;
- The client’s primary beneficiaries are her siblings:

¹⁷ This technique may also be helpful to avoid certain consequences of the separate share rule discussed above.

¹⁸ In other words, if a separate share could be funded with an IRD item, then it will be deemed to receive a pro rata share of the income generated by the IRD item whether or not it actually receives the IRD items.

¹⁹ Treas Reg 1.663c-2(b)(3).

- The siblings are not financially wealthy and are expected to immediately liquidate any IRD items left to them and pay the associated income tax liabilities;
- The client wishes to leave her siblings their interests outright and free of trust;
- The client serves on the board of a charitable organization and wishes to make a significant bequest of a specific dollar amount to the organization under the terms of her estate plan (the client also wants to retain the ability to change the amount of the gift should she resign from the board).²⁰

ANALYSIS²¹

As the client wishes to reserve the right to alter the amount of the charitable bequest, the assets to be used to satisfy the bequest will need to be included in the client's gross estate for estate tax purposes. This is not of great concern since the estate will be entitled to an offsetting charitable deduction for estate tax purposes as the gift will be an outright gift to a qualifying organization.

As part of the overall estate plan, it is also a goal to lower the ultimate fiduciary income taxes that will ultimately be payable by the client's estate after her death. Fulfilling this goal will

²⁰ The charitable organization involved is a qualifying charity under the IRC and bequests to the organization made in proper form will qualify for charitable deductions for both estate tax and income tax purposes.

²¹ The analysis will only examine the planning of the intended charitable bequest and not other issues raised by the client and her wishes.

reduce the administration expenses of the estate, and correspondingly increase the amount ultimately receivable by her residuary beneficiaries. In light of this goal, there are potential fiduciary income tax savings to be gained if the retirement accounts, which will constitute IRD, are used to satisfy the charitable bequest.

The client consulted with her financial institution to obtain copies of her existing beneficiary designations and their current beneficiary designation forms. Upon review of the client's IRD assets, it was determined that her existing beneficiary designation should be changed to achieve the result. Unfortunately, the following complications occurred in consulting with the financial institution²²:

- The institution required a percentage and would not permit a designation which allowed the three siblings to each receive one-third;
- The institution's designation provided that the share of a predeceased designated beneficiary would be payable to the surviving designated beneficiaries and not the issue of the predeceased beneficiary;²³
- The institution would not permit the gift of a specific dollar amount to the charitable organization on the beneficiary designation form.²⁴

²² For purposes of this discussion, we will ignore whether the financial institution could be compelled to honor a beneficiary designation that could be created to achieve the client's precise wishes as the client did not want to risk the possibility of the institution failing to honor such a designation after her death, nor the cost of potential litigation to compel the institution to accept the designation.

²³ It was the client's intent that the issue of a sibling who predeceased her receive their parent's share. This is consistent with the rest of the estate plan given the effect of the New York anti-lapse statute.

²⁴ The client was unwilling to give a percentage of the account to the charitable organization in fear that the account would be worth significantly more or less at the time of her death than its current value, resulting in a distortion of her intended estate plan.

Given the facts and circumstances, and after further consultation with the client who did not wish to change financial institutions, a course of action was agreed upon that would have the retirement accounts payable to the estate as the designated beneficiary.

This beneficiary designation in favor of the estate does not impact any potential estate tax liability as the assets will be included in the decedent's gross estate for estate tax purposes regardless of who the designated beneficiaries are by virtue of the client's ability to change the designated beneficiary. Further, the usual concerns on deferring the income tax to the beneficiaries and allowing them to continue the tax-deferred growth are not applicable in this situation given that her siblings intend to immediately liquidate the retirement accounts. As such, there are no negative income tax consequences by having the IRD assets payable directly to the estate. Therefore, there are no negative tax consequences of the proposed beneficiary designation.

Although there are no negative tax consequences of the proposed beneficiary designation, there are certain potential non-tax consequences including:

- As the estate will be the beneficiary, only a properly appointed fiduciary of the estate will be able to collect the IRD assets. This may result in a delay to the ultimate beneficiaries who would otherwise have been able to collect the assets by providing a copy of the decedent's death certificate to the financial institution.
- As the assets are payable to the estate, they will be subject to the claims of the creditors of the decedent's estate. Depending on state law, this may expose these assets to such claims where they may not have been otherwise.

- As the assets will be subject to administration, it may increase the administration expenses of the estate under state law, including executor commissions, attorney fees and court filing fees.

It is important to note that, when the estate collects the IRD assets, a Form 1099 will be issued to the estate and the income will be includible in the estate's fiduciary income tax return in the appropriate fiscal year. As such, we still needed to plan for the goal of obtaining the charitable deduction for the bequest to the charity in the same fiscal year in which the income will be reported.²⁵

As discussed above, a traditional general legacy does not provide a charitable deduction for fiduciary income tax purposes as it is payable from principal. Further, under the separate share rules and concepts of DNI, it is unlikely the estate could take the position that the charitable bequest was satisfied with the IRD items. After further consultation with the client, it was agreed that the Will would contain an instruction to the Executor to satisfy the charitable bequest from IRD assets first, and from non-IRD assets only to the extent that the IRD assets are insufficient to fully satisfy the bequest.²⁶ This approach should permit the Executor to take a charitable deduction to offset some of the income recognized by the estate in the year the IRD item is collected, thereby reducing the estate's taxable income appropriately for that fiscal year and obtaining the desired charitable deduction.²⁷ Although the author is unaware of any

²⁵ If the timing of the income and deduction are mismatched, the result could negate much, if not all, of the benefit of the income tax deduction to the estate and its beneficiaries.

²⁶ Based upon the client's existing asset mix, it is extremely unlikely that the IRD assets will be insufficient to satisfy the charitable gift.

²⁷ As the charitable deduction is generally available in the fiscal year in which the distribution is made to the charitable organization, subject to certain exception, the author believes that the Executor should insure that the distribution to the charity is made in the same fiscal year that the

precedent which would bind the Internal Revenue Service to allow the charitable deduction, the author proposes that this is the appropriate result based upon the facts and circumstances present.

CONCLUSION

As with most estate planning, it is most effective to begin the planning process prior to the client's death. If the estate planning documents are not drafted appropriately, there may be negative tax consequences that cannot be cured after the client's death.

IRD asset is collected by the estate. This can be done through the timing of collection of the asset and the selection of an appropriate fiscal year.