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Tax Consequences of Equitable Adjustments

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TAX CONSEQUENCES OF EQUITABLE ADJUSTMENTS

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I. INTRODUCTION

The tax consequences of equitable adjustments are largely uncharted. Only one published tax decision has so far considered the issue. Nevertheless, it is arguable, by analogy to other litigated issues, that equitable adjustments produce income, gift, and estate tax consequences to the beneficiaries of estates, and in particular to beneficiaries who serve as executors.[1]

In recent years, discussions of equitable adjustments have become common.[2] Although unknown in many jurisdictions, eq-

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1. The fiduciary of an estate can be a male, a female, a corporation, or two or more individuals or corporations. For consistency of style and brevity of expression, this Article will use masculine nouns and pronouns to refer to this fiduciary.

2. R. COVEY, MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS (1984); E. SCOLES & E. HALBACH, PROBLEMS AND MATERIALS ON DECEDENT'S ESTATES AND TRUSTS 722-806 (3d Ed. 1981); Ascher, *The Fiduciary Duty to Minimize Taxes*, 20 REAL PROP. PROB. & TR. J. 663 (1985); Berall, *Practical Approaches to Avoiding or Making Equitable Adjustments*, ABA Section of Taxation, May 19, 1984 Meeting, Washington. D.C.; Blattmachr, *A Primer on the Effects of Equitable Adjustments*, 124 TR. & EST. 21 (June 1985). Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 INST. ON EST. PLAN. 14-1 (1984)[hereinafter cited as Blattmachr, *Tax Effects*]; Carrico, *Advanced Problems with Equitable Adjustments*, ABA Section of Taxation, Annual Advanced Study Sessions: Advanced Taxation of Income of Trusts and Estates (1983)[hereinafter cited as Carrico, *Advanced Problems*]; Carrico, *Equitable Adjustments and Related Professional Responsibility Problems in Estate Planning*, 37 So. CALIF. TAX INST. 191 (1985)[hereinafter cited as Carrico, *Equitable Adjustments*]; Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*, 36 TAX LAW. 545 (1983); Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 IOWA L. REV. 273 (1981)[hereinafter cited as Dobris, *Limits*]; Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms*, 65 IOWA L. REV. 103 (1979)[hereinafter cited as Dobris, *Equitable Adjustments*]; Moore, *Conflict-*

uitable adjustments have a long history in some states.[3] The need to make an adjustment arises when an executor, by making certain tax elections, breaches one of many fiduciary duties, often to comply with another duty having a higher priority. Typically, the election enriches one group of estate beneficiaries at the expense of another group.

Equitable adjustments first arose as a judicial reaction to the unfair consequences that arise from the breach of a fiduciary duty. An equitable adjustment allocates estate income to the disadvantaged beneficiaries to compensate for the inequity, even though the allocation is often contrary to state fiduciary accounting principles.

Two types of equitable adjustments, both derived from New York surrogate court cases,[4] are well established in some states—the Warms adjustment and the Holloway adjustment. The potential exists, however, for many other types. In approximately thirty-four states, equitable adjustments are not established by statute or by judicial precedent and are not in common practice.[5] Nevertheless, equitable adjustments are possible in most states.[6]

The setting for a Warms adjustment, one of the two common types of equitable adjustments, is easily illustrated. The executor of an estate can elect to deduct estate administration expenses as either estate tax deductions or income tax deductions.[7] If deducted on the estate tax return, the tax benefit of the deduction typically inures to the estate's principal beneficiaries. An election to deduct the expenses on one or more of the estate's income tax returns, however, transfers the tax savings of the deduction to the estate's income beneficiaries. Since estate administration expenses are generally paid out of principal rather than income, under applicable rules of fiduciary account-

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ing Interests in Postmortem Planning, 9 INST. ON EST. PL. 19-1 (1975); Moore, *Conflicts in Post-mortem Planning after the Tax Reform Act*, 12 INST. ON EST. PL. 6-1 (1978).

3. *See* Carrico & Bondurant, *supra* note 2, at 605-28.

4. *In re* Estate of Warms, 140 N.Y.S.2d 169 (Sur. Ct. 1955); *In re* Estate of Holloway, 67 Misc. 2d 132, 323 N.Y.S.2d 534 (Sur. Ct. 1971), *rev'd*, 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. 1972).

5. Carrico, *Equitable Adjustments*, *supra* note 2, at 19-7 to -8.

6. *See infra* notes 74-87 and accompanying text.

7. I.R.C. § 642(g).

ing,[8] an election to deduct the expenses on income tax returns shifts any benefit of the deduction away from the beneficiaries who bear the cost of the expense. An equitable adjustment, however, if made, restores the estate principal by reallocating estate income to the principal account. The other established equitable adjustment, a Holloway adjustment, will be explained in detail below.[9]

Equitable adjustments may produce income, gift, and estate tax consequences for estate beneficiaries and executors. If an equitable adjustment is owed, but not made, an income tax consequence may arise.[10] By contrast, if a beneficiary is due an equitable adjustment and does not assert his right to it, a gift may result.[11] If a beneficiary dies, the potential equitable adjustment may represent an asset of the new estate or may decrease the value of the new estate.[12] For the fiduciary who is also a beneficiary, the power to make an equitable adjustment in the fiduciary's absolute discretion may be a general power of appointment; if it is, the beneficiary-executor may encounter additional income, gift, and estate tax problems.[13] All these consequences may exist whether or not the adjustment is actually made. In addition, varying state law precedent for equitable adjustments multiplies the number of potential tax issues.

It is impossible to devise any one simple drafting solution for all the tax problems because of the number of potential equitable adjustments, the varying state law, and the wide variety of factual contexts in which adjustments can arise. Nevertheless, carefully tailored drafting can eliminate the problems. Estate planners, however, must analyze equitable adjustment issues on a client by client basis since the solution in one case may not work in another.

This Article has four objectives. First, it explains the factual settings and the mechanics for the two common equitable adjustments. Second, it explores the potential for equitable adjustments in jurisdictions where they are not now made. Third, it

8. REV. UNIF. PRINCIPAL & INCOME ACT § 5(a), 7B U.L.A. 145, 160 (1985).
9. *See infra* subpart II(C).
10. *See infra* subpart III(B)(1).
11. *See infra* subpart III(A)(2).
12. *See infra* subparts III(A)(3), III(B)(2).
13. *See infra* subpart III(C).

analyzes the tax consequences of equitable adjustments for beneficiaries and executors of estates. Finally, it suggests some drafting solutions to the problems facing estate planners and their clients.

II. THE ADJUSTMENT

A. The Origins of Equitable Adjustments: Fiduciary Duties

The executor of an estate is a fiduciary and must act in the best interests of the estate beneficiaries. To do otherwise is a breach of his duty for which he can be surcharged. While an executor has many specific fiduciary duties, it is possible to identify at least four that can interact to create the need for equitable adjustments.[14] These four are the duties: (1) to be impartial,[15] (2) to conserve the estate,[16] (3) to account for estate principal and income in accordance with state law (typically the Revised Uniform Principal and Income Act[17] or a similar statute), and (4) to report income of the estate in the manner required by Subchapter J of the Internal Revenue Code.[18] In the context of equitable adjustments, the duty to conserve the estate can be described as the duty to minimize the total taxes of the estate, both income and estate taxes.[19]

An inherent potential for conflict exists among the executor's duties. For example, the duty to conserve the estate and save taxes may require the executor to violate the duty to be impartial. Similarly, the duty to conserve may conflict with the duty to account for estate income and principle according to local fiduciary accounting principles. Under established precedent the need for equitable adjustments arises when two duties conflict in such a way that the executor cannot avoid breaching one

14. Carrico & Bondurant, *supra* note 2; Dobris, *Limits, supra* note 2; Dobris, *Equitable Adjustments, supra* note 2.

15. RESTATEMENT (SECOND) OF TRUSTS § 183 (1959); 2 A. SCOTT, THE LAW OF TRUSTS § 183 (3d ed. 1967); *In re* Estate of Bixby, 140 Cal. App. 2d 326, 334, 295 P.2d 68, 73 (1956).

16. RESTATEMENT (SECOND) OF TRUSTS § 176 (1959); 2 A. SCOTT, *supra* note 15, § 176.

17. REV. UNIF. PRINCIPAL & INCOME ACT § 5, 7B U.L.A. 145, 160 (1985). As of 1986, 29 states have adopted the Revised Act. *Id* at 145.

18. I.R.C. §§ 641-92.

19. Ascher, *supra* note 2.

of them.

B. The Warms Adjustment

The Warms adjustment, which is the best known equitable adjustment, derives its name from *In re Estate of Warms*,[20] the first reported decision to recognize the fiduciary obligation to adjust the shares of beneficiaries for the adverse impact of a tax election. In *Warms* the decedent bequeathed two-fifths of his estate to his nieces and the remainder to his spouse in trust for life.[21] The executor of Mr. Warms' estate elected to deduct the estate administration expenses as income tax deductions rather than as estate tax deductions. The failure to claim the expenses as estate tax deductions increased the estate taxes payable out of the principal of the residuary.[22] Deducting the administration expenses on the income tax returns, on the other hand, reduced the estate income tax liability. Because the residuary beneficiaries did not receive all the tax savings of the income tax deduction, a New York surrogate's court required the estate's income account to reimburse the estate's principal account for the extra estate taxes.

The following example illustrates the need for a Warms adjustment:

> *Example 1.* A dies in 1986 with a $2,000,000 gross estate. He leaves everything to a trust that is to pay all the income to his daughter, D, for life and the remainder to his son, S, at D's death. The will directs that all estate taxes and expenses of administration be paid out of the residuary estate. Deductible administration expenses total $200,000.

If the executor elects to deduct the administration expenses on the estate tax return, the principal passing to the trust, after taxes and expenses, totals $1,265,000.[23] On the other hand, if the

20. 140 N.Y.S.2d 169 (Sur. Ct. 1955).

21. The bequest in trust apparently did not qualify for the estate tax marital deduction.

22. I.R.C. § 2053 permits the deduction of estate administration expenses in determining the adjusted gross estate. Additional deductions are permitted in determining the taxable estate. Not deducting the expenses on the estate tax return causes the adjusted gross estate and the taxable estate to be larger and the tax liability larger.

23. In 1986 estate taxes on a $1,800,000 taxable estate (gross estate of $2,000,000 less $200,000 of expenses) equal $535,000. This example assumes that state death taxes

executor of the estate elects to deduct the administration expenses on the estate's income tax returns,[24] the net estate passing to the trust totals $1,175,000.[25] If it is assumed that the estate can deduct the expenses in a 50% income tax bracket, the $200,000 of administration expenses saves the estate $100,000 in income taxes, but the estate taxes increase by $90,000.

Thus, the executor's decision to deduct the administration expenses on the income tax returns reduces the principal of the residuary estate by $90,000. Since fiduciary accounting income is normally computed without reduction for estate administration expenses, the daughter's net income increases by $100,000, which produces a dramatic shift of assets from the trust to the daughter. Nevertheless, if the estate's income tax bracket is higher than the estate tax bracket, the executor has a clear duty to make the election to reduce the total tax liability.[26]

Although the tax law permits the executor to elect between the estate tax deduction and the income tax deduction, state fiduciary accounting law does not.[27] Estate administration expenses are a charge against principal, not income.[28] Since the election provides a benefit for the estate's income account at a substantial cost to the principal account, its exercise violates the fiduciary duty to be impartial and is contrary to fiduciary accounting rules. At the same time, however, the election discharges the executor's duty to conserve the estate.

When the duty to conserve conflicts with the duty to be impartial and violates fiduciary accounting rules, equity intercedes. A Warms adjustment reallocates estate income to offset the adverse consequences of the tax election. The mechanics of effecting this adjustment in example 1 are easy to illustrate. Under normal fiduciary accounting rules, A's daughter would receive all

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equal the state death tax credit. The net estate passing to the trust is, thus, $1,265,000 ($2,000,000 less $200,000 of expenses and less $535,000 of estate taxes).

24. I.R.C. § 642(g) permits an executor to elect between an income tax deduction or an estate tax deduction for most estate expenses unless § 691(b) is applicable. If it is, these expenses are deductible on both returns.

25. Estate taxes on a $2,000,000 taxable estate in 1986 equal $625,000. This example assumes that state death taxes equal the state death tax credit. The net estate passing to the trust is, thus, $1,175,000 ($2,000,000, less $200,000 of expenses, still chargeable to principal, and less $625,000 of estate taxes).

26. Ascher, *supra* note 2.

27. REV. UNIF. PRINCIPAL & INCOME ACT § 5(a), 7B U.L.A. 145, 160 (1985).

28. Id.

the income generated in the estate.[29] The Warms adjustment, however, directs $90,000 of the estate income to the principal account. The daughter then receives the remaining income.[30]

Since the executor who makes the Warms adjustment accomplishes the entire transaction on his books of account, no money actually changes hands. The executor simply makes a charge to the income account and a credit to the principal account. It is as though the executor takes money out of one pocket and puts it in another. Thus, the adjustment restores the amount of the estate principal to the size it would have been if the executor had not made the income tax election.

The Warms adjustment is either in common practice or required by law in New York,[31] Florida,[32] California,[33] and twelve

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29. REV. UNIF. PRINCIPAL & INCOME ACT § 5(b), 7B U.L.A. 145, 160 (1985).

30. The *Warms* opinion did not discuss the mechanics of the Warms adjustment. It is arguable that there is more than one way to divide the tax savings if the potential recipient of an equitable adjustment receives a portion of the income tax savings under the local principal and income act.

An example better illustrates the issue. M dies in 1986 with a $2,000,000 gross estate. He leaves $632,500 to a trust for the benefit of his daughter and the residuary outright to his son. If estate administration expenses are $200,000, the value of the residuary estate is also $632,500. An election by the executor to deduct the estate administration expenses on the estate's income tax returns, however, increases the estate taxes by $90,000 and reduces the residuary estate by the same amount. If it is assumed that the income tax deductions save $100,000 in income taxes, a Warms adjustment can restore the residuary to its former size with $10,000 left over.

Based on these facts, without considering the tax election and a possible equitable adjustment, the trust and the residuary bequest evenly divide estate income under the RUPIA. If the tax election is made and an equitable adjustment is considered, the question becomes whether the estate income is divided before the Warms adjustment or after. If the income is divided first, each beneficiary receives $50,000. The Warms adjustment then takes $40,000 of income from the trust, but leaves the trust with the $10,000 of overall tax savings. In the alternative, if the residuary receives the Warms adjustment before the division of estate income, the residuary receives the $90,000 it needs to be made whole and then receives $5,000, or one-half of the remaining estate income that results from the tax election.

The court in *In re* Estate of Bixby, 140 Cal. App. 2d 326, 339, 295 P.2d 68, 76 (1956), followed the second method, but performed the math a little differently. On the other hand, the petitioners in *Warms* were satisfied to be made whole and did not seek any portion of the net tax savings. Two New York decisions, *In re* Estate of Inman, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Sur. Ct. 1959), and *In re* Estate of Levy, 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Sur. Ct. 1957), required Warms adjustments and discussed the mechanics. While both of these decisions were far less specific than *Bixby*, both required the income account to reimburse the principal account. The language of the courts implies that the reimbursement occurs before the income account is apportioned among the estate's income beneficiaries.

31. N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(B) (McKinney Supp. 1986).

other states.[34] Michigan prohibits adjustments by statute.[35] In the remaining states, Warms adjustments are neither prohibited nor in common practice.[36]

C. *The Holloway Adjustment*

The estate administration expenses election is only one of several tax created inequities that can provide a basis for equitable adjustments. Another inequity arises when an estate makes a distribution of principal to a beneficiary and a portion of the distribution is treated as taxable income. Under the distributable net income (DNI) rules,[37] sections[38] 661 and 662 of the Internal Revenue Code, funds designated as principal for fiduciary accounting purposes may be taxable income for federal income tax purposes. The DNI rules provide that if an estate makes a distribution, it may carry out taxable income to the recipient,[39] even if the distribution is fiduciary accounting principal.[40] On occasion an executor will deliberately cause trust accounting principal to be treated as taxable income. This technique, sometimes called a "trapping distribution," can save significant amounts of income taxes in some circumstances.[41]

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32. *In re* Veith's Estate, 26 Fla. Supp. 145 (Cir. Ct. 1965).

33. *In re* Estate of Bixby, 140 Cal. App. 2d 326, 295 P.2d 68 (1956).

34. Carrico, *Equitable Adjustments, supra* note 2, at 19-7 to -8.

35. MICH. COMP. LAWS ANN. § 700.829(2) (West 1980).

36. Carrico, *Equitable Adjustments, supra* note 2, at 19-7 to -8. According to an American College of Probate Counsel survey, South Carolina is a state where equitable adjustments are not made. *See* CARRICO & BONDURANT, *supra* note 2, at 616. The survey's accuracy, however, is uncertain. In 1986 the author of this Article conducted a survey of the twenty Board Certified Estate Planners in South Carolina. Approximately 50% responded. Of those who did, 5 indicated that they rarely made equitable adjustments, 1 indicated that he made them often, and the remainder indicated that they never made adjustments. In addition, the author surveyed the four largest South Carolina bank trust departments. One did not respond, one indicated that it never made adjustments, one indicated that it rarely made equitable adjustments, and one indicated that it always made equitable adjustments.

37. A discussion of DNI is beyond the scope of this Article, but DNI is discussed in detail in a number of treatises and articles. *See, e.g.,* M. FERGUSON, J. FREELAND & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES (1970).

38. Unless otherwise indicated, all uses of "section" or "sections" refers to the Internal Revenue Code of 1954, as amended.

39. Distributions carry out DNI unless I.R.C. § 663(a)(1) provides an exception.

40. Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972).

41. Several commentators discuss trapping distributions in great detail. *See, e.g.,* Cornfeld, *Trapping Distributions,* 14 INST. ON EST. PL. 14-1 (1980); Englebracht & Helm-

Because distributions may carry out DNI, a recipient must report income to the extent of DNI received.[42] As a consequence, the estate's fiduciary accounting income is not taxed in full because the estate receives an income tax deduction equal to the distribution. Subsequent distribution of the accumulated estate income in a later year has no income tax consequence.[43] In summary, the recipient of the principal pays income taxes on principal, while the estate's accumulated income is subsequently distributed income tax free.

Here, as in the *Warms* scenario, the disparity between fiduciary accounting rules and income tax reporting creates a conflict for the fiduciary. In *In re Estate of Holloway*,[44] a New York surrogate's court ordered an equitable adjustment when a distribution of principal was treated as income for federal income tax purposes. In that case a trust created under Mr. Holloway's will received a distribution from the estate, and the income tax laws treated a portion of the principal as income. When a guardian *ad litem* for minor beneficiaries petitioned the court for an equitable adjustment, the New York court required the income account to make restitution to the principal.[45]

The following example illustrates the need for a Holloway adjustment:

> *Example 2.* B dies in 1986 with a $1,000,000 gross estate and leaves $500,000 outright to his surviving spouse, using a pecuniary formula marital deduction clause, and the remainder to his children. In 1987 the estate has net income of $100,000.

For income tax purposes, a distribution of the entire marital bequest in 1987, if there are no other distributions, is $400,000

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bright, *The Use of Trapping Distributions in Post-Mortem Tax Planning*, 59 TAXES 716 (1981); Mulligan, *Timing is the Key to Cutting Estate Income Through Making of Trapping Distributions*, 50 J. TAX. 342 (1979).

42. I.R.C. § 662.

43. Distribution of accumulated income by an estate does not invoke the throwback rules, which are limited to distributions by trusts. *See* Treas. Reg. § 1.665(a)-OA(d). If the distribution of the accumulated income occurs at a time when the estate has DNI, the distribution is treated as taxable income to the extent of DNI.

44. 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. 1972).

45. In its first opinion the court did not grant the request. Upon rehearing, however, the New York State Bankers Association filed an amicus curiae brief and told the court that adjustments were common. *Id.* at 362, 327 N.Y.S.2d at 866.

of principal and $100,000 of income.[46] The surviving spouse pays income taxes on the $100,000 of income the estate received and retained; the estate pays no income taxes.[47] If, on the first day of the next tax year, the estate distributes all remaining assets including the $100,000 of accumulated income, the residuary beneficiaries receive the accumulated fiduciary income free of income taxes.

In the example the estate saved at least $41,000 in income taxes,[48] but the widow's income taxes increased at least $37,000.[49] If an equitable adjustment is made, the estate reimburses the widow for the additional income taxes she paid, but the estate keeps the excess savings.[50] The mechanics of the adjustment are less clear if the widow's income tax cost exceeds the estate's income tax savings since no case has thus far considered this possibility.[51] The amount of the adjustment, however, is probably limited to the estate's income tax savings.[52]

Only one reported decision directly followed *Holloway*. In *Salesky Estate*[53] the Pennsylvania Orphan's Court required a Holloway type adjustment as a result of a distribution of principle that was treated as income. In *Estate of Cooper v. Parkinson*,[54] a Florida appellate court seemed to imply that it would follow *Holloway*. Subsequently, however, in *Williams v. Harrington*,[55] another Florida court specifically declined to make an equitable adjustment. In *Williams* the widow elected against the will and petitioned for her elective share. Upon distribution the elective share was treated as taxable income. According to the court, the widow's election and the tax laws, rather than any act

46. If there are other distributions during the tax year, the DNI is divided among the recipients. *See* I.R.C. § 662.

47. A formula marital bequest does not qualify for the exception to the DNI rule of I.R.C. § 663(a)(1). *See* Treas. Reg. § 1.663(c)-1(b).

48. Income taxes of the estate are computed by using 1985 rates for estates, assuming the estate has $100,000 of taxable income.

49. Estimated income taxes are computed by using the 1985 rates for a single individual, assuming that the beneficiary has no other income.

50. Salesky Estate, 15 Pa. Fiduc. 213 (Orphans' Ct. 1965).

51. Salesky Estate, 15 Pa. Fiduc. 213, 216 (Orphans' Ct. 1965), implies that the equitable adjustment is limited to the income tax savings achieved by the estate.

52. It is possible that the executor may be surcharged if the extra tax cost was avoidable. He has potentially violated his duty to conserve the estate.

53. 15 Pa. Fiduc. 213 (Orphans' Court 1965).

54. 186 So. 2d 844 (Fla. Dist. Ct. App. 1966).

55. 460 So. 2d 533 (Fla. Dist. Ct. App. 1984).

of the executor, triggered the adverse tax consequences. The court distinguished inequities caused by the executor's acts from those caused by the beneficiary and held that the latter did not warrant an equitable adjustment. This distinction seems valid. When a fiduciary intentionally makes a distribution of principal that the tax law treats as income, he deliberately violates the duty to be impartial; in these circumstances, the equitable adjustment is appropriate. In *Williams*, however, the executor did not create the problem by sophisticated planning; the beneficiary brought it upon herself. Other courts have used the same distinction to reject equitable adjustments in other circumstances.[56]

Two methods are available for effecting the Holloway adjustment. The executor can make a bookkeeping entry similar to the one described above for a Warms adjustment,[57] or he can make an additional distribution to the beneficiary as reimbursement for the tax cost of the first distribution. As explained later, the method selected can cause different tax consequences to the recipient.

D. *Unlimited Marital Deduction*

A significant equitable adjustment issue arises from the interplay of a marital deduction formula clause and the election to deduct estate administration expenses on the estate's income tax return. In this context an election to deduct expenses on the income tax return has a substantial effect on the beneficiaries.

The following example illustrates the significance of this election:

> *Example 3.* C dies in 1986 with a $1,000,000 gross estate. He leaves the maximum marital deduction (less the unified credit equivalent) to his spouse in trust, using a pecuniary formula clause, and the residuary estate outright to his children by a former marriage. Estate administration expenses are $100,000.

In this example, if the executor deducts the estate administration expenses on the estate tax return, the widow's trust re-

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56. *In re* Estate of Dick, 29 Misc. 2d 648, 218 N.Y.S.2d 182 (Sur. Ct. 1961). *But see* Dobris, *Equitable Adjustments, supra* note 2, at 143.

57. *See supra* subpart II(B).

ceives $400,000,[58] and the children receive $500,000.[59] If, however, the executor elects to deduct the administration expenses on the estate's income tax returns instead, the allocation of estate assets is different. The widow's trust must receive $500,000 to avoid payment of estate taxes.[60] Since the testator's intent is generally the elimination of estate taxes, the unlimited marital deduction formula increases the marital bequest.[61] As a result, the children receive $400,000,[62] or $100,000 less than if the expenses are deducted on the estate tax return. This reallocation has a substantial economic impact on the residuary.

An executor with the power to make this election is in a very difficult position. His duty to be impartial is in direct conflict with his clear duty to save taxes.[63] No matter where the expenses are deducted, no estate taxes are due. An income tax deduction, however, achieves an immediate tax savings if sufficient income is generated to make use of the deduction. Only by looking at the widow's potential estate tax liability, at her death, can the executor find any justification for not electing to deduct the administration expenses on the income tax returns, which is speculative in many situations.

This example does *not*, however, result in a Warms adjustment. In *Warms* the income account reimburses the principal account for the estate tax cost of not deducting the expenses on the estate tax return. The measure of the adjustment is the amount of additional estate taxes payable. In the example there are no additional estate taxes.

What is the judicial response to this shift in assets? Few courts have considered the issue, but those that have, with only

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58. A $1,000,000 gross estate less $400,000 marital deduction and less $100,000 administration expenses leaves a taxable estate of $500,000. No estate taxes are due after taking into account the unified credit.

59. A $1,000,000 gross estate less $400,000 marital deduction and less $100,000 administration expenses leave $500,000.

60. A $1,000,000 gross estate less $500,000 marital deduction leaves a $500,000 taxable estate. No taxes are due after taking into account the unified credit.

61. Rev. Rul. 55-643, 1955-2 C.B. 386; R. COVEY, *supra* note 2, at 29, 123 (1984); Blattmachr, *Tax Effects, supra* note 2, ¶ 1403.1, at 14-7; Evans, *Administrative Powers and the Marital Deduction*, 20 REAL PROP. PROB. & TR. J. 1161 (1985).

62. A $1,000,000 gross estate less $100,000 administration expenses and less a $500,000 marital deduction leaves $400,000.

63. The testator may relieve the executor of his obligation by including a provision to that effect in his will.

one exception,[64] have declined to require an adjustment.[65] The one decision that ordered an adjustment was later overruled by legislative action[66] and distinguished by the court that made the decision.[67] If a court were to require an adjustment, an estate tax liability would be created, contrary to the frequently expressed intent of testators to eliminate federal estate taxes by maximizing the marital deduction.

E. Other Adjustments

A number of other situations also create "inequities" that might justify equitable adjustments. Nearly every election or decision by an executor has the potential to cause a shift of assets from one group of beneficiaries to another.[68] Disproportionate distributions to equal beneficiaries of an estate can create the need for an adjustment.[69] The differences between tax accounting and fiduciary accounting cause a net after tax difference probably not intended by the testator. Electing a tax year for the estate or the timing of the final distributions to close an estate can also create inequities among beneficiaries.

The Qualified Terminal Interest Property (QTIP) election presents an additional equitable adjustment problem that is un-

64. *In re* Estate of Levy, 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Sur. Ct. 1957).

65. *In re* Veith's Estate, 26 Fla. Supp. 145 (Cir. Ct. 1965); *In re* Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Sur. Ct. 1960); *In re* Estate of Inman, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Sur. Ct. 1959).

66. N.Y. Est. Powers & Trust Law § 11-1.2(B) (McKinney Supp. 1986).

67. *Id.* § 11-1.2(B); *In re* Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Sur. Ct. 1960).

68. A new potential adjustment arose with the addition of I.R.C. § 643(d) to the Internal Revenue Code. This section provides that a distribution of assets in kind by an estate carries out DNI only to the extent of the asset's adjusted basis or fair market value, whichever is less. The beneficiary's adjusted basis in the asset received equals the estate's adjusted basis. In the alternative, the executor can elect to recognize gain or loss on the distribution. If the election is made, the distribution carries out DNI to the extent of fair market value, and the beneficiary's adjusted basis equals fair market value.

The § 643(d) election, as other tax elections, has the potential to cause an equitable adjustment. For example, the recipient of the assets reports more income if the election is made. The estate has less income tax, but a gain is incurred. Fiduciary accounting rules are unlikely to place the benefit of the election where the taxes fall, and the basis for an equitable adjustment exists. Since this provisions is new, Michigan, which prohibits all adjustments, is the only state where the status of this potential equitable adjustment is clear.

69. *See In re* Estate of Cooper v. Parkinson, 186 So. 2d 844 (Fla. Dist Ct. App. 1966); Salesky Estate, 15 Pa. Fiduc. 213 (Orphans' Ct. 1965).

resolved and has not been widely discussed by commentators.[70] An executor with the discretion to make a QTIP election has the power to defer estate taxes by making the election or to forgo any election and cause a current estate tax.[71] The QTIP election, thus, has the potential to shift assets among beneficiaries. Although no court has considered this issue, the precedent of the cases denying an equitable adjustment on facts similar to example 3 should be applicable.[72]

The total number of potential equitable adjustments is considerable. For example, one commentator has identified sixteen in addition to the Warms and Holloway adjustments.[73]

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70. Ascher, *The Quandary of Executors Who Are Asked to Plan the Estates of the Dead: The Qualified Terminable Interest Property Election*, 63 N.C.L. REV. 1 (1984); Berall, *supra* note 2; Carrico, *Equitable Adjustments, supra* note 2.

71. The following example illustrates the problem:

> D dies in 1986 with an estate of $1,000,000. His will leaves the widow the maximum marital deduction (less the unified credit equivalent) in a QTIP trust, which will go to "their" children on her death. The residuary estate goes outright to his children by an earlier marriage.

Putting aside the administration expenses issue, each set of children will eventually receive $500,000, free of federal estate taxes. If, however, the widow is wealthy in her own right, and has $500,000 of her own assets, she might decide, if named executrix, to forgo the QTIP election in D's estate. This causes D's estate to pay $190,000 in estate taxes out of the residuary (and out of the assets of the first set of children).

If she also dies in 1986, her children receive $1,000,000, and his children receive $310,000. If D's estate elects the QTIP marital deduction and she dies in 1986, either the QTIP marital trust or her separate assets pay $190,000 of estate taxes. Her children receive $810,000, and his children receive $500,000. The widow, with the discretion to make a QTIP election, has the power to take $190,000 away from his other children and give them to her children.

It is not clear that the widow can make such a selfish election without violating the fiduciary duty to be impartial. At least one court has determined that when a conflict of interest arises, the fiduciary owes a higher duty to the other beneficiaries and must exercise elections to her own detriment. *See In re* Estate of Colp, N.Y.L.J., January 20, 1976, at 8, col 2 (Sur. Ct. 1976). This case, however, has been criticized. *See* Ascher, *supra* note 2, at 711-13. If this case is valid, however, the widow may be surcharged if she forgoes the QTIP election.

Although no reported decision has resolved this conflict, the cases cited *supra* note 65 seem applicable. The Connecticut legislature passed a statute in 1983 to prohibit adjustments for the consequences of a QTIP election. Notwithstanding the current precedent, it is foreseeable that some court, somewhere, will require an adjustment if the facts are similar to those in the example and if extrinsic evidence suggests that the decedent assumed that the election would be made.

72. *See In re* Veith's Estate, 26 Fla. Supp. 145 (Cir. Ct. 1965); *In re* Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Sur. Ct. 1960); *In re* Estate of Inman, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Sur. Ct. 1959).

73. Carrico, *Equitable Adjustments, supra* note 2.

F. Possible Proliferation in Other Jurisdictions

There is a potential for a Warms adjustment in states where equitable adjustments are not now required. In any of these states, a petition to a court of equity, based on facts similar to *Warms*, should result in an adjustment. No reported court decision has refused to make a Warms adjustment,[74] and in at least fifteen states it is accepted either by statute or by court decision.[75]

The Holloway adjustment is less widely accepted; *Holloway*[76] and *Salesky*[77] are the only reported decisions directly on point. In *In re Estate of Coe*,[78] the decedent's will granted the executor discretion to settle all questions of income and principal. Nevertheless, the fiduciary declined to make an adjustment, and a New York surrogate's court refused to surcharge him for his failure to make an adjustment. The *Williams* court in Florida also declined to make a Holloway adjustment.[79]

Despite the lack of judicial mandate, a court is likely to require a Holloway adjustment if the facts of a case are similar to *Holloway*. No reported decision has denied an equitable adjustment on facts comparable to those in *Holloway*, and the use of Holloway adjustments is widespread in some parts of the country.[80]

In addition, it is possible to interpret the Revised Uniform Principal and Income Act (RUPIA) to require Warms and Holloway adjustments.[81] Although neither *Warms* nor *Holloway* was

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74. The court in *In re* Estate of Backus, 106 Misc. 2d 463, 434 N.Y.S. 2d 106 (Sur. Ct. 1980), when making a Warms adjustment, removed § 691 Income in Respect of a Decedent (IRD) items from the computation. This seems correct as IRD, although principal for fiduciary accounting purposes, is still subject to income taxes.

75. Carrico, *Equitable Adjustments, supra* note 2, at 19-7 to -8.

76. *See supra* notes 43-44 and accompanying text.

77. *See supra* note 53 and accompanying text.

78. 80 Misc. 2d 374, 363 N.Y.S. 2d 265 (Sur. Ct. 1975).

79. *See supra* note 55 and accompanying text.

80. Cornfeld, *supra* note 41, ¶1405. A 1981 survey by the American College of Probate Counsel, however, did not indicate any such common practice. *See* Carrico & Bondurant, *supra* note 2, at 566.

81. RUPIA § 5 sets forth the distribution pattern for estate income. RUPIA § 5(b)(2) specifically charges taxes on estate income against the income before distribution. Significantly, this section provides that the charge is for accrued taxes and is not limited to taxes actually paid. This distinction is meaningful when other RUPIA sections are examined. RUPIA § 13(a)(6) charges income of a trust with taxes levied against income,

based on the RUPIA, the *Holloway* court discussed section 5(b)(2) of the Act.[82] At a minimum, the RUPIA provides support, if only theoretical, for both Warms and Holloway adjustments.[83]

Even if the RUPIA does not require equitable adjustments, they are still consistent with the Act's provisions.[84] Equitable adjustments are not expressly prohibited by the RUPIA. States that have adopted the Act may look to the law of equity or other statutory law to determine if equitable adjustments are mandated. Finally, since RUPIA section 2 provides that the governing instrument can override all the Act's provisions, a testator is free to resolve all income and principal issues as he desires.

Passage of the proposed 1986 Tax Reform Act may significantly affect the need for equitable adjustments in the future. The House version of the Act completely rewrites the rules for income taxation of estates and trusts,[85] and eliminates the concept of DNI. Thus, if Congress enacts the House version, inequities caused by the DNI rules will not occur, and the need for the corresponding equitable adjustments will disappear.[86] The Senate Finance Committee version of the legislation, on the other hand, does not repeal the concept of DNI, but does curtail the

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but only for income taxes paid by a trustee. By contrast, the RUPIA § 5 charge against estate income for income taxes is not conditioned on the payment of the income tax by the executor. When a distribution of principle is treated as income, income taxes are due on the estate income, but the distribution shifts the liability. The taxes are accrued in the traditional sense of things.

If the estate does not pay its income tax liability because the distribution carried out the income tax liability, the executor has excess money that does not belong to the income beneficiaries. RUPIA § 5 does not specify the beneficiary of the unallocated excess money. Although there is no authority, it is logical that the excess money should reimburse the person who actually paid the taxes for the estate, *i.e.* the recipient of the DNI. In *In re* Estate of Bixby, 140 Cal. App. 2d 326, 336, 295 P.2d 68, 74 (1956), the California Court of Appeal stated, "On the basis of logic and as a matter of equity, the conclusion is inescapable that income taxes assessed against the estate's income during the period required for administration should be charged against that income . . . ." Clearly, the regular income beneficiaries are not entitled to the money.

82. 68 Misc. at 365, 327 N.Y.S.2d at 869.

83. Richard Covey believes that the RUPIA supports equitable adjustments. *See* R. Covey, *supra* note 2, at 52-57.

84. Dobris, *Equitable Adjustments, supra* note 2, at 129.

85. H.R. 3838, 99th Cong., 1st Sess., § 1221, 131 Cong. Rec. 12,681-85 (daily ed. Dec. 17, 1985).

86. The House version also repeals the § 643(d) election discussed *supra* note 68.

tax savings achieved by using a trust's status as a separate taxpayer.[87]

The election to deduct estate administration expenses on estate income tax returns survives both proposed revisions, and, thus, the need for Warms adjustments will continue. Further, since equitable adjustments are based on the law of equity, there is no reason they cannot be expanded beyond the Warms and Holloway adjustments. In fact, the House version provides for several new tax elections that may be the basis for new equitable adjustments. In addition, the House version of tax reform does not affect existing estate and trust income tax rules for trusts that were irrevocable before September 25, 1985, and estates of decedents who died before September 25, 1985.[88] As a result, existing equitable adjustment issues will continue for some time, even if the House version becomes law.

In summary, equitable adjustments are not widely established by either case law or statutes.[89] Nevertheless, there is little reason to doubt the equitable basis for such adjustments and the potential for their use in all states except those that prohibit them by statute.

III. Tax Ramifications

Equitable adjustments raise potential income, gift, and estate tax issues, although only one reported case is directly on point.[90] Several commentators have made observations about the possible tax consequences,[91] but only two[92] have analyzed the issues in any depth.[93] Nevertheless, existing precedent addressing

87. S. Rep. No. 313, 99th Cong., 2d Sess. 866-68 (1986).

88. H.R. 3838, 99th Cong., 1st Sess., § 1211(c), 131 Cong. Rec. 12,680 (daily ed. Dec. 17, 1985).

89. Since *Warms* there have been only 22 reported decisions.

90. Britenstool v. Commissioner, 46 T.C. 711 (1966); *see infra* notes 168-69 and accompanying text.

91. *See* Moore, *Conflicting Interests, supra* note 2, ¶ 1915; Berall, *supra* note 2; Blattmachr, *Tax Effects, supra* note 2; Carrico, *Advanced Problems, supra* note 2; Carrico, *Equitable Adjustments, supra* note 2.

92. *See* Blattmachr, *Tax Effects, supra* note 2, ¶ 1404; Carrico, *Equitable Adjustments, supra* note 2, at 19-17 to -19.

93. Several commentators have discussed the possibility that a simple trust may not be a simple trust in a year in which it retains income to replenish principal as a part of making a Warms adjustment. This, however, is of minor importance. Most Warms adjustments are made by estates that are complex trusts for income tax purposes, but are

analogous situations suggests how a court might rule if presented with the issues.

Tax issues might occur in at least three possible factual situations. First, an inheritance might be subject to a charge for an equitable adjustment; second, a taxpayer might be the potential recipient of an equitable adjustment; or third, a taxpayer might be both the executor of the estate and a beneficiary. To consider the tax issues, it is necessary to examine each of these circumstances separately. In addition, tax consequences may vary depending on whether the equitable adjustment is made by a bookkeeping entry or by an actual distribution to the injured party. Further, failure to make any adjustment, if an adjustment is warranted, can also have tax consequences.

A. *The Beneficiary Due an Adjustment*

1. *Income Taxes*

In *Commissioner v. Glenshaw Glass Co.*,[94] the Supreme Court declared that "undeniable accessions to wealth, clearly realized," are income.[95] Courts frequently use this test to determine if a taxpayer realizes income. In *Fundamentals of Federal Income Taxation*,[96] Professor Freeland and his coauthors provided a useful analytical test to determine gross income under the Supreme Court's edict. They proposed that "gross income includes the receipt of any financial benefit which is:

> 1. Not a mere return of capital, and
> 2. Not accompanied by a contemporaneously acknowledged obligation to repay, and
> 3. Not excluded by specific statutory provision."[97]

Under this test, the recipient of an equitable adjustment does not realize income. Instead, the amount received is replacement

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not subject to the throwback rules of I.R.C. §§ 665-68. In addition, the Service, in I.R.S. Letter Ruling 8501084 (Jan. 17, 1985), has ruled that a simple trust has "outside" income for purposes of the throwback rules if it receives an equitable adjustment. *See* Cornfeld, *supra* note 41, at 14-22.

94. 348 U.S. 426 (1955).

95. *Id.* at 431.

96. J. Freeland, S. Lind & R. Stephens, Fundamentals of Federal Income Taxation (5th ed. 1985).

97. *Id.* at 64.

of principal that was lost as a result of the tax election by the executor. With both the Warms and Holloway adjustments, the beneficiary has lost principal (capital) that is replaced through the equitable adjustment.

In addition, some commentators have suggested that the adjustment is not income because it is compensation for damages or a debt of the estate.[98] Although these commentators cite no authority for their proposition, it is true that equitable adjustments are in the nature of compensation for damages.[99] The tax election has depleted principal by appropriating the benefit of a tax deduction. An equitable adjustment restores the principal.

Section 104 provides certain exclusions from income for personal injury damage recoveries, but equitable adjustments are not among them. Fortunately, however, section 104 is not exclusive. Case law has also excepted other payments for damages from gross income. In *Boehm v. Commissioner*,[100] for example, the Second Circuit recognized that damages received for partial injury to property, not in excess of a taxpayer's basis, are not income.

More importantly, precedent holds that reimbursement of tax costs is not income. In *Clark v. Commissioner*,[101] a client recovered damages from his attorney for income taxes that the client paid because the attorney incorrectly filed the client's tax return. The Board of Tax Appeals held that the recovery was in the nature of a replacement of capital and, therefore, was not income. The theory applied in *Clark* would also support the proposition that equitable adjustments are not income.

Existing precedent, thus, suggests that receipt of the adjustment should not be treated as income. This, however, is not the end of the inquiry. The method by which the adjustment is made can convert it to income.

The beneficiary of an adjustment that is accomplished by a bookkeeping entry does not have income under the general rules for income taxation of estates.[102] Instead of using a bookkeeping

98. Dobris, *Equitable Adjustments, supra* note 2, at 144; Moore, *Conflicting Interests, supra* note 2, ¶ 1915; Blattmachr, *Tax Effects, supra* note 2, ¶ 1408, at 14-26.

99. Dobris, *Equitable Adjustments, supra* note 2, at 144.

100. 146 F.2d 553 (2d Cir.), *aff'd*, 326 U. S. 287 (1945).

101. 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B. 4.

102. According to Richard Covey, professional executors do not treat these adjustments as income. *See* R. COVEY, *supra* note 2, at 55.

entry to make an equitable adjustment, however, the executor may elect to make an additional distribution to a beneficiary to reimburse for the tax cost of the tax election. The Internal Revenue Service, in a 1985 letter ruling, held that an equitable adjustment distribution carried out DNI.[103] In that ruling one trust (Trust 1), according to its terms, made a distribution to another trust (Trust 2). As a result of the distribution, Trust 2 received DNI (and taxable income) from Trust 1, even though, for fiduciary accounting purposes, the distribution was characterized as principal. In a subsequent tax year, the trustee made a Holloway adjustment. Trust 1 distributed to Trust 2 the amount necessary to replenish the principal of Trust 2 for the income tax consequence of the distribution in the prior year. The Service ruled that the distribution in the second year represented taxable income to Trust 2 since the amount of the distribution was less than the DNI of Trust 1 for the tax year.[104]

This letter ruling seems correct. Trust 2 received the second distribution in its capacity as a beneficiary of Trust 1.[105] While it is arguable that the status of Trust 2 is that of a creditor and, therefore, the DNI rules are inapplicable, no statute or case supports that proposition.[106] Under Subchapter J DNI rules, a distribution to a beneficiary carries out DNI and is taxable income. It is noteworthy, however, that the Service did not rule that the equitable adjustment was income per se.

The Service's DNI interpretation also has precedential support. In several revenue rulings, the Service has held that funding a pecuniary formula marital deduction in kind with appreciated assets triggers gain.[107] The theory underlying the rulings is

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103. I.R.S. Letter Ruling 8501011 (Jan. 17, 1985).

104. Letter Ruling 8501011 was clarified by a second ruling issued on the same day. In I.R.S. Letter Ruling 8501084 (Jan. 17, 1985), the Service held that the accumulated income that results from the equitable adjustment, after reduction for the income taxes in year two, represents undistributable net income. This means that when the trust ultimately terminates, the remaindermen will receive income subject to the throwback rules.

105. Blattmachr, *Tax Effects, supra* note 2, ¶ 1408, at 14-26, discusses whether the receipt of the equitable adjustment is in the capacity of a creditor or a beneficiary. That article, which was published prior to I.R.S. Letter Ruling 8501011, speculated that the distribution of an equitable adjustment carries out DNI.

106. Lyeth v. Hoey, 305 U.S. 188 (1938).

107. Rev. Rul. 56-270, 1956-1 C. B. 270; Rev. Rul. 60-87, 1960-1 C.B. 286. *But cf.* Rev. Rul. 55-117, 1955-1 C.B. 230 (partial distribution to a residuary trust does not trigger income); Rev. Rul. 64-101, 1964-1 C.B. 77 (distribution of dower rights does not trigger income); Rev. Rul. 71-167, 1971-1 C.B. 163 (distribution of income due on delayed

that the amount due the beneficiary is a debt of the estate. When the estate satisfies its obligation by using appreciated property, a taxable disposition occurs.[108]

Despite the classification of a pecuniary formula marital bequest as a debt, distributions by an estate to the surviving spouse still carry out DNI. The specific bequest exception in section 663(a) is inapplicable. Treasury Regulation section 1.663(a)-1(b) requires that the amount of a marital bequest be identified as of the date of death to avoid the DNI rules. The amount of a formula marital bequest, however, cannot be determined until assets of the estate are appraised and the executor makes various tax elections. Similarly, an equitable adjustment is not determinable at the date of death; an adjustment does not arise until after the executor makes a tax election, and the amount of the adjustment depends on a number of factors. For these reasons, application of the DNI theory to equitable adjustment distributions seems correct even if the debt theory applies.[109]

2. *Gift Taxes*

A beneficiary due an equitable adjustment may have a gift tax liability if the right to receive the adjustment is not as-

dower rights does carry out DNI). In Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), the Second Circuit determined that the satisfaction of a specific pecuniary bequest in kind with appreciated assets causes recognition of gain. *See also* Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), *aff'd*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936).

108. The Supreme Court embraced this concept in a different context. *See* United States v. Davis, 370 U.S. 65, *reh'g denied*, 371 U.S. 854 (1962).

109. The letter ruling did not consider the possibility that the second distribution is the basis for another equitable adjustment since it replaces principal, but is income for tax purposes. Notwithstanding the feeling that equitable adjustments will never end, if the first adjustment is mandated, then the second may be as well. *See* Cornfeld, *supra* note 41, at 14-22.

One possible tactic by the executor may help avoid the circular problem. If the executor anticipates an adjustment at the time of the first distribution, an additional distribution at that time to reimburse for estimated income taxes will eliminate the need for the second distribution and the additional adjustments. If all the estate's DNI is already distributed, a distribution of the exact dollar amount of the equitable adjustment will suffice. If, however, the first distribution does not carry out all the estate's DNI, a more complicated adjustment is needed. The amount of the adjustment needs to be increased to the point that the amount of the adjustment, after income taxes, is sufficient to replace the income taxes incurred on the total distribution. This complicated mathematical computation might lead an executor to forgo this "easy method" and deal with the decreasing circle of adjustments or not adjust at all.

serted.[110] The exception to the discharge of indebtedness income problem, discussed below, is donative intent. Although this rule is helpful to the estate or the beneficiary that owes an adjustment, it causes a gift tax problem for the beneficiary who is due an adjustment.

The potential recipient of an equitable adjustment who intentionally forgoes an adjustment may be making a taxable transfer. Section 2511 imposes a gift tax on all transfers of property that are made for less than full and adequate consideration.[111] For example, gift taxes apply to indebtedness that is indirectly forgiven[112] or for which the statute of limitations has expired, whether or not the creditor intended the lapse.[113]

In Revenue Ruling 84-105,[114] the Service ruled that a widow who did not object to the underfunding of a marital trust made a gift to the estate's residuary beneficiary. In that ruling the estate was allowed an estate tax marital deduction of 200x dollars. When the executor completed the funding of the marital bequest, the amount transferred to the surviving spouse's trust was 160x dollars, or 40x dollars less than the amount allowed as a marital deduction in the federal estate tax proceedings. The widow did not assert her right to have her marital bequest fully funded when a local probate court approved the final accounting that disclosed the underfunding. The Service ruled that the widow, by failing to insist on full funding of the trust, made a taxable gift to the decedent's son, the residuary beneficiary. By analogy, the failure to assert a right to an equitable adjustment is a taxable transfer.[115]

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110. Rev. Rul. 84-105, 1984-2 C.B. 197; Cornfeld, *supra* note 41, at 14-22.

111. There is no question that the gift, if it occurs, is to the beneficiaries and not to the estate. In Helvering v. Hutchins, 312 U.S. 393 (1941), the Supreme Court declared, "One does not speak of making a gift to a trust rather than to . . . its beneficiaries." *Id.* at 396.

112. Treas. Reg. § 25.2511-1; W. H. Myers v. Commissioner, 27 T.C.M. 975 (1968).

113. Estate of Lang v. Commissioner, 613 F.2d 770 (9th Cir. 1980), *aff'g* 64 T.C. 404 (1975); Rev. Rul. 81-264, 1981-2 C.B. 185.

114. 1984-2 C.B. 197.

115. In the alternative, it is possible that a gift to the executor, individually, may occur if the beneficiary does not object to the executor's failure to make the adjustment by attempting to have court surcharge him. It may be too late to make the other beneficiaries give up the adjustment, when the beneficiary discovers that the executor has not made the equitable adjustment. In this case, the gift may be to the executor. The relationship of the beneficiary due the adjustment to the executor and the estate's beneficiaries who owe the adjustment is likely to be determinative of who receives the gift. Any

Further, Treasury Regulation section 25.2514-1(b)(1) provides that a power to consent to a fiduciary's accounting "is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein." The negative implication of this regulation is that the right to object to an accounting that will shift beneficial interest is a power of appointment and that a beneficiary who has a right to an equitable adjustment has such a power. Since the expiration of a power of appointment results in a gift by the power holder, the beneficiary who does not assert his right to an equitable adjustment may incur a gift tax liability.

Even a beneficiary who is unaware of the right to an adjustment can still be liable for gift taxes; lack of knowledge or donative intent does not negate a gift. In *Commissioner v. Wemyss*,[116] the Supreme Court declared that donative intent, in the conventional sense, is not required to make a gift.[117] Subsequently, in *Estate of James C. Freeman v. Commissioner*,[118] the Tax Court ruled that the decedent held a taxable general power of appointment over a trust created by his parents, even though he never saw the trust agreement and was unaware of the power of appointment. The court included the value of the trust in the decedent's gross estate pursuant to section 2041, despite his lack of knowledge. Similarly, other cases have held that a decedent's mental incompetence is irrelevant to the operation of section

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gift to the executor is a gift to him individually, not in his fiduciary capacity. This is so because he personally, and not the estate, is liable for a surcharge. Since it is a factual question of whether the other beneficiaries must give up assets or the executor must make up the loss, determining who is the recipient of the gift is made on a case by case basis.

An additional issue is whether the "deemed gift" qualifies for the present interest annual exclusion. While it is possible that a gift in this context is a present interest, depending on the particular facts, gifts in trust are generally gifts of future interests. *See* I.R.C. § 2503(b). If the adjustment occurs inside an estate or a trust, it is likely to be a future interest and not qualifying for the $10,000 annual exclusion.

The annual exclusion question may have a different answer if the gift is to the executor. Since a surcharge for failing to make the adjustment is extracted from the executor individually and not the estate, it represents a present benefit to the executor. This gift should pass the present interest test and qualify for the $10,000 annual exclusion.

116. 324 U.S. 303 (1945).

117. *Id.* at 306.

118. 67 T.C. 202 (1976).

2041.[119]

No cases have considered the gift tax ramifications when a taxpayer is unaware of an expiring power of appointment. There is no basis, however, to conclude that gift tax section 2514 would yield a different result from estate tax section 2041, since gift tax and estate tax provisions are read *in pari materia*.[120] As the Tax Court stated in *Freeman*, "The existence of the power of appointment brings it within the ambit of section 2041(a)(2)."[121]

3. *Estate Taxes*

An equitable adjustment due a beneficiary at the time of death affects the size of his gross estate. Section 2033 includes in a decedent's gross estate all assets in which the decedent has a right at the time of death.[122] Treasury Regulation section 20.2033-1 provides that a gross estate includes all property beneficially owned by a decedent. It seems clear, then, that if a decedent dies in a state where equitable adjustments are well established, section 2033 applies, and the right to an equitable adjustment is an asset of the decedent's estate.[123] If, however, the decedent dies in a state that does not recognize equitable adjustments, the situation is less clear. Since he may not have a "right" to the adjustment at death, the adjustment may not be an asset of the estate.

Valuation of the right to an adjustment is, of course, not

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119. Boeving v. United States, 650 F.2d 493 (8th Cir. 1981); Estate of Alperstein v. Commissioner, 613 F.2d 1213 (2d Cir. 1979); Pennsylvania Bank & Trust Co. v. United States, 597 F.2d 382 (3d Cir. 1979). *But see* Williams v. United States, 634 F.2d 894 (5th Cir. 1981).

120. Merrill v. Fahs, 324 U.S. 308 (1945).

121. 67 T.C. 202, 209 (1976).

122. Estate of Bogley v. United States, 514 F.2d 1027 (Ct. Cl. 1975); Rev. Rul 75-145, 1975-1 C.B. 298.

123. If the prior estate has not yet been distributed, the asset included in the new decedent's estate is an interest in the prior estate. *See* Estate of Hanch v. Commissioner, 19 T.C. 65 (1952). The equitable adjustment is one of the assets due the new decedent from the first estate. An appraiser should consider the value of the equitable adjustment when appraising the value of an interest in the prior estate. If the new decedent has received all that is due from the prior estate except the equitable adjustment, a valuation of the equitable adjustment should be made separately and included in the decedent's gross estate as an interest in the prior estate. Presumably, it would be reported on Schedule F of IRS Form 706 as miscellaneous property as is the interest from the prior estate.

easy, but the right must, nevertheless, be valued. An estate may include any number of assets, such as tort claims, that are difficult to appraise; yet these assets have been and are required to be valued.[124] Treasury Regulation section 20.2031-1 provides that all property of a decedent's gross estate be appraised at its fair market value, and the right to an equitable adjustment is no exception.[125]

The situation is different, however, when a potential equitable adjustment is in the discretion of an executor and, at the time of the beneficiary's death, the executor has not yet indicated how he will exercise his discretion. Section 2033 includes in the gross estate only those assets in which the decedent has a right.[126] If the executor has discretion to make the adjustment, no such right exists, and the value of the equitable adjustment should not be included in the decedent's gross estate.

B. Adjustment Owed

The taxpayer who benefits from a tax election made by an executor may "owe" an equitable adjustment. More accurately, a portion of his or her inheritance may be subject to a charge for the adverse tax consequences of the tax election. Potential income and estate tax issues exist for this beneficiary.

1. Income Taxes

The beneficiary whose inheritance may be reduced by an equitable adjustment does not appear to have gross income if the adjustment is made.[127] On the other hand, an income tax consequence may arise if the adjustment is *not* made. It depends on whether the potential adjustment is the beneficiary's debt or a debt of the estate or a debt at all. It is not clear whether it is

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124. The Supreme Court, in Burnett v. Logan, 283 U.S. 404 (1931), held that for income tax purposes, difficult to value assets are not always valued. When appropriate, valuation is deferred. For estate tax purposes, however, the valuation issue must be resolved. *Id.* at 413.

125. Treas. Reg. § 20.2031-1.

126. Estate of Bogley v. United States. 514 F.2d 1027 (Ct. Cl. 1975).

127. One commentator has suggested that the beneficiary who owed the adjustment is deemed to have received a distribution and DNI since his or her liability was discharged. *See* Cornfeld, *supra* note 41, at 14-22.

the estate or the beneficiary's inheritance that owes the equitable adjustment. From the estate's point of view, an equitable adjustment merely shifts assets from one beneficiary to another. Nevertheless, from the beneficiary's point of view, it is not truly his debt either. It represents a potential charge against his inheritance, as is true of all debts of an estate.

Under the *Glenshaw Glass* and Freeland tests, set out above,[128] the failure to make an adjustment appears to produce an income tax consequence for the estate beneficiary who owes the adjustment; he receives additional assets that are not a return of capital and are not accompanied by the execution of a note of repayment. Similar windfalls, such as punitive damages and treasure trove, are taxable income.[129] Likewise, public utilities realize income when security deposits are no longer refundable to former customers because the statute of limitations has expired.[130]

Section 102, which excludes gifts and inheritances from income, is the only statutory exclusion that might exempt from income an equitable adjustment that was not made. The additional amount received by a beneficiary when an equitable adjustment is not made, however, is certainly not an inheritance since it results from the executor's inaction rather than from the decedent's death.[131] As discussed above, failure to make an equitable adjustment may be a gift by the persons entitled to it if they fail to assert their right. If the failure to make an equitable adjustment results from donative intent, section 102 eliminates any income tax consequences for the beneficiary who owes the adjustment.

In states such as New York, where equitable adjustments are required by statute, the failure to make an adjustment has

128. *See supra* notes 94-97 and accompanying text.

129. The Supreme Court in Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955), determined that punitive damages are income. At one time the Service included punitive damages for personal injuries under the § 104(a)(2) exclusion from income. *See* Rev. Rul 75-45, 1975-1 C.B. 47. Recently, however, the Service reversed its position. *See* Rev. Rul. 84-108, 1984-2 C.B. 32.

Treas. Reg. § 1.61-14(a) declares that treasure trove is income. *See also* Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970).

130. Boston Consol. Gas Co. v. Commissioner, 128 F.2d 473 (1st Cir. 1942). *See also* Rev. Rul. 75-300, 1975-2 C.B. 23.

131. Lyeth v. Hoey, 305 U.S. 188 (1938).

more certain income tax consequences, despite the absence of any income tax cases on point. The potential adjustment, though not a debt in the conventional sense, represents a liability. Therefore, the benefit received from the failure to make an adjustment is similar to a discharge of indebtedness.[132] In *Estate of Emelil Bankhead v. Commissioner*,[133] an estate realized income when a debt it owed was discharged by the expiration of the statute of limitations. The decedent and her family owned 249 of 250 outstanding shares in a corporation. At the time of her death, Mrs. Bankhead owed the corporation approximately $45,000, but the corporation did not file a claim against her estate within the statutory period for creditor's claims. According to the Tax Court, the failure to file a timely claim triggered discharge of indebtedness income. The court declared, "It is this undeniable economic benefit that creates income for purposes of the Internal Revenue Code under circumstances such as those here present."[134]

The Tax Court reaffirmed its position in *Carl T. Miller Trust v. Commissioner*,[135] which was factually similar to *Bankhead*. In *Carl T. Miller Trust*, the court declared that a taxpayer realizes discharge of indebtedness income if assets are freed from a debt, whether secured or unsecured.[136] Further, it makes no difference that the taxpayer's liability on a debt is not personal.[137] By analogy, then, failure of an executor to make an equitable adjustment may cause an income tax consequence.

Under the *Glenshaw Glass* test for income, the crucial question is whether any accession of wealth has occurred. The value of the estate remains the same. Assets stay in one account rather than moving from one account to another if the adjustment is made. In *Carl T. Miller Trust* the taxpayer argued that since the debtor estate owned a large portion of the creditor corporation, the debt was an asset of the corporation and the failure to file a claim was meaningless. If the debt was discharged, the increase in the value of the estate was offset by the decreased

132. United States v. Kirby Lumber Co., 284 U.S. 1 (1931); I.R.C. § 61(a)(12).

133. 60 T.C. 535 (1973). *See also* Carl T. Miller Trust v. Commissioner, 76 T.C. 191 (1981).

134. 60 T.C. 535, 540 (1973).

135. 76 T.C. 191 (1981).

136. *Id.* at 195.

137. Rev. Rul. 82-202, 1982-2 C.B. 35.

value of the corporation. Despite the appeal of the argument, the Tax Court rejected it. The court determined that a change in the corporation's value might be an estate tax valuation issue, but it did not change the fact the estate had been relieved from a liability.[138]

If failure to make an adjustment is a discharge of indebtedness, the question remains whether the income is realized by the decedent's estate or by the beneficiary whose inheritance owes the adjustment. In both *Bankhead* and *Miller*, the estates and not the beneficiaries realized the income, although beneficiaries of the estate ultimately received the benefit of the creditor's failure to file a claim. In each case the estate was liable for the debt, and, thus, when the statute of limitations expired, it was the estate that was discharged from the liability. By analogy, it is the estate, or more accurately, the assets in the possession of the executor, that owes an equitable adjustment. Thus, it seems that the estate, not the beneficiary, realizes income.[139]

In *Helvering v. American Dental Co.*,[140] the Supreme Court established a donative intent exception to the discharge of indebtedness rule. If the gratuitous exception applies, no discharge of indebtedness income occurs; instead, as discussed above, the beneficiary due the adjustment has a gift tax problem.[141]

In states that have no authority for equitable adjustments, the failure to make an adjustment may not have any income tax consequence. The application of the discharge of indebtedness income theory should apply only if the beneficiary has a *right* to the adjustment. Unless a legally enforceable liability exists, there is no debt to discharge.[142] Thus, the income tax conse-

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138. In *Miller* the estate did not own 100% of the corporation. While this helped negate the taxpayer's argument, the Tax Court rejected it as a determining factor. 76 T.C. 191, 200 (1981).

139. In the alternative, it is arguable that the beneficiaries who beneficially own the assets of the estate relieved from making the equitable adjustment have an accession to wealth and, thus, realize the discharge of indebtedness income. Even under this theory, however, the estate may still be taxed on the income since it is the taxable entity in possession of the assets at the time of the discharge. Other types of income generated from assets beneficially owned by the estate's beneficiaries are taxed to the estate. Although no authority exists for or against the position, taxing the estate seems the more logical conclusion and is consistent with the conduit theory of estate income taxation.

140. 318 U. S. 322 (1943).

141. *See supra* notes 110-21 and accompanying text.

142. I.R.C. § 108 defines "indebtedness" as "an obligation, absolute and not contingent."

quence depends on whether the beneficiary has a "right" to the adjustment, and as indicated above, this issue is determined by state law.

Whether a right to an adjustment exists in a particular state may also depend on which type of adjustment is potentially due. The Warms adjustment is well established by court decision and by statute.[143] The Holloway adjustment, on the other hand, is supported by only two cases, although it may be in common practice. The other potential adjustments are without either judicial or statutory basis. To the extent that the lack of authority means that the equitable adjustments are not required, there may be no right to the adjustments and, therefore, no income tax consequences for failing to make them.

Finally, no income tax consequence should result from the failure to make an adjustment when the governing document grants the executor discretion to make the adjustment and state law does not override that discretion.[144] The cancellation of indebtedness problem should apply only if there is an unasserted right to an adjustment, and no such right exists when the power to make the adjustment is in the executor's discretion.

2. *Estate Taxes*

The gross estate of a beneficiary who dies owing an adjustment should be smaller than if no adjustment were owed. More accurately, if the inheritance due from the prior estate is yet to be reduced by an equitable adjustment at the time of the new decedent's death, the value of the inheritance due should be reduced by the amount of the potential adjustment.

The new decedent's gross estate includes the inheritance yet to come from the earlier estate at its fair market value, determined at the time of the new decedent's death. If an adjustment is owed, the appraised value of the inheritance is reduced by the

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143. Declining to make an adjustment because of the lack of cases and statutes is not wise. Several commentators believe that the paucity of cases results from the wide acceptance and common use of this adjustment. A 1981 survey of the American College of Probate Counsel does not support the commentators' theory. *See Carrico & Bondurant*, *supra* note 2, at 605-28. Nevertheless, caution is in order.

144. *See In re* Estate of Backus, 106 Misc. 2d 463, 434 N.Y.S.2d 106 (Sur. Ct. 1980); *In re* Estate of Coe, 80 Misc. 2d 374, 363 N.Y.S.2d 265 (Sur. Ct. 1975); *In re* Estate of Le Compte, 52 Misc. 2d 549, 276 N.Y.S.2d 208 (Sur. Ct. 1966).

amount of the adjustment.[145] The equitable adjustment is not a debt of the new decedent's estate.[146] The speculative nature of the equitable adjustment does not alter this result,[147] although it may affect valuation.

In states that do not recognize equitable adjustments, the estate tax issue is not clear, but the valuation approach seems appropriate. The decedent is due an inheritance from the prior estate. When valuing that interest, the probability of giving up an equitable adjustment should be reflected in the appraised value of the inherited interest.[148]

Finally, there should be no estate tax significance when the executor of the first estate has the discretion to make the adjustment, but, as of the time of the beneficiary's death, has not decided how he will exercise his discretion. A subsequent exercise of discretion by the executor to make an adjustment will not affect the value of the inheritance since events that occur after the death of the new decedent do not change the value. In *Estate of Wood v. Commissioner*,[149] for example, the Tax Court did not decrease the value of an inheritance due for income taxes of the first estate that accrued after the second decedent's death.

C. The Fiduciary-Decedent

The beneficiary who is also the executor of the estate faces additional income, gift, and estate tax issues. Depending on the amount of discretion granted the executor by the governing instrument, significant tax issues may exist.

1. Income Taxes

In addition to the income tax problems described above, the beneficiary who is also the executor has yet another problem.

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145. Bahr v. Commissioner, 119 F.2d 371 (5th Cir. 1941).

146. *Id.*

147. Pending tort claims are estate tax deductions. *See* Estate of Nilson v. Commissioner, 31 T.C.M. 708 (1972). Other speculative assets, such as contingent remainder interests, are estate assets.

148. For a discussion of the potential for equitable adjustments in states where equitable adjustments are not currently made, see *supra* notes 74-89 and accompanying text.

149. 54 T.C. 1180 (1970). Wood was a beneficiary of an estate at the time of his death. After his death the first estate sold assets and incurred an income tax.

The power to make an equitable adjustment may cause the executor to be taxed on estate income even if the power is not exercised. Although several theories can be advanced to support this proposition,[150] it remains entirely theoretical. If this problem does exist, however, it can be avoided in either of two ways: the decedent could name a coexecutor with the beneficiary, or he could restrict or prohibit the power to make an equitable adjustment. Either method should prove effective.

2. *Gift Taxes*

The executor of an estate who has the discretion to make an equitable adjustment has the ability to shift estate income from one beneficiary to another. This power presents no problem for an executor who is not a beneficiary of the estate. If, however, the executor is a beneficiary, this power may be a taxable general power of appointment within the meaning of section 2514. This section defines a general power of appointment as "a power which is exercisable in favor of the individual possessing the power . . ., his estate, his creditors, or the creditors of his estate."[151]

Although the power to make an equitable adjustment is not called a power of appointment, the gift tax regulations make it

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150. I.R.C. § 678 taxes income to anyone who has the power to vest income or corpus of a trust in himself. For § 678 to apply, the power must be exercisable solely by the beneficiary, which means that a cofiduciary will prevent a beneficiary from being taxed on the income that can be shifted by an equitable adjustment.

It is questionable whether § 678 applies to an estate since no cases have applied it. The statute specifically refers to trusts, and in most situations, an estate is not likely to be subject to the § 678 rules. Treas. Reg. § 1.678(a)-1(a) refers to "testamentary or inter vivos" trusts.

If § 678 applies to a beneficiary-executor, two cases provide that § 678 is not applicable where the prohibited power is subject to an external standard. *See* Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950), *rev'g* 14 T.C. 198 (1950), *after remand by* 163 F.2d 796 (3d Cir. 1947), *rev'g* 7 T.C. 890 (1946); United States v. Smither 205 F.2d 518 (5th Cir. 1953), *aff'g* 108 F. Supp. 772 (S.D. Tex. 1952).

Even if § 678 does not apply, the theory of Mallinckrodt v. Commissioner, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945), might still cause an executor to be taxed on estate income. Section 678 is the statutory adoption of the *Mallinckrodt* principle. The Eighth Circuit's decision relied on general theories of taxation. Nevertheless, Estate of Harwood v. Commissioner, 46 B.T.A. 750 (1942), determined that a sole executor and sole beneficiary of an estate was not taxed on undistributed estate income. It is noteworthy that *Harwood* preceded *Mallinckrodt.*

151. I.R.C. § 2514(c). *Cf.* estate tax § 2041.

clear that nomenclature is not determinative for identifying powers of appointment.[152] It is equally clear that local law is not controlling for gift tax purposes.[153] Once the label attached to the power is disregarded, it is apparent that the power to make an equitable adjustment has the potential to be a taxable power of appointment.

In example 1 above,[154] the residuary trust is potentially due $90,000 from the income account. The executor, therefore, has the power to shift $90,000 away from the decedent's daughter and to the trust. If the son is the executor, he has the power to appoint $90,000 to the trust of which he is the remainderman and might, therefore, hold a general power of appointment.

It is possible, however, that an executor's power to make an equitable adjustment is not a power of appointment. The gift tax and estate tax regulations both provide that a power to allocate receipts between income and principal held in a fiduciary capacity "whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment."[155] The question is whether this language means that a power to make an equitable adjustment is not a general power of appointment and provides a safe harbor from the gift tax.

In states that require equitable adjustments, the power is probably within the regulation's safe harbor. Since the executor is required to make the equitable adjustment, he has a duty, not a "power," to enlarge or shift beneficial interests. The regulation exception, however, limits the exception to situations when the power to shift assets among beneficiaries is an "incidental consequence of the discharge of such fiduciary duties." Unfortunately, neither the regulations nor any judicial or administrative pronouncements discuss the meaning of the quoted phrase.[156] It should be noted, however, that all allocations of principal and income cause real shifts among beneficiaries. The power to make

152. Treas. Reg. § 25.2514-1(b)(1).

153. *Id.*

154. *See supra* subpart II(B).

155. Treas. Reg. §§ 25.2514-1(b)(1), 20.2041-1(b)(1).

156. I.R.S. Letter Ruling 8332007 (Aug. 3, 1983) mentions the regulation, but does not analyze the meaning of the language.

an equitable adjustment is no greater than the normal power to allocate receipts between principal and income held by a fiduciary. As a result, the power to make an equitable adjustment should not be a general power of appointment.

In states that have neither statutory nor judicial authority for equitable adjustments, the power to make an equitable adjustment is still probably not a general power of appointment. A power to make an equitable adjustment, whether based on the law of equity or, possibly, on the Revised Uniform Principal and Income Act, is a power exercisable by a fiduciary in a fiduciary capacity. If the governing instrument grants discretion, it is still exercisable in a fiduciary capacity. The regulation does not specify that the power to allocate must be derived from any particular source; it merely restricts the safe harbor to powers exercisable in a fiduciary capacity. A power to make an equitable adjustment falls within that category.

On the other hand, a broad power in a will to make equitable adjustments, not limited to exercise in a fiduciary capacity, is outside the regulation's safe harbor. Such a broad grant of power can occur when a will gives the executor absolute discretion to make equitable adjustments and state law does not interfere with the exercise of that discretion.[157] In this situation, the power to make an equitable adjustment may be a taxable power of appointment.

What course of action might avoid the gift tax? First, the testator could restrict the power by drafting, as discussed below.[158] Second, the testator could name two beneficiaries as coexecutors. For instance, in example 1 the daughter could be named coexecutrix, along with the son. A power exercisable only with the consent of an adverse party is not a taxable power.[159] Since the power would affect the decedent's daughter, she would be an adverse party, and the power would not be taxable.[160]

In summary, as long as the power to make an equitable adjustment is exercisable by the executor in a fiduciary capacity and not in his absolute discretion, it should not be a general

157. 3 A. SCOTT, *supra* note 15, § 187. *See also* Rowe v. Rowe, 219 Or. 599, 604-05, 347 P.2d 968, 971 (1959).

158. *See infra* part IV.

159. I.R.C. § 2041(b)(1)(c)(ii).

160. Treas. Reg. § 20.2041-3(c)(2).

power of appointment within the meaning of section 2514. Caution should be exercised, however, since this issue is not well defined. At a minimum, wills that permit discretionary equitable adjustments should specifically limit the power to make an equitable adjustment so that it is only exercisable in a fiduciary capacity. It would also strengthen the executor's argument if the power is incidental to the power to allocate receipts between income and principal. Specific drafting suggestions are discussed in part IV of this Article.

3. Estate Taxes

Finally, what if the decedent was an executor who died possessing the power to make an equitable adjustment in his own favor? The preceding discussion has argued that the power to make an equitable adjustment is not a general power of appointment. If this analysis is incorrect, however, then the decedent-executor holds a general power of appointment at the time of death, and the value of the potential adjustment is included in the new decedent's gross estate.[161]

A power to make an equitable adjustment that lapses during the executor's lifetime may also cause an estate tax problem if it was a general power of appointment. Section 2041 includes in a decedent's estate the value of property that was subject to a general power of appointment that has lapsed if the decedent retains certain interests in the property.[162]

D. Marital Deduction Issues

The marital deduction is the most popular tax savings technique in estate planning. Virtually every wills form book focuses on the marital deduction and the estate tax advantages it provides. Good draftsmen are very careful to avoid all potential problems related to marital deductions[163] and should, therefore, consider the possible effect of an equitable adjustment on the marital deduction.

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161. If the second death occurs within nine months of the first death, it is possible that the executor of the second estate could disclaim the power to adjust.

162. Treas. Reg. § 20.2041-3(d).

163. *See* Evans, *supra* note 61. *See also* R. WILKINS, DRAFTING WILLS AND TRUST AGREEMENTS: A SYSTEMS APPROACH, ¶¶ 9.30W, 13.67W, at 337, 414 (2d ed. 1980).

In example 3 above,[164] the election to deduct estate administration expenses on the income tax returns causes the marital deduction to increase and the residuary to decrease. The few cases that have considered this issue have not required an equitable adjustment.[165] These cases, however, were decided in only two states, and no appellate court has yet addressed the issue. Such limited precedent is hardly determinative of the issue.

Few cases have provided any discussion of the mechanics of equitable adjustments. The courts that have discussed this issue have concluded that the adjustment is accomplished by shifting estate income, but not estate principal, to compensate the injured party. In example 3, however, the income tax savings achieved by the section 642(g) election are not sufficient to make the residuary beneficiary whole.[166] Any court that decides to make an adjustment under these circumstances has two choices: it can give additional estate income to the residuary, or it can reduce the principal amount of the marital deduction.[167]

If the executor reduces the principal of the marital bequest, the amount of the estate tax marital deduction is likely to be affected. In *Estate of Britenstool v. Commissioner*,[168] an election to deduct estate adminstration expenses against income reduced a residuary charitable bequest. The estate, however, made an equitable adjustment. The Tax Court determined the estate's charitable deduction by considering what the charity received after the adjustment, and the IRS has acquiesced in this result.[169] By analogy, whatever passes to the surviving spouse after an equitable adjustment qualifies for the marital deduction. In example 3, if the widow's trust must give up some of the marital

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164. *See supra* subpart II(D).

165. *See In re* Veith's Estate, 26 Fla. Supp. 145 (Cir. Ct. 1965); *In re* Estate of McTarnahan, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Sur. Ct. 1960); *In re* Estate of Inman, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Sur. Ct. 1959).

166. If the marital bequest is outright instead of in trust, the residuary will already be entitled to all estate income and the income tax savings generated by the deduction. Since, however, the income tax savings will not totally replace the principal lost as a result of the tax election, an equitable adjustment must infringe on the marital share if the residuary is to be made whole.

167. A third choice for the executor is to partially compensate the residuary beneficiaries.

168. 46 T.C. 711 (1966).

169. Rev. Rul. 78-445, 1978-2 C.B. 242; I.R.S. Letter Rulings 7811022 (Mar. 17, 1978), 8016003 (Apr. 30, 1980).

share to the children, the estate tax marital deduction is reduced and will not be large enough to eliminate all federal estate taxes.

Any attempt to use additional estate income to make the residuary whole may precipitate another problem. Treasury Regulation section 20.2056(b)-4(a) provides that the value of the marital deduction allowable for estate tax purposes must take into account "the effect of any material limitations upon her right to income from the property." Unfortunately, no cases or rulings explain the meaning of this regulation.[170] Treasury Regulation section 20.2056(b)-5(f)(9) provides, however, that the marital deduction is not lost altogether if the surviving spouse does not receive any estate income.[171] Nevertheless, the amount of the marital deduction may be reduced.[172] Treasury Regulation section 20.2056(b)-5(f)(9) makes a specific reference to Treasury Regulation section 20.2056(b)-4 when the right to income from the trust is expressly postponed. Although the negative implication of the reference is that unless the income is expressly postponed, the valuation question does not arise, Treasury Regulation section 20.2056(b)-4 contains no such limitation on its application. Whether this presents a problem is unknown.[173] One commentator has suggested that a problem does arise when the surviving spouse has a right to the income under state law, but exercise of the discretion to make an equitable adjustment takes some of it away from the spouse.[174]

Distributions of principal that are treated as income pose a different threat to the marital deduction. When all or a portion of the marital bequest is income because of the DNI rules, the valuation issue of Treasury Regulation section 20.2056(b)-4 must be considered. In example 2 the amount received by the widow is not worth $500,000 to her since she will lose a portion of it to income taxes. The estate tax marital deduction should not be

170. I.R.S. Letter Ruling 8033103 (Aug. 3, 1983) discusses the application of the regulation when a decedent's will provides 3.5% annual income on the marital share instead of the amount of income prescribed by state law.

171. *See* Rev. Rul. 77-346, 1977-2 C.B. 340.

172. For additional discussion, see Adams, *Questions and Answers on Estate Planning and Administration,* 125 TR. & EST. 50, 54 (January 1986).

173. One commentator believes that Treas. Reg. § 20.2056(b)-4 should not apply if state law imposes the restriction. *See* R. COVEY, *supra* note 2, at 72. Nevertheless, the same commentator suggests a precautionary drafting solution to ensure that the marital deduction is not jeopardized. *Id.* at 73-74.

174. *See* Blattmachr, *Tax Effects, supra* note 2.

affected if a gift results when the right to an adjustment is not asserted. If, however, the widow cannot force the adjustment and the executor does not make it, then, arguably, the marital deduction is affected, as it is underfunded. From a pure economic analysis, the amount allowable as a marital deduction is not being transferred to the widow, and the remainder of the estate is unjustly benefiting at the expense of the surviving spouse.[175]

Although the logic of this argument seems clear, there is some precedent against it. In *Estate of Robinson v. Commissioner*,[176] the Tax Court held that, for estate tax purposes, an item of income in respect of a decedent (IRD) was valued without reduction for the potential income tax due. In a letter ruling the Service ruled that the potential income taxes on items of IRD are ignored for marital deduction funding purposes as well. The Service conceded that reducing the value of items of IRD for potential income taxes is exceedingly complex, although not impossible.[177]

Items of IRD are analogous to distributions of principal that are treated as income for tax purposes. Both are principal for fiduciary accounting purposes, although both are subject to income taxes when received. After income taxes are paid, the recipient no longer has what was distributed. Nevertheless, a distribution of principal that is treated as income may be distinguished from IRD. In *Robinson* the Tax Court determined that Congress enacted section 691(c) to provide relief from an obvious inequity. This subsection gives an income tax deduction for the estate taxes attributable to the item of IRD. In the case of the distribution of principal treated as income, however, the Internal Revenue Code provides no relief. In addition, the speculative nature of estimating the income tax on an item of IRD does not exist for the distribution of principal that is treated as income. When this type of distribution occurs, it is possible to determine with precision the tax savings to the estate and the

175. Although not precedent for the current situation, draftsmen should be aware that in the 1960s, when estate administrators were manipulating the marital deduction by using estate tax values for funding purposes, the Internal Revenue Service came down hard on the technique. *See* Rev. Proc. 64-19, 1962-1 C.B. 682.

176. 69 T.C. 222 (1977).

177. I.R.S. Letter Ruling 7827008 (July 11, 1978).

tax cost to the beneficiary.

Since the estate tax issue is in many ways a valuation question, the general valuation test of a willing buyer-willing seller should be considered. Would someone pay the surviving spouse $500,000 for the right to $500,000?[178] Ignoring the time value of money, the answer is yes. For the widow, however, the situation is different. No one would pay $500,000 to assume her place as a beneficiary. The value of what the widow receives, when it includes DNI, is not worth $500,000. It is worth $500,000 only if it is funded when the estate has no DNI or if an equitable adjustment is made. When the widow does not receive assets equal in value to the estate's marital deduction, the amount of the marital deduction should be reduced.[179]

These possible challenges to the marital deduction are theoretical and are not supported by any cases. Nevertheless, the analysis is not farfetched or unrealistic. In 1983 the Connecticut legislature considered the possibility real enough to warrant legislation prohibiting equitable adjustments that might affect a QTIP marital trust.[180] The mere possibility that the marital deduction might not be allowed for the full amount contemplated by the decedent's will should prompt cautious estate planners to adopt drafting solutions.

IV. DRAFTING PROPOSALS

Although equitable adjustments may cause potential tax problems, careful drafting can resolve or at least minimize those problems. No one drafting solution, however, is suitable for all clients; different situations require different approaches.

A. *Protecting the Marital Deduction*

Any equitable adjustment that arguably affects the marital deduction should be prohibited.[181] The particular provisions

178. For simplicity sake, it is assumed that the $500,000 is cash.

179. This is not a problem that someone must bear because no one benefits as with IRD. If the marital share receives DNI, then someone else will receive a benefit, accumulated income, without having to pay income taxes.

180. CONN. GEN. STAT. ANN. § 45-100d(d) (West 1981 & Supp. 1986).

181. At least two commentators agree. *See* Blattmachr, *Tax Effects, supra* note 2, ¶ 1414; Moore, *Conflicts, supra* note 2, ¶ 606.4. *But see* Evans, *supra* note 61, at 1183-85.

needed will vary depending on who serves as executor. If the client names an independent executor, a will clause such as the following would permit equitable adjustments and protect the marital deduction:[182]

> My executor shall have the discretion, but shall not be required, to make adjustments in the rights of any beneficiaries, or among the principal and income accounts, to compensate for the consequences of any tax decision or election, or of any investment or administrative decision, that my executor believes has had the effect, directly or indirectly, of preferring one beneficiary or group of beneficiaries over others; *provided, however, my executor shall not exercise his discretion in a manner that causes the loss or reduction of the marital or charitable*[183] *deduction as may herein be provided.*[184]

If the executor is also a beneficiary, the discretionary power to make an equitable adjustment must be limited in a manner that conforms with Treasury Regulation sections 20.2041-1(b)(1) and 25.2514-1(b)(1). As discussed above, a power to allocate between principal and income held in a fiduciary capacity is probably not a general power of appointment.[185] Two will provisions are suggested for the beneficiary-executor situation.

First, the will should require that any general power to allocate receipts between principal and income only be exercisable in a fiduciary capacity. This result can also be accomplished if the will specifies that the executor holds all powers in a fiduciary capacity. Second, the power to make equitable adjustments should be classified as a power to allocate receipts and disburse-

182. The effectiveness of marital deduction savings clauses is not free of doubt. *See* Rev. Rul. 65-144, 1965-1 C.B. 442. In Rev. Rul. 75-440, 1975-2 C.B. 372, however, the Service ruled that it would honor the effect of savings clauses if, from a reading of the entire document, the disqualifying power was not intended to apply to the marital trust. Since the savings provision proposed in this Article is a part of the same sentence granting the power to make equitable adjustments, there can be little doubt that the testator does not intend for the disqualifying power to effect the marital deduction. In many ways the proposed savings provision is similar to the restriction found in Upjohn v. Commissioner, 1972-2 U.S.T.C. ¶ 12,888 (W.D. Mich. 1972). For a further discussion of marital deduction savings clauses, see R. COVEY, *supra* note 2, at 181-82.

183. Although not discussed in this Article, the charitable deduction should be protected in the same manner as the marital deduction.

184. This form is adapted, with minor alteration, from R. WILKINS, *supra* note 163, Form 13.90W, at 419 (as amended in NEWS FROM DRAFTING WILLS AND TRUST AGREEMENTS: A SYSTEMS APPROACH, April-May 1986, at 1).

185. *See supra* notes 151-57 and accompanying text.

ments. This provision strengthens the argument that the power to make the adjustment is protected by Treasury Regulation section 25.2514-1(b)(1). A possible form might read as follows:

> My executor, *as the fiduciary of my estate*, shall have the discretion, but shall not be required, *when allocating receipts of my estate between income and principal*, to make adjustments in the rights of any beneficiaries, or among the principal and income accounts to compensate for the consequences of any tax decision or election, or of any investment or administrative decision, that my executor believes has had the effect, directly or indirectly, of preferring one beneficiary or group of beneficiaries over others; provided, however, my executor shall not exercise his discretion in a manner that would cause the loss or reduction of the marital or charitable deduction as may herein be provided.

B. Directing the Section 642(g) Election

The drafting solutions set out above are not the only choices. For larger estates, it may be advisable to eliminate the need for a Warms adjustment by prohibiting the section 642(g) election to deduct estate administration expenses on income tax returns.[186] While this forgoes any current income tax deduction, it increases the amount of the residuary and decreases the size of the marital deduction and of the surviving spouse's potential estate.

It may not be advisable, however, to forgo the section 642(g) election if the potential surviving spouse[187] is young and the time value of the income tax savings outweigh the additional estate taxes at the second spouse's death. It is also not advisable when the value of both spouses' combined estates is less than $1,200,000. In that situation, because no federal estate tax liability will arise at the second death, the income tax savings are the

186. Of course, this recommendation is subject to how a testator might view the potential shift of assets between the marital share and the residuary illustrated in example 3.

187. When clients make their estate plans, it is, of course, unknown which spouse will die first and how old each spouse will be at the time of death. Estate planners must assume, when preparing documents, that clients may die shortly after the documents are prepared. In time, the client's documents may need to be amended as a result of changed circumstances, such as increased age.

only tax savings available.

The section 642(g) election is not the only source of tax election problems. Unless Congress enacts the House version of the 1986 Tax Reform legislation, which eliminates the concept of DNI,[188] distributions of principal that are treated as income might cause problems as well. A testator, therefore, might wish to grant the executor a power to make equitable adjustments to overcome the inequities caused by a distribution of principal treated as income, while at the same time prohibiting the section 642(g) election. All other potential adjustments might also be prohibited, except to the extent that the marital or charitable deduction is affected. Such a provision might read as follows:

> My executor may not elect to deduct estate administration expenses on any income tax returns of my estate as permitted by Internal Revenue Code section 642(g). My executor shall have the discretion, but shall not be required, to make adjustments in the rights of any beneficiaries, or among the principal and income accounts, to compensate for the consequences of distributions of estate principal considered income as a result of Internal Revenue Code sections 661 and 662; provided, however, my executor shall not exercise his discretion in a manner that causes the loss or reduction of the marital or charitable deduction as may herein be provided. My executor may not make any other adjustments in the rights of any beneficiaries, or among the principal and income accounts, to compensate for the consequences of any other tax decision or election, or of any investment or administrative decision; provided, however, my executor shall make any adjustments as are necessary to prevent the loss or reduction of the marital or charitable deduction as may herein be provided.

The following provision can be used to deny the section 642(g) election and to permit the beneficiary-executor to make a Holloway adjustment:

> My executor may not elect to deduct estate administration expenses on any income tax returns of my estate as permitted by Internal Revenue Code section 642(g). My executor, *as the fiduciary of my estate*, shall have the discretion, but shall not be required, *when allocating receipts of my estate between income and principal*, to make adjustments in the rights of any

188. *See supra* notes 85-86 and accompanying text.

beneficiaries, or among the principal and income accounts to compensate for the consequences of distributions of estate principal being considered income as a result of Internal Revenue Code section 661 and 662; provided, however, my executor shall not exercise his discretion in a manner that causes the loss or reduction of the marital or charitable deduction as may herein be provided. My executor shall not make any other adjustments in the rights of any beneficiaries, or among the principal and income accounts to compensate for the consequences of any tax decision or election, or of any investment or administrative decision; provided, however, my executor shall make any adjustments as are necessary to prevent the loss or reduction of the marital or charitable deduction as may herein be provided.

C. *Prohibiting Equitable Adjustments*

As a final alternative, a testator might prohibit all discretionary equitable adjustments. To ensure that the marital deduction is not lost or reduced for failure to make an equitable adjustment, the draftsman should add a proviso that protects the marital deduction. A provision to prohibit equitable adjustments might read as follows:

> My executor shall not make adjustments in the rights of any beneficiaries, or among the principal and income accounts, to compensate for the consequences of any tax decision or election, or of any investment or administrative decision; provided, however, my executor shall make any adjustments as are necessary to prevent the loss or reduction of the marital or charitable deduction as may herein be provided.

The draftsman should not use a provision that directs equitable adjustments. Potential equitable adjustments are numerous, and a direction to make adjustments might cause a fiduciary to make all possible adjustments.[189] This would be an administrative nightmare for the executor and is not likely to be cost effective.

One question remains: should the testator affirmatively prohibit equitable adjustments or is silence on the issue enough?

189. Carrico, *Equitable Adjustments*, *supra* note 2, discusses 18 different potential equitable adjustments.

Unfortunately, silence probably is not a prudent course of action in states that do not have well-defined parameters for equitable adjustments. The tax issues alluded to above all depend on the beneficiary having a right to the equitable adjustment. If no right to an equitable adjustment exists, either because it is in the discretion of the executor or because it is prohibited, the worst of the beneficiary's problems disappear. For the executor-beneficiary, it is better for the testator to limit the power to make adjustments than to rely on state law to bring the beneficiary-executor within the safe harbor of Treasury Regulation section 25.2514-1(b)(1).

V. Conclusion

Equitable adjustments are complex, and their tax consequences uncharted. Only in states where the legislature or the courts have established definite parameters do estate planners have a solid basis for evaluating the issues. In the states where neither the courts nor the legislature have acted, the estate planner stands on uncertain ground.

The discussion of the tax issues in this Article is, in many instances, theoretical and speculative. Only one tax case has given any consideration to the tax ramifications of equitable adjustments.[190] Nevertheless, the drafting suggestions set out above can protect estates, beneficiaries, executors, and estate planners from the potential problems. Unfortunately, no one solution can resolve every situation. Client circumstances and needs vary, and the drafting responses must be sensitive to these differences.

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190. Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966).