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Richard E. Thigpen

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INCOME TAX PRECAUTIONS

RICHARD E. THIGPEN*

When the portal of death closes upon an income taxpayer, he may rest in peace but his executors, trustee or beneficiaries may encounter problems of income tax that the lamented decedent may well have provided against. The testator's intentions (both good and bad) should be ascertained from him during life and clearly expressed in his will, to be published by probate after his death.

"Income tax precautions" means forethought in estate planning, not simply to reduce estate and inheritance taxes but to provide the most undiminished income for the beneficiaries of the estate. In order to chart the course of an estate, counsel must be given full and adequate information as to the testator, his property, the objects of his bounty, and provisions made for his beneficiaries by way of *intervivos* trusts or life insurance.

1. *The Testator.*

What are his family and dependent obligations?

What is the status of his business interests? Is he a sole proprietor, a partner, or an officer-stockholder? If a sole proprietor—could the business be continued or must it be liquidated? If a partner—death dissolves the partnership, and what provision is made for the transfer of his interest to surviving partners, or for his interest continuing? If an officer-stockholder, must his stock interest be sold, either to the corporation or surviving stockholders?

What amount of his income is derived from transferable assets? (Stocks, bonds, etc. as contrasted with personal services).

What are the settlement provisions with respect to the proceeds of life insurance?

2. *The Testator's Property.*

What kind of property does he own?

When did he get it and what did it cost? How was it acquired?

What is the present fair market value?

Generally, under Section 113 (a) (5) of the Internal Revenue Code, the basis of "property transmitted by death" is the fair market value at date of death or at the optional valuation date, one year after death. The problem of valuation is simple with respect to listed stocks and bonds. The valuation of closely held stocks may be troublesome, but here, as in real estate valuations, competent appraisals are most useful.

* Member of the Charlotte North Carolina Bar.

If the estate contains commercial, developed real estate, acquired by the testator at a low cost, the valuation at death, if higher would give the devisees of the real estate a stepped-up basis for depreciation and subsequent gain or loss. The appraisal by competent real estate men should make a reasonable allocation of the value between the land and the buildings. Obviously, the retention of such property by the testator so that it is transmitted at death gives his devisees a higher basis for depreciation and subsequent gain or loss, than the intervivos gift of the property to his donees, because the basis of property acquired by gift is "the same as it would be in the hands of the donor . . . except that if such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value."

Section 366 of the Revenue Act of 1948 amended section 113 (a) (5) of the Internal Revenue Code so that "community property held by the decedent and the surviving spouse under the community property laws of any State" shall be treated as property transmitted at death, and therefore take as its basis the valuation at death (or one year later if the optional valuation is used), provided "one-half of the whole of the community interest in such property" is included in the decedent's gross estate. But since North Carolina is not a community property state, this provision does not affect the surviving spouse's interest in an estate by the entirety. The full value of an estate by the entirety is included in the gross estate of the testator, except to the extent that the surviving spouse can prove that she paid for some or all of the property. Without such proof, the basis of the property in the hands of the surviving spouse, is the original cost of the property. Under Federal law, an estate by the entirety, includible in the deceased spouse's gross estate at a valuation of \$100,000, but which cost the spouses only \$10,000, would have the \$10,000 cost basis to the surviving spouse. If the surviving spouse sells the property for \$100,000, there would be a taxable gain of \$90,000 with a capital gains tax of \$22,500.

Survivorship in joint tenancies has long been abolished in North Carolina¹ but joint tenancies have not been abolished, and the joint tenants may enter into a contract vesting the property in the survivor. A common example is the purchase of stock or bonds in joint tenancy with direction that the survivor became the owner of the property. Assume that joint tenants acquired property, which at the death of one had a fair market value of \$100,000, and a cost of only \$20,000. The basis in the hands of the survivor would be \$20,000 and upon a sale shortly after the death of one joint tenant, the survivor realizes a taxable gain of \$80,000 and is liable for a tax of \$20,000 under Federal Law.

¹ N. C. GEN. STAT., §41-2 (1943).

Prior to the Revenue Act of 1948 joint tenancies and estates by the entirety had some advantages, enabling the splitting of income from such tenancies. But now, certainly income tax-wise, there is no justification for such tenancies which may indeed prove costly to the survivor.

3. *The Objects of the Testator's Bounty.*

The natural objects of testator's bounty will be his wife and children or grandchildren.

What are their ages, business experience, and other income?

This information should indicate the type of disposition to be made of his property.

Upon his death a new taxpayer, the estate, comes into being. If the wife has no sufficient income, it might be well to provide that income during the period of administration shall be distributed to her. If there are minor children, the widow will doubtless use some of the income for their support, but if the income is paid to her, it will be taxed to her. The testator could well direct that the income be paid to each child, and thereby provide more taxpayers with less aggregate income tax than if all the income, during administration, went to the widow.

It is to be noted that title to real estate vests in the devisees at death, and hence income therefrom belongs to the devisees, unless the testator makes real estate available for the payment of debts and directs otherwise.

Another problem incident to the period of administration is the matter of executor's commissions. Such commissions are deductible in determining the decedent's gross estate, and such commissions constitute taxable income to the executor. If the executor is an individual to whom the testator would make a bequest, the testator should consider and weigh the probable saving in estate and inheritance taxes, against the probable income tax upon the commissions received by the executor. If the testator determines that the reduction in estate and inheritance taxes is more important, then he should direct the payment of commissions or compensation to the executor. But if the will is silent as to the executor's compensation and he renders his services free of charge, he has realized no taxable income. But in any case where no commissions are actually paid there would be no deduction in determining the net estate.

The executor may be forced to sell certain assets, thereby realizing taxable gain, or sustaining a loss, during the period of administration. This necessity may come about as the result of the common practice of making bequests in money instead of portions or percentages of the estate, and from not authorizing distributions in kind. In *Kenan v.*

Commissioner,² the Second Circuit Court of Appeals held that where under the terms of a will, trustees were obligated to pay a fixed sum of money to a beneficiary, and, as was permissible under the will, made the prescribed payment partly in cash and partly in securities, the trustees were taxable on the gain realized from the appreciation in value of the securities.

The lives of testators do not conform to the same pattern, particularly as to the number, capacity and needs of their beneficiaries. Income splitting by husband and wife terminates with the death of either spouse—but that same income (if derived from transferable property) may be split more than two ways and reduce the income tax burden. Perhaps the best way is to provide multiple trusts, with definite provision for the distribution and accumulation of the income. In contemplating such multiple trusts, full consideration should be given to income of beneficiaries from intervivos trusts or proceeds of insurance, as well as the earning capacity of individual beneficiaries. If the testator's son, for example, is already a man with substantial income, the son might prefer to have some or all of his interest go to his children (the testator's grandchildren), with lower tax rates applied to such income.

Testamentary trusts may be advantageously used, with income tax economy. The accumulation of income in the trust, under the terms of the will, restricts the tax to the trust, which has only a \$100 exemption. The distribution of the income to individual beneficiaries, each of whom has the \$500 exemption, will reduce the tax on the income from the trust—unless the beneficiaries are in high surtax brackets. The tax liability of the beneficiaries of a trust is determined by the amount of income distributable to them, which may be different from that actually distributed. If the beneficiary has the right to the income, it is nontheless taxable to him if he chooses to let the income accumulate in the trust. In the case of *Mallinckrodt v. Nunan*³ such accumulated income was taxed to the beneficiary, where

“by the terms of the trust instrument, the trustees could not distribute trust income to petitioner [beneficiary] except upon his request, and were obliged to add to trust corpus all undistributed net income at the end of each taxable year. The trustees were bound to abide by the exact terms and conditions of the trust instrument. By its terms trust income was not distributable to petitioner unless he elected to withdraw it by requesting that it be paid to him.”

So, for the sake of the beneficiary's income tax liability—beware of giving the beneficiary discretionary rights to income.

Where there is likelihood of expenses and losses to a trust, it may

² 114 F. 2d 217 (C.C.A. 2d 1940).

³ 146 F. 2d 1 (C.C.A. 8th 1945), *cert. denied*, 324 U.S. 871 (1944).

be wise to give the trustee power to allocate expenses or losses either to income or corpus for the purpose of obtaining the most favorable tax result. In a case where the fiduciary was given such discretionary power, the allocation was sustained and only the distributable income was taxed to the beneficiary; in *Thornton v. Commissioner*⁴ wherein the Tax Court said

“The distributable income of a trust is the amount which the trustee is required by the terms of the trust indenture or by decree of court to distribute to the beneficiary—the amount which is demandable by the beneficiary. Where the beneficiary does not have the power to demand distribution of the income, it is not taxable to him or her.”

As has been succinctly stated,⁵ “the two major principles of estate income tax planning to be applied are: (1) to create as many different taxpayers as possible in order to reduce the over-all surtax of the estate and heirs; and (2) to arrange for the distribution of taxable income to, or its retention by, taxpayers with the largest amount of income tax deductions.”

In conclusion, the ordinary estate will not present very difficult income tax problems; only the larger estates will justify full and ample consideration of multiple trusts and the resulting income tax upon the trusts and beneficiaries.

⁴ 5 T.C. 1177, 1185 (1945).

⁵ Friedman and Silbert, *Planning for the Income of an Estate and Its Heirs*, 17 *FORD. L. REV.* 1 (1948).