St. John's Law Review

Volume 4
Number 2 *Volume 4, May 1930, Number 2*

Article 25

June 2014

# Income Taxation of Estates and Trusts Under the Revenue Act of 1928

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# TAX COMMENT

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## INCOME TAXATION OF ESTATES AND TRUSTS UNDER THE REVENUE ACT OF 1928.

For income tax purposes an estate or trust is regarded as a tax entity and the taxes applicable to the estate or trust are the same as those imposed upon individuals.[1] While the term estate is used vaguely in the statute, specific reference is made to decedents' estates during the period of administration and it is the income received by such estates during this period that the law aims to subject to the tax.

The statute also aims to impose a tax upon the income on any property held in trust. The trustee as fiduciary is required to file a return of all the income received by the trust, as representative of the trust entity.[2] That portion of the income which is to be distributed to the beneficiaries is allowed as a deduction in computing the net income of the estate or trust and is taxable to the respective beneficiaries. But the trustee is taxed on all income which is to be accumulated or held for future distribution.[3] The remainderman or person ultimately entitled to receive the *corpus* of the estate or the accumulations of income will, of course, receive such fund or income tax free, since gifts or legacies are not taxable. In this way adequate provision is made in the law for avoiding the double taxation of the same fund or income.

Not all trusts are subject to tax. In the case of a revocable trust the tax is levied against the grantor on all the income of the trust regardless of who the beneficiary of the income may be, provided the grantor has the right to revest in himself title to the *corpus* or the income.[4] The income in this case is deemed to be a gift to the beneficiary. Similarly the income of a trust created to provide for the payment of premiums on insurance policies on the lives of the grantors (insurance trusts) would be taxable to the grantor.[5] The income is deemed to be used for the benefit of the grantor.

In general, the net income of the estate or trust is determined in the same manner as that of an individual. In addition to the usual

[1] Rev. Act of 1928, Sec. 161; Bankers Trust Co. v. Bowers, 295 Fed. 89 (C. C. A. 2nd, 1923); Baltzell v. Mitchell, 3 F. (2nd) 428 (C. C. A. 1st, 1925); Nichols v. U. S. 64 Ct. Cl. 241 (1927).

[2] Taylor v. Davis, 110 U. S. 330, 4 Sup. Ct. Rep. 147 (1883).

[3] Rev. Act of 1928, Sec. 162; Reg. 74, Art. 861, Art. 1320.

[4] Rev. Act of 1928, Sec. 166; Reg. 74, Art. 881; Wharton v. Lederer, 24 F. (2nd) 233 (E. D. Pa., 1927).

[5] Rev. Act of 1928, Sec. 167.

deductions permitted an individual, the estate or trust may, in arriving at the net income subject to tax, deduct all income paid or permanently set aside pursuant to the terms of the will for charitable purposes; and also, as has been indicated, income to be distributed currently by the fiduciary to the beneficiaries. In the latter case, such deductions must be included in computing the net income of the beneficiaries whether the income is actually distributed to them or not.

The type of trust referred to above should be distinguished from a type formed for purposes of business or investment and for conducting business activity. Such trusts may be classified as associations and these are taxed as corporations. The test employed to determine the taxability of such organizations as individuals or corporations is whether or not such organizations are engaged in doing business in *quasi*-corporate form. In the former case they are deemed to be associations to be taxed as corporations.[6] A discussion of the problems arising with respect to this type of trust is not within the scope of the present article. It is the decedent's estate and true trust that concern us in this discussion.

Upon the death of a decedent, one tax entity ends and a new one begins. The personal representative of the decedent is required to file a return for the taxable year of the decedent that ended with his death.[7] The estate itself for the period of administration becomes a separate entity and is liable for tax on all its income. The Regulations [8] consider an estate to be in the process of administration during the period required by the executor to perform the ordinary duties pertaining to administration. While the trust estate usually commences after the termination of the period of administration it is possible for both the executor and trustee to be functioning at the same time, in which event there are two separate taxable entities, each one subject to tax on the income separately received by it.[9]

The most important effect of decedent's death from the point of view of income tax liability is that all the property and rights of decedent are capitalized.[10] The value of the property at the time of the death of decedent thus becomes the basis for determining future gain or loss [11] and any appreciation in the value of such property as of the date of death over the cost to the decedent escapes income taxation altogether. Items of income such as interest or dividends collected by the estate are considered capital if they accrued before decedent's death and income of the estate if accrued subsequent to

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[6] Reg. 74, Art. 1314; Hecht v. Malley, 265 U. S. 144, 44 Sup. Ct. Rep. 462 (1923); Hemphill v. Orloff, 277 U. S. 537, 48 Sup. Ct. Rep. 577 (1928); White v. Hornblower, 27 F. (2nd) 777 (C. C. A. 1st, 1928).

[7] Reg. 74, Art. 741.

[8] *Ibid.* Art. 863.

[9] Titusville Trust Co., 3 B. T. A. 868 (1926).

[10] Nichols v. U. S., *supra* Note 1.

[11] Rev. Act. of 1928, Sec. 113a (5).

his death.[12] Where decedent reports his income on a cash basis, such income escapes income taxation entirely. The effect of treating assets of the estate as capital for estate tax purposes is to limit the liability of the estate for income tax on items commonly considered as income. In the case of a decedent's interest in a partnership, money due up to the date of death is not income but part of the *corpus,* but where the partnership agreement provides for the continuation of the business beyond the date of death, money earned after the date of death becomes income of the estate.[13]

In the case of property sold by the estate, a resulting gain will be considered taxable income. Whether there has been a gain will be determined by the value of the property at the time of decedent's death regardless of a possible enhancement in value up to the date of death. Furthermore in the case of such sales the estate may avail itself of the capital net gain provisions [14] to limit the tax, and the two-year period during which a taxpayer must hold such property to take advantage of the tax on capital assets commences with the date of decedent's death.

While the valuation of an estate for the purpose of estate taxes is considered the basis for determining subsequent gain or loss for income tax purposes, in the case of intangible assets this valuation may be recognized by the Treasury Department as merely an estimate. If such estimate is subsequently shown to have been erroneous, the courts will permit the income tax liability to be considered without regard to the Federal Estate Tax.[15] A right to revise the Estate Tax exists in the government.

Where property has been distributed by the executor to the trustee and then sold by the trustee, any gain or loss is measured by the difference between the selling price and the value of the property at the date of decedent's death, and the value of the property at the date of distribution to the trustees has no effect on such gain or loss.

Except for the deductions allowed in connection with charitable contributions and with payments of income to beneficiaries, allowable deductions are generally the same as for individuals. Expenses arising from the operation of trust property are clearly deductible from the income of the trust, but in the case of estates, expenses of the estate present special problems. For example, expenses of administration of an estate are not allowable deductions,[16] but are chargeable to the *corpus* of the estate. This would include attorneys'

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[12] *Supra* Note 8; also U. S. v. Carter, 29 F. (2nd) 121 (C. C. A. 5th, 1927); Safe Deposit & Trust Co. of Baltimore v. U. S., 64 Ct. Cl. 697 (1927); *In re* Frank, 6 B. T. A. 1071 (1927).

[13] *Supra* Note 8; also Bull, 7 B. T. A. 993 (1927); Brown, 10 B. T. A. 1036 (1928).

[14] Rev. Act of 1928, Sec. 168; Reg. 74. Art. 863; Bankers Trust Co. v. Bowers, 23 F. (2nd) 941 (S. D. N. Y., 1928). *Contra* McKinney v. U. S., 62 Ct. Cl. 180 (1926).

[15] U. S. v. Carter, *supra* Note 12; Reg. 74, Art. 595.

[16] Reg. 74, Art. 282.

fees, executors' commissions and the other expenses commonly recognized as affecting the *corpus* of the estate. However, such expenses as are incurred by the estate in the management of its property for income-producing purposes are allowable deductions from gross income.[17] Where deductions are allowed only to the estate or trust, beneficiaries cannot utilize such deductions to reduce their own income.[18]

If the trust is viewed as a business being carried on by the trustee, then it is evident why the commissions of the trustee should be considered as an ordinary and necessary expense in the operation of the business of the trust.[19] Not so, however, with the estate administered by the executor. Here the functions of the executor may be twofold, being partly to administer the estate with a view to the distribution of the assets among the beneficiaries and partly to manage and operate the property so as to produce income. The commissions to which the executor would be entitled on such income are allowed as a deduction from gross income of the estate.[20] Attorney's fees would be similarly apportioned, those in payment of services rendered in connection with the activities of administration being charged against the *corpus,* and such fees as were paid for services applicable to the management of estate property being allowable as deductions.[21]

The deduction for taxes presents several problems. In general estates may deduct taxes. The Federal Estate tax may be deducted by the estate only, and state inheritance taxes, whether imposed upon the right of the decedent to transmit the property or on the right of the beneficiary to receive it are similarly deductible only by the estate.[22] The problem of when the estate tax may be deducted depends upon whether the estate reports on the cash or accrual basis. In the former case it is deductible in the year when paid; in the latter case it is deductible when due and payable one year after decedent's death, this being the date the estate taxes accrue.

A bad debt in the form of an uncollectible account is an allowable deduction to the estate and the statutory net loss provisions permitting a tax-payer to deduct such net loss over a period of two successive years are available also to estates and trusts.[23]

With respect to the deductions for depreciation and depletion, in the case of estates only the fiduciary may take the deduction; in the

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[17] Hansen, 6 B. T. A. 860 (1927); Seligman, 10 B. T. A. 840 (1928).

[18] Baltzell v. Mitchell, *supra* Note 1; Cadman v. Miles, *infra* Note 30.

[19] Bendheim, 8 B. T. A. 158 (1927).

[20] Mead, 6 B. T. A. 752 (1927).

[21] Seligman, *supra* Note 17.

[22] Rev. Act of 1928, Sec. 23 (c); Reg. 74, Art. 154; U. S. v. Woodward, 256 U. S. 632, 41 Sup. Ct. Rep. 615 (1920); Keith v. Johnson, 271 U. S. 1, 46 Sup. Ct. Rep. 415 (1925); U. S. v. Mitchell, 271 U. S. 9, 46 Sup. Ct. Rep. 418 (1925).

[23] Rev. Act of 1928, Sec. 169.

case of trusts, the deduction may be apportioned as between the beneficiaries entitled to the income and the trustees holding the *corpus* for the remainderman.[24] As in the case of the computation of gain or loss, the basis for calculating depreciation is the value of the property on the date of decedent's death.[25]

Charitable bequests are deductible without limitation by the estate or trust,[26] if such amounts are paid or permanently set aside during the year for such charitable purposes.

Payments to beneficiaries are allowable deductions peculiar to estates and trusts,[27] the incidence of the tax falling upon the beneficiaries themselves with respect to such payments. The payments contemplated by the statute are distributions of income made or to be made currently; a distribution from the *corpus* being non-deductible and, of course, not taxable to the beneficiary.[28]

In the case of trusts, therefore, income which is not distributed is taxable to the fiduciary. In the case of estates, as a rule, all the income is accumulated during the period of administration and so taxable to the fiduciary. Where a gain results from the sale of property, it is taxable to the fiduciary if the gain is income to the remainderman. If the gain is income to the beneficiary, it is deductible from gross income of the estate and taxable to the beneficiary. Where the income is to be apportioned between the beneficiary and the remainderman then the incidence of the tax falls on both on the basis of the income apportioned to each.[29] The scope of this article makes the present treatment of the subject of accumulations and distributions of income necessarily general and meagre. The importance of this problem warrants a more comprehensive discussion.

A bequest of income is taxable as income and not exempt even though it is property acquired by the beneficiary by gift, bequest, devise or descent.[30]

In the case of beneficiaries who must account in their individual returns for income of the trust or estate distributable to them, such income retains its individual character and the beneficiary treats such income as if he himself had directly received it. Thus where a trust receives dividends on stock held by it, the beneficiary entitled to

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[24] *Ibid.* Sec. 23 (k) (1); Reg. 74, Art. 201; Heywood, 11 B. T. A. 29 (1928).

[25] Barnes, 8 B. T. A. 360 (1927).

[26] Bowers v. Slocum, 20 F. (2nd) 350 (C. C. A. 2nd, 1927).

[27] Rev. Act of 1928, Sec. 162 (B), (C); Blair v. Norton, 26 F. (2nd) 765 (C. C. A. 1st, 1928); Crocker *et al.* v. Nichols, 27 F. (2nd) 598 (D. C. Mass., 1928).

[28] Willcuts v. Ordway, 19 F. (2nd) 917 (C. C. A. 8th, 1927); Tyler, 9 B. T. A. 255 (1927).

[29] Erswell, 1 B. T. A. 1254 (1925); Whitcomb, 4 B. T. A. 80 (1925); Strecker, 6 B. T. A. 19 (1927).

[30] Irwin v. Gavit, 268 U. S. 161, 45 Sup. Ct. Rep. 475 (1925); Cadman v. Miles, 28 F. (2nd) 823 (C. C. A. 4th, 1928); Allen v. Brandeis, 29 F. (2nd) 363 (C. C. A. 8th, 1928).

any portion of such dividend income similarly treats the income as dividends and becomes entitled to the credit against net income allowed an individual in determining the amount to be subject to normal tax rates. Similarly exempt interest income received by the trust would also be exempt when distributed to a beneficiary.[31]

In this brief survey of the law with respect to the taxation of estates and trusts under the Revenue Act of 1928, no attempt has been made to go into the finer points that arise in connection with each individual estate. The general principles of the law as applicable to all estates and trusts have been indicated. Numerous provisions in the law attempt to safeguard the payment of taxes and the responsibility for such payment is fixed both upon the fiduciary and the beneficiaries.[32]

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EXCISE TAX—IMMUNITY OF GOVERNMENTAL INSTRUMENTALITIES.—Plaintiff, a business corporation organized under the laws of Massachusetts, owned a large number of United States Liberty Bonds and Federal Farm Loan Bonds together with bonds of Massachusetts counties and municipalities. The Commonwealth, in determining plaintiff's excise tax for the year 1926, included as a measure of determination, the interest earned from the federal, county and municipal bonds. After making payment of the tax under protest, plaintiff sought an abatement which was denied. Subsequently the constitutionality of the statute was upheld by the Supreme Judicial Court. On appeal, *held,* that the statute is unconstitutional in that the tax on the federal bonds is in derogation of the constitutional power of Congress to borrow money on the credit of the United States, as well as in violation of the Acts of Congress declaring such bonds and securities to be non-taxable and, as to the county and municipal bonds, it impairs the obligation of the statutory contract of the state by which such bonds were made exempt from state taxation. Macallen v. Massachusetts, 279 U. S. 620, 49 Sup. Ct. Rep. 432 (1929).

Of particular importance is this decision, not alone because of its tremendous effect in many jurisdictions, but also because of the trend of decisions prior to it. No one denies the validity of the statement that the Federal Government may not tax the income arising from the obligations of a state or any of its governmental subdivisions,[1] or that the states are without right to tax the instrumentalities of the

[31] Rev. Act of 1928, Sec. 163 (a), (b); Reg. 74, Art. 821.

[32] *Ibid.* Sec. 161 (b), 311, 312 (a), (b); Reg. 74, Art. 862; U. S. C. A. 31, Secs. 191, 192.

[1] Collector v. Day, 78 U. S. 113, 124-5 (1870); Pollock v. Farmers Loan and Trust Co., 157 U. S. 429, 583, 588, 15 Sup. Ct. Rep. 673 (1895).