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Fiduciaries often face many tax options and elections during the administration of an estate or trust. The manner in which the fiduciary exercises, or does not exercise, tax elections and options will significantly affect one, some, or all of the beneficiaries. In some cases, it may cause the fiduciary to have made a gift for federal gift tax purposes. This article explores some of the ways in which a fiduciary might be treated as making a gift by exercising or not exercising certain tax elections or options.

General Rules Regarding Gifts

As a general rule, only individuals can make transfers that are subject to federal gift tax. See Code § 2501(a)(1). Certain "look-through" rules apply when a legal entity, such as a corporation, rather than a natural person, makes or receives a transfer. Treas. Reg. § 25.2511–1(h)(1). Any completed transfer for less than full and adequate consideration in money or money's worth by an individual to someone else is subject to gift tax unless an exemption, exclusion, or deduction applies. Treas. Reg. § 25.2511–2(b). A transfer of property is complete to the extent the donor does not retain an interest in the property or dominion and control over the property to render the transfer incomplete. A transfer made at arm's length, free of donative intent, and in the ordinary course of business is deemed to be made for full and adequate consideration. Treas. Reg. § 25.2512–8. An individual may make a gift under Section 2511 by transferring an interest

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in his or her property to another, or under Section 2514 by the exercise, release, or lapse of a general power of appointment in favor of another.

A beneficiary of a trust may be treated as making a gift for federal gift tax purposes in the same ways: (1) under Section 2514 by the exercise, release, or lapse of a general power of appointment of property held in the trust in favor of another or (2) under Section 2511 by the transfer of an interest the beneficiary holds in the trust. For example, the exercise of a special power of appointment in favor of another by the income beneficiary of a trust is a gift of the income interest lost by that exercise. Treas. Reg. § 25.2514–1(b)(2); *Estate of Regester v. Commissioner,* 83 T.C. 1 (1984). Similarly, the irrevocable assignment by the presumptive remainder beneficiary of a vested remainder interest in property (subject to being divested only in the event he or she fails to survive another or the occurrence of another event) is a gift. Treas. Reg. § 25.2511–1(h)(6).

A transfer of trust property in which the trustee has no beneficial interest, by a trustee acting in his or her fiduciary capacity to another individual, is not considered a transfer subject to gift tax. Treas. Reg. § 25.2511–1(g)(1). For example, a trustee who makes a discretionary distribution to a beneficiary of income or corpus of the trust would not be treated as making a gift, even though the trustee is the legal owner of the trust estate. This may not be true if the trustee is also the grantor or a beneficiary. Treas. Reg. § 25.2511–1(g)(2).

Even if a trustee is also a beneficiary of the trust, a transfer by the trustee is not subject to gift tax if it is made under a fiduciary power limited by a reasonably fixed or ascertainable standard that is set forth in the trust instrument. This definition includes a clearly measurable standard under which the holder of a power is legally accountable; for example, a power to distribute corpus for the beneficiary's education, health, maintenance, or support; for the beneficiary's reasonable support and comfort; or to enable the beneficiary to maintain an accustomed standard of living. The implication is that a fiduciary who has a beneficial interest in property will be treated as making a gift by transferring it to another if the transfer, even if effected in a fiduciary capacity, is not in accordance with such an ascertainable standard.

Analogies in the Estate Tax

The interaction between state law fiduciary duty concepts and transfer tax principles is context-sensitive. For example, in the estate tax context, if the grantor of a trust limits her retained powers by an ascertainable standard, the grantor avoids inclusion under Section 2036(a)(2). See Rev. Rul. 73–143, 1973–1 C.B. 407. Generally, the grantor can avoid inclusion under Section 2036(a)(2) when a retained power is subject to a fiduciary duty that state law imposes on corporate officers and directors. See *United States v. Byrum,* 408 U.S. 125 (1972). On the other hand, if a grantor retains discretion, as trustee, to choose among beneficiaries in making distributions, Section 2036(a)(2) will apply in the absence of an ascertainable standard. In other words, the general fiduciary duty that state law imposes on a trustee is not sufficient to negate the applicability of Section 2036(a)(2). See *United States v. O'Malley,* 383 U.S. 627 (1966).

The regulations under Section 2041, relating to estate tax inclusion of property over which the decedent holds a general power of appointment, take a two-track approach. In the case of a power to consume or invade trust property, the powerholder is deemed to have a general power of appointment unless the power is limited by an ascertainable standard. Treas. Reg. § 20.2041–1(c)(2). In the case of an administrative power, by contrast, there is no need for the power to be circumscribed by an ascertainable standard to avoid estate tax inclusion. If the power is held in a fiduciary capacity, the duty generally applicable to a fiduciary will suffice to avoid inclusion. Treas. Reg. §§ 20.2041–1(b)(1); 25.2514–1(b)(1). Even if the exercise of the administrative power can produce significant benefits for the powerholder, Section 2041 does not apply under this rule. See, e.g., PLR 8908032. What

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accounts for the Treasury's willingness to exclude from the reach of Sections 2041 and 2514 administrative powers that are subject to general fiduciary duty principles while, at the same time, these general principles are insufficient to avoid inclusion under Section 2036 for a grantor? Although the rationale for this distinction is not clear, the more lenient approach taken in the case of administrative powers probably reflects a concern that, were the rule otherwise, Sections 2041 and 2514 would prevent the designation of a beneficiary as a trustee in the overwhelming majority of cases, given that trustees typically have discretion regarding various administrative matters. Although the administrative power provision is helpful for grantors who wish to name a beneficiary as trustee, it remains unclear whether any given power will fall within its scope.

Actions by Fiduciaries That Might Be Considered Gifts

As indicated above, under certain circumstances, an executor or trustee who is a beneficiary of the estate or trust (an "interested fiduciary") might be deemed to have sufficient control over and interest in the estate or trust property that an action taken in a fiduciary capacity might be considered a gift by the fiduciary. There seem to be at least two categories of actions that might result in a gift by the interested fiduciary: (1) the actual distribution of property by the fiduciary and (2) the exercise by a fiduciary of certain tax-related elections under a will or trust that have the effect of altering the value or existence of other beneficial interests in the estate or trust. This might occur when the exercise (or non-exercise) of a tax election or option is viewed as the equivalent of the exercise, release, or lapse of a general power of appointment held by the fiduciary or the fiduciary is deemed to have transferred a property interest he or she holds individually.

Possible Gifts by Fiduciaries Through Tax Elections and Options

Failure to Exercise Right of Reimbursement

For example, an executor who also is the residuary legatee of the decedent's probate estate and whose will does not direct all estate taxes on nonprobate property to be paid from the residue probably would be treated as making gifts if the executor does not seek reimbursement of the estate taxes allocable to those receiving or holding taxable nonprobate property. This failure to seek reimbursement appears to be a release by the executor of a general power of appointment. The executor has the power to obtain the property for his or her individual benefit but chooses not to do so. As indicated above, it seems virtually certain that the exercise, release, or lapse of a general power held by a fiduciary in favor of another is a gift. See, e.g., Code § 2207B (addressing reimbursement for estate taxes attributable to a qualified terminable interest property (QTIP) trust included in the decedent's estate under Code § 2044).

Election to Deduct Administration Expenses

As a general rule, an executor may choose to deduct administration expenses for income or estate tax purposes. Code §§ 212, 642(c), 2053. The choice by the fiduciary to deduct them on the fiduciary income tax return (Form 1041) or on the federal estate tax return (Form 706) may reduce or augment the marital deduction available in the decedent's estate. If the executor is the surviving spouse or one of the other beneficiaries, then this might be considered a gift to the surviving spouse or the other beneficiaries. If the fiduciary is a beneficiary of the marital deduction share or the balance of the estate, the fiduciary might be deemed to have made a gift to the other beneficiaries by electing to deduct administration expenses on the income tax return or the estate tax return, depending on the circumstances.

For example, a wife dies in 2004 (when the federal estate tax exemption equivalent is $1.5 million), leaving an estate of $2.5 million, and provides in her will that the minimum amount necessary to reduce her federal estate tax to its minimum shall pass to her U.S. citizen husband (and thereby qualify for the marital deduction under Code § 2056), with the balance passing to her daughter. Assuming the decedent had made no prior gifts that used any of her estate tax exemption equivalent and the estate had no debts, taxes, or expenses to pay, the first $1 million would pass to her husband, leaving a taxable estate of $1.5 million to pass, estate-tax-free, to her daughter. If the decedent's estate incurs $100,000 of estate administration expenses, the executor must decide whether to deduct those expenses on the estate tax return or on the estate income tax return. If the executor deducts them on the estate tax return, the minimum amount necessary to qualify for the marital deduction is now $900,000, still leaving $1.5 million to pass to the daughter. In effect, the burden of the expenses will be borne by the husband. If the executor deducts the expenses on the income tax return, the entire $100,000 will be borne by the daughter's share. If the husband is named as the executor, he can essentially take an extra $100,000 of his wife's estate for himself by deducting those expenses on the income tax return, or have the daughter receive an extra $100,000 by deducting them on the estate tax return. It is arguable that if the husband chooses to take the expenses on the estate tax return, so that he receives less and the daughter receives more, he has made a gift to her. An analogous issue arises if the daughter is executor. She can benefit herself or the husband depending on where she takes the expenses. It is arguable that she will make a gift to him if she takes them in a manner so as to benefit the husband. As discussed later, state law limitations on how an interested fiduciary may exercise a power and adjustments required by state law between the interests of the beneficiaries may avoid the potential imposition of gift tax in such cases.

As in the case of an interested executor who fails to force reimbursement for contribution of estate tax, the executor who may exercise the power to deduct estate administration expenses in a manner that financially favors him or her but fails to do so may be treated as making a gift. Such an exercise would be treated as a gift on the ground that the fiduciary's exercise of the tax option is the equivalent of the exercise, release, or lapse of a general power of appointment in favor of another.

Election of Alternate Valuation Date

The choice whether to elect the alternate valuation date under Code § 2032 will change how much tax will be due and may also result in a shift of property from one beneficiary to another. For example, a man dies in 2004 with an estate having a date-of-death value of $2.7 million, consisting of property jointly owned with rights of survivorship with his sister worth $1.6 million (all of which is included in his estate under Code § 2040) and a probate estate of $1.5 million. His will provides that his wife is to receive the minimum amount necessary to reduce his federal estate tax to its minimum, with any balance passing to his son. Because the property jointly owned with his sister exceeds the estate tax exemption equivalent of $1.5 million, his entire probate estate will pass to his wife. On the alternate valuation date, the value of the property owned at death with the sister drops to $1.3 million while the value of the probate estate remains at $1.5 million. Because the jointly owned asset is the only property subject to estate tax, taxes will be lower if alternate valuation is selected, but, using alternate valuation date values, the minimum marital deduction amount necessary to reduce the federal estate tax to its minimum drops from $1.5 million to $1.3 million. As a result, $200,000 would pass to the son. If the widow is executor, she can benefit herself by using date-of-death values or benefit the son by choosing alternate valuation. If the son is the executor, the result will be the same. If the interested executor chooses to benefit the other probate beneficiary, will he or she be deemed to have made a gift? Again, it is arguable that the fiduciary would be treated as exercising a general power of appointment in favor of another by deciding to use the valuation date that benefits the other person and reduce by the same amount what the executor personally will receive.

Clayton QTIP Election

Another case in which a fiduciary's decision may result in a shift in property from himself or herself to another occurs in a so-called *Clayton* QTIP election. See Treas. Reg. § 20.2056(b)–7(d)(3)(i); *Estate of Clayton v. Commissioner*, 97 T.C. 327 (1991), rev'd, 976 F.2d 1486 (5th Cir. 1992). The regulations allow an estate tax marital deduction for property passing into a trust described in Section 2056(b)(7) (a QTIP trust) to the extent the executor makes the election under that section, even if the property would pass in a form not qualifying for the marital deduction to the extent the executor does not elect the treatment under the section. In other words, to the extent the executor makes the QTIP election, the property will pass into a trust from which the surviving spouse will be entitled to receive the income for life. To the extent the executor does not make the QTIP election, the property probably will pass in a different way, which may not qualify for the marital deduction. If the surviving spouse is the executor, he or she may be deemed to have made a gift to the extent he or she does not elect QTIP treatment when the estate planning document provides for a *Clayton* QTIP. Similarly, if one of those who would receive

property to the extent QTIP treatment is not elected is an executor, that fiduciary may make a gift to the extent he or she elects QTIP treatment. Again, the basis for the gift by the spouse or the other interested executor would be the exercise, release, or lapse of a general power of appointment in favor of another.

Spouse/Executor Failure to Elect QTIP

A spouse who is an executor should not be treated as having made a gift by not electing QTIP treatment when the interest created for the spouse under Section 2056(b)(7) is not a *Clayton* QTIP but a "regular" QTIP. In such a case, the form of the spouse's interest in the deceased spouse's estate will not change by the election, because in either case the spouse will be entitled to all of the income from the trust for life. But, to the extent the executor does not elect QTIP treatment, estate taxes may increase. The executor may decline to elect QTIP treatment for several reasons. For example, the estate of the spouse who is first to die may have available estate tax credits that will be useable only if the estate of the deceased spouse is taxable or the taxable estate is larger. If the surviving spouse might die relatively soon after the first spouse dies, generating estate tax in the first estate may provide the estate of the surviving spouse with a prior transfer credit under Section 2013 that would reduce the overall taxes that will be due on both estates. If the QTIPable trust carries the additional estate taxes generated by not electing QTIP treatment, its corpus will be smaller and so will the income the surviving spouse receives for his or her lifetime. The reduction in the income interest held by the spouse by failing to elect QTIP treatment should not be a gift, however, because no property interest seems to be transferred to or for another individual. The gift tax applies only to the transmission of property to another individual—here, the transfer is to the IRS (and, perhaps, some state tax authority).

Suppose, however, that the executor who will decide the extent to which the QTIP election is made is a beneficiary who will benefit from the choice to make the election. For example, the executor is the daughter of the husband who dies first. His estate is so small that it will be taxed at less than the "top" federal estate tax rate. The widow has property of her own. When she dies, the property in the trust her husband has created for her probably will face higher estate taxes if it is included in the widow's estate under Section 2044 than if the tax were paid at the husband's death. This will occur for two reasons: first, the widow's property will be combined with that in the QTIP and be pushed into a higher estate tax bracket, and second, the estate tax on the QTIP will be imposed under Section 2207B at the highest marginal rate(s) her estate will face. In such a case, the daughter likely would be economically better off by not electing QTIP treatment. By making the election, no tax is due in the estate of the first spouse to die and the surviving spouse has a larger income interest for life. The action of the daughter as executor increases the economic benefit to the surviving spouse, and that benefit is capable of being measured. It is not certain, however, what the daughter has "lost." Although one might speculate that the daughter's remainder interest in the QTIP ultimately will be greater if no QTIP election is made, that cannot be certain. Between the deaths of the two spouses, levels of estate tax exemption, rates of estate tax, and other legal developments could mean the daughter will net more if the QTIP election is made. The "loss" of property to the daughter seems to be too speculative to measure and, therefore, it seems that her decision to elect QTIP treatment should not constitute a gift. See generally Mitchell M. Gans, *Gift Tax: Valuation Difficulties and Gift Completion*, 58 Notre Dame L. Rev. 493 (1983). Certainly, if the trustee, other than the daughter, may invade the QTIP trust other than under an ascertainable standard, the daughter's expectancy in the remainder is highly speculative and may have a market value approaching zero.

Method of Administration

A fiduciary normally has broad powers of management over the property, including the right to decide whether assets should be sold or exchanged and how funds should be invested. In many cases, these administrative powers can profoundly affect beneficiaries. For example, a trustee of a trust required to pay income to a beneficiary may control, within broad parameters, how much income the trust produces. The beneficiary will probably receive more and the successor beneficiaries less if the trustee invests for current income production rather than for growth. If the trustee is a beneficiary of the trust, the fiduciary may invest to benefit himself or herself, on the one side, or other beneficiaries, on the other. For example, if the trustee is entitled to all income, the trustee may benefit personally, at least in the short run, by investing heavily for relatively high current income production rather than for long-term growth. On the other hand, if the trustee is a remainder beneficiary, the fiduciary probably may favor himself or herself by investing heavily for long-term growth rather than for current income production. The manner in which the trustee/beneficiary exercises that investment power does not seem to be a gift. "The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, *exercisable 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." Treas. Reg. § 25.2514–1(b)(1) (emphasis added).

Other "management" powers might be treated differently. For example, under the law of most states, a trustee may exercise a power to adjust the income and corpus accounts in a manner that is reasonable and impartial and/or to convert a trust to a unitrust (that is, one paying a fixed percentage of the changing value of the trust). It is uncertain whether that power, if held by a trustee who is a beneficiary of the trust, falls under the regulatory exception under Section 2514 quoted previously. At least some states have foreclosed an interested trustee from exercising those powers, which should foreclose the possibility of such a trustee from making a gift by reason of a power to adjust or to convert. See, e.g., N.Y. Est. Powers & Trusts Law (EPTL) § 11–2.3(b)(5)(C)(vii), (viii) (power to adjust). New York law contains no similar restriction for a unitrust conversion. See EPTL § 11–2.4.

Disproportionate Distributions of Basis

Often, more than one person will succeed to interests in an estate or trust. Frequently, under local law or the terms of the governing instrument, the fiduciary will have the authority to distribute different assets with different income tax bases to different beneficiaries even though they are entitled to the same share or proportion of a share as other beneficiaries. For example, a woman dies and leaves her estate in equal shares to her two sons but names only her younger son as the executor. When the administration of the estate ends, the estate available for distribution consists of a block of stock then worth $500,000 with a basis of $350,000 and a bond then worth $500,000 and with a basis also equal to $500,000. If local law or the governing instrument permits the executor to distribute different assets to different beneficiaries, nonhomogeneous distributions to the brothers probably will not result in any taxable exchange for income tax purposes. See Rev. Rul. 69–486, 1969–2 C.B. 159. Armed with such authority, the younger son may personally benefit by distributing the bond to himself and the stock to his brother. If he fails to do so, will he be making a gift? The value of the economic benefit he would be conferring on his brother probably can be measured.

Other Elections and Options

As indicated earlier, there are dozens of tax options and elections fiduciaries may make. Many will benefit one beneficiary at a cost to another. How the benefit or detriment of the election affects the beneficiaries between or among themselves may be easy or difficult to discern. For example, an interested executor who is a skip person for generation-skipping transfer tax purposes would immediately benefit by allocating the decedent's remaining GST exemption under Section 2632 to his or her bequest as opposed to allocating it to bequests made to other skip persons. The saving probably is simple to discern, but the benefits and costs of electing under Section 2032A to have real property used in a farm or other closely held business especially valued for estate tax purposes may be much more difficult to determine. It is unlikely, however, that difficulty in determining the exact amount of property shifted would prevent the IRS from claiming that an interested fiduciary has made a gift by exercising (or not exercising) the election.

State Law Curbs on Fiduciary Action

Even an expansive reading of the portion of Treas. Reg. § 25.2514–1(b)(1) relating to administrative provisions (quoted above) does not per se prevent a shift in property by a tax election exercised by an interested fiduciary from characterization as a gift by such a fiduciary. In the event such a shift might otherwise be deemed a gift, state law may limit an interested fiduciary's exercise (or non-exercise) of a tax option or election so as to prevent gift characterization.

State law may control certain tax elections and options. For example, many states require that, for purposes of determining the extent to which noncash assets satisfy a dollar (pecuniary) legacy, such assets must be valued at their date-of-distribution fair market value. See, e.g., EPTL § 2–1.9(b)(1). Some states further limit the manner in which certain tax elections may be taken into account in readjusting interests of beneficiaries. See, e.g., EPTL § 11–1.2. In any case, most states prohibit a fiduciary from engaging in any act of self-dealing, although some states permit self-dealing with court approval or allow the prohibition to be waived in the governing instrument. See *Restatement (Third) of Trusts* § 228 (1992). Some statutes, however, invalidate provisions of a governing instrument that attempt to grant a fiduciary immunity from certain actions. See EPTL § 11–1.7. At least in some cases, these limitations may curb the manner in which a fiduciary, who is also a beneficiary, may exercise tax elections so that such a trustee or executor should not be treated as having made a gift even if he or she exercises the election in a manner that results in a shift of property from himself or herself to another beneficiary.

In determining whether to instruct interested fiduciaries on how to exercise a tax option, one court has stated: "The principles governing judicial intervention should trace the fiduciary's own guidelines in exercising tax elections. These have been summarized as three aspects of fiduciary duty: (1) the duty to minimize the over-all tax burden on the estate and its beneficiaries; (2) the duty of impartiality; and (3) the duty to abstain from self-dealing." *In re Estate of Rappaport,* 467 N.Y.S.2d 814, 816 (N.Y. 1983).

In a seminal case, *Matter of Colp,* N.Y. Law J., Jan. 20, 1976, p. 8, col. 2, the decedent's widow and the decedent's son by a prior marriage were the executors and beneficiaries under his will. Each desired to elect a different valuation date for estate tax purposes. The valuation date each sought would have resulted in that executor receiving more as a beneficiary under the will than if the other election were made. The court refused to instruct the executors on how they should exercise the tax election but, in effect, required them to make a decision that would not result in financial injury to other beneficiaries of the estate. That case suggests that an interested fiduciary would not be able to exercise a tax election in a manner that personally benefited him or her at the expense of another beneficiary who is not also a fiduciary—and that, in turn, suggests that the fiduciary should not be treated as making a gift, in such a case, if the exercise is to the detriment of the fiduciary and benefits the other beneficiary.

The same court that decided *Colp* later decided *In re Estate of Fales,* 431 N.Y.S.2d 763 (N.Y. Surr. Ct. 1980). In *Fales,* the court did direct the fiduciaries on how to exercise a power that had tax consequences when the fiduciaries would personally benefit, potentially at the expense of others who were not fiduciaries; in fact, the court permitted them to exercise the power to benefit themselves. The surrogate stated, in reaching his decision: "I now believe that this court should provide guidance

STATE LAW NORMALLY PROHIBITS A TRUSTEE FROM COMMITTING AN ACT OF SELF-DEALING.

and direction to fiduciaries presented with *Colp*-type tax election decisions and other determinations involving tax consequences." Id. at 764.

That same court, in considering the issue of how a fiduciary, apparently regardless of whether the fiduciary is also a beneficiary, should exercise a tax election, suggested that "[i]t may well be, for example, that fiduciaries should minimize taxes for their estates whether or not their choice benefits themselves, and that the beneficiaries or this court ought to strike a compromise for the equitable purpose of sharing the gains and losses which shelter the estate as a whole." *Fales,* 431 N.Y.S.2d at 764. In other words, the court is suggesting that, perhaps, the fiduciary should exercise a tax election (or option) in a manner that reduces overall taxes and then share the savings to make whole those who "lost" by the election. In some ways this is an inviting concept that, if local law does require that an interested fiduciary who is "injured" by the election be made whole, should prevent such a fiduciary from being deemed to have made a gift. The net result would be that there would be no shift of property from the fiduciary to another beneficiary; it would simply be a shift from the tax authorities to another beneficiary. Indeed, federal tax law strongly suggests that the effects of an equitable adjustment, when required by local law, will be determinative of the ultimate tax consequences of the election. See, e.g., *Estate of Britenstool v. Commissioner,* 46 T.C. 711 (1966), acq. and nonacq. 1978–2 C.B. 1, 3.

Nevertheless, the court that decided *Rappaport* may have come to a somewhat different judgment in another context. In *Estate of Louise Gould,* N.Y. LAW J., Oct. 21, 2002, p. 26, col. 6 (Surr. Ct. Nassau Co.), the trustee was, along with his brother, a remainder beneficiary of a trust entitled to one-half of the property in a trust that his mother had created for his now-deceased father. The trustee had distributed assets with a higher income tax basis to himself than to his brother. Governing law allowed a trustee to make nonhomogeneous distributions. The court, apparently without considering what would result in the largest tax savings and directing that each beneficiary at least be made whole, ordered the interested trustee

> to exchange the requisite securities for cash from the [remainder beneficiary who is the trustee] so as to equalize the benefit of the distribution as of the date of the initial distribution. In other words, the [brother who is not a trustee] will return one-half of the shares of [low basis] stock to the [brother who is the trustee] while the [brother who is the trustee] shall give [the brother

who is not a trustee] one-half of the cash he originally retained, plus accrued interest.

Id.

State law normally prohibits a trustee from committing an act of self-dealing. Exercising an election in a manner that personally benefits the fiduciary could be viewed, at least in some states, as an unlawful and voidable act of self-dealing. If that were the case, the IRS would have a powerful argument that an election that benefits the fiduciary personally is voidable as a matter of state law and, therefore, will be ignored for federal tax purposes.

In any case, in deciding whether state law, which does not seem well-developed on the issue in any jurisdiction, may so restrict an interested trustee or executor in making a tax election, at least two additional issues probably should be considered. The first is determining whether state law limits the manner of exercise of a tax option by an executor or trustee who may personally benefit from it. Although instructions may be sought from the local court having jurisdiction over the estate, as occurred in *In re Estate of Fales,* such local court decisions may not bind the IRS or the federal courts. See *Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967). It is at least arguable that, if the fiduciary is instructed by the court before making the election, exercising the option in favor of another is not a gift. See Rev. Rul. 73–142, 1973–1 C.B. 405. Here it is arguable that, if the local court decision is made before the election is made, the election falls under the protection of Rev. Rul. 73–142. See also *Harris v. Commissioner,* 340 U.S. 106 (1950). The IRS might contend, however, that commencing the proceeding, if and when it results in the elimination of the power to exercise it in the fiduciary's own favor, is the equivalent of a release of a general power of appointment if the court's decision is not consistent with local law.

One should also explore whether state law might require, as suggested above, that the fiduciary exercise the option in the manner that minimizes overall taxation, as is suggested by the court's statement in *In re Estate of Fales* quoted above. If that result were required by state law, there would seem to be no gift when a fiduciary so exercises a tax election even if the election results in a shift from an interested fiduciary to another beneficiary. State law might, in turn, require an equitable adjustment back to the interested fiduciary. Such a direction should foreclose the possibility that the interested executor or trustee has made a gift. See generally Joel Dobris, *Equitable Adjustments in Post Mortem Income Tax Planning,* 65 Iowa L. Rev. 103 (1979). And, although much has been written about equitable adjustments, the law is actually sparsely developed. In some cases, an equitable adjustment is prohibited by state law. See, e.g., EPTL § 11–1.2(b)(1). In addition, the net tax savings may not change, such as in the case in which the executor may allocate the decedent's unused GST exemption to more than one bequest to skip persons.

Summary, Conclusions, and Sample Language

It is not certain if or when the exercise of a tax election or option will cause a fiduciary to be treated as making a gift when the exercise results in a shift of property from an interested fiduciary to another beneficiary. Basic gift tax rules, however, suggest that a gift might be made in some situations. In at least one case, the concerned fiduciaries sought and obtained the appointment of an independent trustee to exercise discretion. See *Estate of Lillian Goldman,* N.Y. Law J., Sept. 5, 2003, p. 20 (Surr. Ct. N.Y. Co.). Although state law may adequately restrict how an interested fiduciary may exercise tax elections, the law may not be adequately developed in many states to give confidence in that result.

Great prudence would suggest that no beneficiary ever be appointed as an executor or trustee. That, of course, is unrealistic. A more practical solution to avoiding the potential gift problem, perhaps, is to have appropriate provisions in the governing document.

For example, the property owner might appoint a fiduciary who is not a

beneficiary to make all tax elections that could result in an enlargement or shift of any beneficial interest. Such a provision might read as follows:

> [Name of fiduciary who is not a beneficiary] shall alone make all decisions with respect to any and all tax elections and options, under federal, state, or local law, the exercise or nonexercise of which could result in an enlargement, diminution, or shift of any beneficial interest hereunder. [Name of fiduciary who is not a beneficiary] shall participate in no other fiduciary decision hereunder.

Alternatively, the governing document could require the appointment of a fiduciary who is not a beneficiary under the instrument if the fiduciaries, who are beneficiaries, may exercise a tax election or option that could enlarge or shift any beneficial interest. Such a provision might read:

> No individual fiduciary shall participate in any decision with respect to any tax election or option, under federal, state, or local law, that could enlarge, diminish, or shift his or her beneficial interest hereunder from or to the beneficial interest hereunder of another person. If the only fiduciary or fiduciaries who otherwise could exercise such tax election or option hold such beneficial interests hereunder, another individual or a bank or trust company (but not an individual, bank or trust company that is related or subordinate within the meaning of Code Section 672(c) to any acting fiduciary hereunder) shall be appointed by the fiduciary or fiduciaries then acting hereunder and the fiduciary so appointed shall alone exercise such election or option. ■