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INCOME IN RESPECT OF A DECEDENT: DEDUCTIONS, CAPITAL GAINS, AND DOUBLE DEDUCTIONS*

Clarence J. Ferrari, Jr.†

Mr. Justice Holmes once said that “the life of the law is not logic but experience.” The taxation of income items uncollected at the date of death has been an unsatisfactory and inconsistent experience in its historical context. Congressional and judicial attempts to subject income, “earned” by decedents while living, to income taxation after death is a reflection of efforts to reconcile two conflicting policies in the tax law.

First, although section 443(a)(2) closes a decedent’s taxable year on the date of his death, the intervention of death should not cause income “earned” while the decedent was alive to escape taxation. Cash and accrual basis taxpayers should be treated similarly in the event of death. Secondly, section 1014 requires that “property” as contrasted with income, receive a basis in the hands of the recipient equal to the fair market value of the property at the date of death. A brief review of the Congressional and judicial efforts to reconcile this conflict is imperative to fully understand the material which follows.

The Background of Section 691

Prior to the 1934 Revenue Act, accrued income of a cash basis taxpayer was not included in his final return nor was it reportable as income by the personal representative of his estate. The right to such income was burdened only by the federal estate tax and escaped income taxation in its entirety. This result was grounded on the theory that at the time of the taxpayer’s death these income items became “corpus” which passed to his estate and, when later reduced to cash, constituted a mere conversion of capital into a different form. The deductibility of the decedent’s accrued expenses was disallowed on the same theory.

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The revenue loss and the obvious inequity in favor of cash basis taxpayers caused the Congress to move to the opposite extreme in the enactment of sections 42 and 43 of the Revenue Act of 1934. Those sections provided generally that regardless of the method of accounting employed by the taxpayer, all income accrued up to the date of his death was properly includable in his final return.¹ Accrued deductions were similarly treated.²

Notwithstanding the fact that prior to the enactment of the 1934 Revenue Act the term "accrued" had acquired a relatively well-established meaning, the judiciary abandoned these precedents in *Helvering v. Enright's Estate*,³ and attributed to that term a broader connotation than had theretofore existed. The treatment of deductions in the decedent's final return was also made consistent with the reasoning of the *Enright* case.⁴

1939 Code Provision

The exaggerated income bunching caused by the *Enright* rationale created an inequity of the same magnitude as that which existed prior to 1934. Section 126 of the 1939 Code was enacted to remedy this situation. It forms the basis for the current tax treatment of income in respect of a decedent.

The theory of section 126 was to tax such income in the same manner as if the decedent had lived, received the income, paid the tax thereon, and passed the income, net of tax, to his estate. The income is taxed to the recipient when received and an income tax deduction is allowed for the portion of the federal estate tax attributable to the inclusion of the value of the right to such income in the decedent's gross estate.

The treatment of such income under section 691 of the Internal Revenue Code of 1954 is the same as under section 126 of the 1939 Code, differing only in the extension of its coverage to income of successive decedents. It is a corollary to section 451 of the Internal Revenue Code which provides generally that the taxable income of a decedent for the period prior to his death does not include items accrued only by reason of death.

¹ Rev. Act of 1934 § 42.

² Rev. Act of 1934 § 43.

³ 312 U.S. 636, 61 S. Ct. 777, 85 L. Ed. 1093 (1941); *Pfaff v. Comm'r*, 312 U.S. 646, 61 S. Ct. 783, 85 L. Ed. 1099 (1941).

⁴ *Estate of Lewis Cass Ledyard, Jr.*, 44 B.T.A. 1056 (1941). *rev'd* on this point

Constitutionality Upheld

In *Richardson v. United States*⁵ the taxpayer challenged the constitutionality of section 691 on the ground that it was a tax on "principal." The court rejected the contention holding that section 691 imposed a tax on "income" and was therefore constitutional because it was within the scope of the Sixteenth Amendment.

Lack of Definition

Section 691 applies to "all items of gross income in respect of a decedent" but neither the Code nor Treasury Regulations defines the term. A determination of the scope of the term must necessarily precede an analysis of the tax treatment of such income and the initial portion of this paper will attempt to categorize judicial precedent and administrative pronouncements in order that any gaps left by the Congress or the courts may be recognized.

COMPENSATION

The Regulations provide that income in respect of a decedent shall include all accrued income of a cash basis taxpayer.⁶ Thus any compensation in return for services rendered prior to death by a deceased employee, and paid thereafter, is income in respect of a decedent and is taxable to the employee's estate or successor in interest when received.⁷

A discretionary payment authorized by the employer's board of directors and paid subsequent to death was held to be such income notwithstanding the fact that the decedent had no vested right thereto.⁸ Bonus payments to the personal representative or widow of a deceased employee have been held to be income in respect of a decedent even though neither the employee nor his estate had an enforceable right thereto, and even though the amount of the bonus was not determined until after the employee's death.⁹

Deferred Compensation Agreements

Since the issuance of Revenue Ruling 60-31,¹⁰ which sets forth the views of the Service relative to the applicability of the doctrine

sub nom. *Comm'r v. Trust Co. of N.Y.*, 143 F.2d 243 (C.A. 2, 1944).

⁵ 294 F.2d 593 (C.A. 6, 1961).

⁶ Reg. § 1.691(a)-1(b)(1).

⁷ *Estate of Fred Basch*, 9 T.C. 627 (1947).

⁸ *Estate of Edward Bausch v. Comm'r*, 186 F.2d 313 (C.A. 2, 1951).

⁹ *O'Daniel's Estate v. Comm'r*, 173 F.2d 966 (C.A. 2, 1951).

¹⁰ C.B. 1960-1, 174.

of constructive receipt to deferred compensation plans, such arrangements have become increasingly popular. Under the usual agreement, the employer promises to pay an amount, after retirement, for work currently performed by the employee. The arrangement is established typically to level out the employee's income over his high and low income years.

Most deferred compensation plans provide that in the event of the employee's death, the remaining payments are to be paid to the surviving spouse or estate of the deceased employee. Amounts received subsequent to the employee's death would be income in respect of a decedent, and taxable to the beneficiary when received.

In *Bernard v. United States*,¹¹ payments received by the taxpayer from her deceased husband's former employer were held to be income in respect of a decedent. Here the contract under which the decedent was employed obligated the employer to make annual payments, based on the decedent's salary and bonuses, to the taxpayer after the decedent's death.

In *Essenfeld v. Commissioner*,¹² the Tax Court held that payments received by a widow were income in respect of her deceased husband since these payments were made pursuant to the decedent's employment contract. The court permitted the \$5,000 exclusion under section 101(b) to be applied against the payments. This result was reached without any discussion of the "nonforfeitable right" exception under section 101(b)(1)(B) which does not allow the exclusion when the decedent had a nonforfeitable right to receive such payments while living.

Agreement for Payments to Begin after Death

The cases involving Florence E. Carr clearly demonstrate the theory which underlies section 691. Mrs. Carr's husband had been employed by a corporation which owed him in excess of one hundred thousand dollars of earned but unpaid commissions on May 23, 1927. He entered into a contract with his employer whereunder he waived and released any and all rights to such commissions in exchange for the employer's promise to pay to his wife, Florence E. Carr, the annual sum of ten thousand dollars for ten years subsequent to his death. Mr. Carr died on June 21, 1951.

In *Florence E. Carr*,¹³ it was held that the payments made to Mrs. Carr in 1951 and 1952 were not income to her. The court

¹¹ 215 F. Supp. 256 (S.D.N.Y. 1963).

¹² 37 T.C. 117 (1961), *aff'd*, 311 F.2d 208 (C.A. 2, 1962).

¹³ 28 T.C. 779 (1957) (N.A., C.B. 1959-1, 6).

specifically noted that the Commissioner had not relied on section 126 (the predecessor of section 691), and that since the petitioner had rendered no services to the employer she received such payments as a gift or property settlement from her husband and thus was not taxable thereon.

Thereafter the question of taxability of similar payments received by Mrs. Carr for the years 1953 through 1957 was litigated. The Tax Court held that under section 126 and its counterpart, section 691(a), such payments constituted taxable income to Mrs. Carr as received.¹⁴ The petitioner argued that income arising from the contractual arrangement should have been reported by Mrs. Carr's husband in 1927, when the original contract was entered into. The Tax Court disagreed on the ground that Mr. Carr realized no income inasmuch as the payments were not to begin until after his death. The argument made in the prior case relative to a gift or property settlement was not raised in the subsequent proceeding.

Decedent Need Not Have Been Entitled to Payment

The *Carr* cases are significant because they indicate that in order to constitute income in respect of a decedent it is not necessary that the decedent would have been entitled to payments had he or she lived. If this were necessary, any payments like those in *Carr*, which were to begin subsequent to death, would escape income taxation.

Fringe Benefits

The Service has ruled that payment of an accrued vacation allowance on behalf of a deceased employee is income in respect of a decedent and taxable to the recipient.¹⁵

To the extent that a successor in interest of a deceased employee receives benefits from a contributory retirement plan qualified under section 401 of the Internal Revenue Code, amounts received on account of employee contributions would be income in respect of a decedent.¹⁶

Under the stock option rules,¹⁷ if the personal representative of a decedent exercises a stock option which was granted to the decedent, the decedent's estate must report as an item of gross income the "compensation" which the decedent would have recognized

¹⁴ Estate of Florence E. Carr, 37 T.C. 1173 (1962).

¹⁵ Rev. Rul. 59-64 (C.B. 1959-1, 31).

¹⁶ Hess v. Comm'r, 271 F.2d 104 (C.A. 3, 1959).

¹⁷ I.R.C. § 421-424.

had he lived to exercise the option.¹⁸ The effect of this rule is to treat such "compensation" as income in respect of a decedent.

Payments to Successor in Interest

Amounts paid to the successor in interest of an independent contractor will invoke the provisions of section 691.

Insurance Commissions

The majority of cases have involved renewal commissions of a deceased life insurance agent which were payable after his death.¹⁹ In *Helen Rich Findlay*,²⁰ the decedent, a life insurance solicitor, executed an agreement prior to his death providing for payment of commissions after his death in stated amounts. By his will he bequeathed a one-half interest in the contract to his widow and one-half to his former wife. The Tax Court held that the amounts received by the legatees were taxable income when received and that it was immaterial that such payments were received under a settlement agreement with the payor.²¹ It is evident that the purpose of section 691(a) will not be thwarted by the form of a transaction, as was attempted in the *Findlay* case where the transfer was by way of a bequest of a contractual property right of the decedent.

Royalties

If an author or inventor contracts, prior to his death, for the transfer of a patent or work in exchange for royalties, amounts paid to the decedent's estate or successor in interest thereafter are income in respect of a decedent.²² The same result has been reached as to amounts received under a contractual license agreement if the payments thereunder are accrued as of the date of the inventor's death. However, royalty payments accrued subsequent to the inventor's death are not income in respect of a decedent.²³

Exclusions from Income

Exclusions from income are applied consistently after the death of a taxpayer. Payments made to the widow of an employee by way

¹⁸ I.R.C. § 421(c)(1).

¹⁹ Estate of Thomas F. Remington, 9 T.C. 99 (1947); *Lantendresse v. Comm'r*, 243 F.2d 577 (C.A. 7, 1957); Rev. Rul. 59-162 (C.B. 1959-1, 224).

²⁰ 39 T.C. 580 (1962).

²¹ See also the companion case of *Irving F. Wright*, 39 T.C. 597 (1962).

²² Rev. Rul. 57-544 (C.B. 1957-2, 361). See also Rev. Rul. 60-277 (C.B. 1960-1, 262).

²³ Rev. Rul. 60-227 (C.B. 1960-1, 262).

of gift do not constitute income in respect of a decedent.²⁴ Likewise, payment to a decedent's successor in interest which represents excludable sick pay under section 105 is not income in respect of a decedent.²⁵

Investment and Passive Income

Since the purpose of section 691 is to reach all accrued income in the case of a cash basis taxpayer, any dividends declared and payable to a shareholder of record prior to his death are taxable to the recipients. If, however, the record date is subsequent to the shareholder's death, they are not accrued and not taxable under section 691.²⁶

Various Kinds of Interest

Dividends receivable on building and loan accounts were treated as income in respect of a decedent notwithstanding the fact that the decedent had no enforceable right to such dividends until the accounts matured or were withdrawn in their entirety.²⁷ Interest owed to the decedent at the time of his death is taxable to the recipient when received.²⁸

Interest accrued on United States Savings Bonds owned by a cash basis taxpayer who did not elect to treat the increase in value as income received in each year is income in respect of a decedent when reported by his estate or successor in interest.²⁹ Revenue Ruling 64-104³⁰ further clarified the treatment of interest on United States Savings Bonds. The unreported increment in value of Series E Bonds as of the date of death, the unreported increment in value of Series E Bonds which constituted a part of the consideration paid for Series H Bonds by the decedent, and the interest payable on Series H Bonds but not received as of the date of death are all treated as income in respect of a decedent in the year in which the bonds are disposed of, redeemed, or reach maturity.

Rental Income

Accrued rental income received after the date of the lessor's death is taxable under section 691. However, the recent case of *Grill*

²⁴ I.R.C. § 102(a).

²⁵ Rev. Rul. 59-64 (C.B. 1959-1, 31).

²⁶ Putnam's Estate v. Comm'r, 324 U.S. 393 (1945).

²⁷ Estate of Wm. P. Cooper, 197 T.C.M. 521 (1960).

²⁸ Richardson v. United States, 177 F. Supp 394 (E.D. Mich. 1959).

²⁹ Rev. Rul. 58-435 (C.B. 1958-2, 370).

³⁰ Rev. Rul. 64-104 (I.R.B. 1964-13, 13).

v. United States,³¹ held that motion picture rentals which were both earned and received after decedent's death were not income in respect of a decedent on the theory that such income was not accrued as of the date of death.

RECEIPTS IN EXCHANGE FOR BUSINESS INTEREST

Partnership Distribution

There are specific statutory provisions, in addition to section 691, governing the taxation of income in respect of a deceased partner.³² In the case of personal service or professional partnerships, amounts paid to the deceased partner's successor in interest represent principally the value of work in process, or accounts receivable, as contrasted with his interest in tangible partnership assets. Thus, it is possible, by careful application of section 736, to establish a program with favorable tax consequences to the decedent's successor in interest and to the remaining partners.

Partnership Income

The decedent's distributive share of partnership income for the portion of the partnership year up to the date of his death, including amounts withdrawn by the decedent prior to his death, is income in respect of a decedent.³³ The taxable year of the partnership with respect to a deceased partner generally continues beyond the date of death of the partner and will close at the end of the normal partnership taxable year.³⁴

It should be noted that if the successor in interest of a deceased partner continues his interest as a partner, either indefinitely or for the purpose of winding up and dissolution, the provisions of section 753 are inapplicable. Nonetheless, the decedent's distributive share of partnership income for the partnership year up to and including the date of his death still constitutes income in respect of a decedent.³⁵

Unrealized Receivables

A possible loophole exists in the case of the treatment of unrealized receivables in the case of the death of a partner. Upon a partner's death, the basis of his partnership interest is increased to an

³¹ 303 F.2d 922 (Ct. Cl. 1962).

³² I.R.C. §§ 753, 736(a).

³³ Reg. § 1.753-1(b).

³⁴ I.R.C. § 706(c).

³⁵ Reg. § 1.753-1(b).

amount equal to the fair market value of the interest at the time of his death.³⁶ Section 1014(c) specifically provides that income in respect of a decedent does not receive the stepped-up basis under section 1014(a). However, the partnership interest itself is not income in respect of a decedent and therefore it would seem that a step-up in basis is not precluded.

If the partnership liquidates the decedent's interest and any portion of the payment is treated as being in exchange for the deceased partner's interest in unrealized receivables, the remainder of the payment which would be in exchange for the deceased partner's partnership interest would be less than the adjusted basis of that interest in the hands of the successor in interest. Thus a loss would be created.³⁷

If the deceased partner's interest were sold by his successor in interest to a remaining partner, the same loophole would exist. The selling price would be allocated in such a way as to attribute a certain sum to the unrealized receivables.³⁸ Regulations section 1.751-1(a)(2) requires that the basis of the section 751 property equal the basis that such receivables would have had under section 732(d), which would be the same amount as that determined by the 751(a) allocation. Therefore, upon an outright sale of the interest, the successor would recognize no income in connection with the unrealized receivables. Several cogent arguments can be advanced in support of a contrary result, but to date the issue has not been litigated.³⁹

Shareholder of Subchapter S Corporation

In the case of the death of a shareholder in a Subchapter S corporation, income in respect of a decedent would not result.^{39a} If the election remains in force subsequent to his death, the successor to the deceased shareholder on the last day of the taxable year of the corporation will be taxed on his entire prorata share of the corporation's income for the taxable year with which or within which the corporation's taxable year ends, reduced by an amount of current year's income which had been distributed to the decedent prior to his death.⁴⁰

³⁶ I.R.C. § 1014(a).

³⁷ I.R.C. § 731(a)(2).

³⁸ I.R.C. § 751(a).

³⁹ The Advisory Group on Subchapter K of the Internal Revenue Code in 1957 made certain suggestions to eliminate this loophole. Proposed legislation was introduced on this point, which was not enacted. H.R. 9662, 86th Cong., 2d Sess. (1960).

^{39a} Rev. Rul. 64-309 (I.R.B. 1964-48, 14).

⁴⁰ I.R.C. § 1373(b).

Sales Made by Decedent

Proceeds received from collection of accounts receivable owing a decedent on the date of his death are taxable under section 691.⁴¹ In *Estate of John A. Biewer*,⁴² the decedent conducted a mercantile business involving the use of inventories but filed his return on the cash basis of accounting. The court included as income in respect of a decedent, collections made by the estate on accounts receivable originating from sales made by the decedent prior to his death. The court did not allow any adjustment under section 481 relative to a change in accounting method. It stated that the estate, in filing its first return, was a separate tax entity and could not be considered as having a "preceding taxable year" within the meaning of the section.

A similar result was reached even though the value of the decedent's interest in the property sold (crops) was not determined until after his death, when the consideration was received by his estate.⁴³

Installment Sales

Section 691(a)(4) provides specific treatment for proceeds resulting from sales made prior to death which were reported on the installment method under section 453. An amount equal to the excess of the face value of the installment obligation over its basis in the hands of the decedent determined under section 453(d)(2) is reportable as income in respect of a decedent. The recipient must report the same proportion of each payment representing gain as the decedent would have had to report had he lived.⁴⁴ In the event that the installment receivable is collected at less than the face value, a full basis recovery is allowed with only the excess taxable to the successor in interest of the decedent.

INADVERTENT REALIZATION OF INCOME IN RESPECT OF A DECEDENT

The outer boundaries of section 691 with reference to the concept of taxable income are, at the present time, unclear. Lending judicial support to the proposition that income as defined in section 61(a) should be all-encompassing is the recent case of *Davison's*

⁴¹ *Dixon v. United States*, 96 F. Supp. 986 (D. Ky. 1951), *aff'd*, 192 F.2d 82 (C.A. 6, 1952).

⁴² 41 T.C. 191 (1963).

⁴³ *Comm'r v. Linde*, 213 F.2d 1 (C.A. 9, 1954).

⁴⁴ Reg. § 1.691(a)-5(a).

Estate v. United States.⁴⁵ The decedent, at the time of her death, was entitled to crop share rentals in cash which had been earned prior to her death, but which had not been determined until thereafter, and crop share rentals in kind earned prior to death which were received by the estate and thereafter sold. The court held that both items were income in respect of a decedent and taxable under section 691.

The result conflicted directly with Treasury Regulations relative to cash basis farmers which provide that crop shares shall be included in gross income only in the year they are reduced to money or its equivalent.⁴⁶ The decision was likewise contrary to Revenue Ruling 58-436,⁴⁷ and to Revenue Ruling 56-496,⁴⁸ which were consistent with the Regulations. Recently Revenue Ruling 58-436 was modified by Revenue Ruling 64-289.^{48a} Under the current rule livestock and farm crops received in kind by a decedent prior to his death and owned by him on that date constitute items of income in respect of a decedent. However, crop-share or livestock rentals in kind received by the decedent's estate subsequent to his death, or the proceeds attributable to the portion of the rent period which runs from the date after death to the end of the rental period, are ordinary income to the estate and not income in respect of a decedent.

Revenue Ruling 58-436 seemingly was intended as an approval of the Tax Court's decision in *Estate of Tom L. Burnett*.⁴⁹ There the decedent cattle rancher, who was on the cash basis, purchased cattle for breeding purposes but not for resale and deducted all expenses from income when and as paid. No inventory was used in computing the gain from cattle sales. He owned livestock valued at approximately \$161,000 on the date of his death. The court held that mere ownership of livestock, which is tantamount to appreciated inventory, was not income accrued to the decedent within the meaning of section 42 of the 1938 Revenue Act.

The *Davison* Court rejected Revenue Ruling 58-436 on the ground that it was an unjustified extension of *Burnett* and further rejected the taxpayer's argument that because the value of the crop shares was unascertainable at death they should not be taxed. In rejecting the latter contention the Court relied on the compensa-

⁴⁵ 292 F.2d 937 (Ct. Cl. 1961). See also *National Bank of Commerce v. Mathis*, 61-2 U.S.T.C. 9741 (E.D. Ark. 1961).

⁴⁶ Reg. § 1.61-4.

⁴⁷ C.B. 1958-2, 366.

⁴⁸ C.B. 1956-2, 17.

^{48a} Rev. Rul. 64-289 (I.R.B. 1964-45, 9).

⁴⁹ 2 T.C. 897 (1943) (A., C.B. 1944, 4).

tion cases such as *O'Daniel's Estate v. Commissioner*⁵⁰ and *Bausch's Estate v. Commissioner*.⁵¹

The proper post-death tax treatment of economic activities of a decedent while living presents a sharp conflict between the notion that income should not escape taxation merely because of the death of its producer, and the concept that "property" should receive a basis equal to its fair market value on the date of the owner's death. From an analysis of the cases the following generalizations as to the nature of income in respect of a decedent can be made:

(a) Such income is not limited to items that would have been reportable as income by the decedent had he lived to receive the same;

(b) The extent or value of the right to receive such income need not be determined or ascertainable on the day of the decedent's death;

(c) The value of the item must be attributable to the economic activities of the decedent prior to death;

(d) Some event tantamount to realization or vesting of the right to such income must occur prior to death. However, the cases indicate that it is incorrect to suppose that only those items properly accruable in a tax sense should be considered within the scope of the term.

"Income-Type Assets"

The results reached in the cases prior to the *Grill* decision⁵² can be rationalized on the theory that such income is predicated on the existence of a peculiar type of asset in a decedent's estate, which is a source of income only to the extent it represents the value of the decedent's economic activities while living. Once that activity produces cash (or its equivalent) the asset itself is extinguished. Illustrative would be the *Linde*⁵³ crops, the *Davison*⁵⁴ rentals in kind, and other types of appreciated assets. In this context, the treatment of bare contractual rights would pose difficult problems.

Payments Arising Out of Personal Service Contract

Benefits paid to a successor in interest of the decedent under a contract requiring the personal services of the decedent would

⁵⁰ Note 9 supra.

⁵¹ Note 8 supra.

⁵² Note 31 supra.

⁵³ Note 43 supra.

⁵⁴ Note 45 supra.

probably give rise to income in respect of a decedent. In *United States v. Woolsey*,⁵⁵ the court held that the sale of an interest in a partnership whose principle asset was a management contract having nineteen years to run was the sale of an "unrealized receivable." If a decedent's estate included such a management contract, any payment received on the sale thereof would probably be held to constitute income in respect of a decedent. This is an incorrect result because it fails to distinguish between the present sale of a future right to *earn* income and a present sale of the future right to *earned* income.

In the case of a management contract, the economic activities of some individual are necessary to render such a contract valuable. The purchaser of such a right would necessarily have to perform substantial services to maintain the value of the right. Consistent with the "income-type asset" theory advanced above, a contrary result would now be reached in the *Burnett* situation and under the facts of Revenue Ruling 58-436.

Cases in Conflict

The *Grill* case is inconsistent with the "income-type asset" theory. The *Grill* Court, relying on Revenue Ruling 60-227, held that motion picture rentals had not been "sold" prior to death and thus those rentals earned after the date of death were not accrued as of the decedent's death. This result seems to be clearly in conflict with *Davison*.

The technique used by the *Grill* Court to determine the existence of income in respect of a decedent frustrates predictability in this area because the results depend in great measure on the form of the transaction. Analyzing the scope of income in respect of a decedent in terms of the nature of the underlying asset offers the alternatives of confusion or the complete emasculation of section 691 which results from a reliance on form rather than substance.

TAX ASPECTS OF INCOME IN RESPECT OF A DECEDENT

If a client's estate includes income in respect of a decedent it is imperative that the tax characteristics of such income be fully considered. Consistent with the taxation of such income in the first instance, it is obvious that the right thereto cannot receive an income tax basis in the hands of the recipient equal to its fair market value

⁵⁵ 326 F.2d 287 (C.A. 5, 1962).

on the date of the decedent's death. This principle has been codified in section 1014(c).

Community Property States

Tax practitioners have been in doubt as to the effect of section 1014(c) in the case of decedents in community property States. It was argued on behalf of the taxpayer that since each spouse in a community property state has a vested interest in one-half of gross income items, the survivor's share was not "income in respect of a decedent" and thus the provisions of section 1014(c) did not apply.

In *Bath v. United States*,⁵⁶ the question presented to the court was whether the surviving spouse was entitled, under section 1014(b)(6), to a stepped-up basis for reporting his community share of a long-term capital gain realized on the sale of community property prior to his wife's death. The sale had been reported on the installment method. The court denied the use of the stepped-up basis on the ground that the provisions of section 1014(b)(6) are operative only when a sale or exchange occurs subsequent to death. The court also alluded to the fact that to allow a contrary result would create a tax disparity between residents of community and common law States.

The court did not consider directly the question whether the surviving spouse's share of such gain was income in respect of a decedent and thus prohibited from obtaining a stepped-up basis under section 1014(c). It did, by inference, indicate that had the installment obligation itself been disposed of after death a different result might have obtained.

In *Bessie Stanley*,⁵⁷ the same question arose in California with reference to capital gain from installment payments received subsequent to the decedent's death on sales made prior thereto. The surviving spouse reported no gain on one-half of the installment payments received subsequent to death. Her theory was that under section 1014(b)(6) her basis for the right to such payments became the fair market value of that one-half interest at the date of her husband's death, and that the fair market value was one-half of the unpaid balances of the installment obligation.

The court held for the Commissioner, stating that it was not the intention of section 1014(b)(6) to give any advantage to a surviving spouse in a community property state as contrasted with a common law state. The court agreed that section 1014(c) renders section 1014(b)(6) inapplicable to such income rights since the deceased

⁵⁶ 211 F. Supp. 368 (S.D. Tex. 1962).

⁵⁷ 40 T.C. 851 (1963).

spouse's community interest constituted a right to receive income in respect of a decedent. Since a portion of the property passing to the surviving spouse is income in respect of a decedent this taints the survivor's one-half to which that spouse had a vested right immediately prior to her husband's death.

If the decedent had bequeathed his community share of the installment receivable directly to his children, it is submitted that the court would reach the same result. Thus it should be clear that the real reason for the *Stanley* decision was to prevent any inequality between community and non-community States. The decision can be supported on that ground. *Johnson v. United States*,⁵⁸ decided by the Federal District Court in Texas, has reached the same result as *Bath* and *Stanley*.

Income Resulting from Sections 1245 and 1250

Income in respect of a decedent retains the same character in the hands of the recipient as it would have had in decedent's hands had he lived.⁵⁹ Any income required to be treated as ordinary income under the recapture provisions of sections 1245 and 1250 will be treated as such notwithstanding the intervening death of the person who earned the income.

The proposed regulations under section 1245 create a practical problem with reference to receipt of installment payments on account of section 1245 property previously sold by the decedent. Such payments may represent part ordinary income in the form of depreciation recapture and part capital gain. Under the proposed regulations, the ordinary income arising from depreciation recapture must be reported in full before the taxpayer can report any portion of gain remaining as capital gain.⁶⁰ Since the language of section 1250 in this respect is identical with that of section 1245, the treatment will presumably apply to section 1250 as well.

Miscellaneous Income Tax Benefits

The income averaging rules under the Revenue Act of 1964 probably will not be available to the recipient of income in respect of a decedent.⁶¹ Any benefit to the recipient of income in respect of a decedent afforded by the dividend exclusion⁶² and the retirement income credit⁶³ are also available.

⁵⁸ *Johnson v. United States*, 64-1 U.S.T.C. 9655 (N.D. Tex. 6/26/64).

⁵⁹ I.R.C. § 691(a)(3).

⁶⁰ Prop. Reg. § 1.1245-6(d).

⁶¹ I.R.C. §§ 1301-1305.

⁶² I.R.C. § 34.

⁶³ I.R.C. § 37.

Deductions in Respect of a Decedent

Under the statutory scheme for taxation of decedent's income, the recipient of income in respect of a decedent may take deductions in respect of that income.⁶⁴ Such deductions include items which had accrued to a cash basis taxpayer but which were unpaid prior to his death and, in the case of an accrual basis taxpayer, amounts that have accrued "only" by reason of the death of the taxpayer.

Section 691(b) limits the items that are deductible thereunder to trade or business expenses;⁶⁵ nonbusiness expenses incurred for the production of income;⁶⁶ interest;⁶⁷ taxes;⁶⁸ and depletion.⁶⁹ Foreign taxes paid are allowed as a credit if they otherwise qualify under section 33. Section 691(b) is exclusive with reference to the deductions which are allowable, and any expenses not within its literal terms are nondeductible.

No capital or ordinary loss carry forward from a decedent to his estate is allowed.⁷⁰ Likewise, deductions allowable under section 691(b) would not include charitable contributions, casualty losses, or medical expenses.

Who May Take Deductions

Deductions in respect of a decedent are allowable to the decedent's estate as and when paid. If the estate is not liable to discharge the obligation which gives rise to the deduction it is allowable to the person who acquires the property subject to the liability.⁷¹

The person entitled to the deduction need not have received any income in respect to a decedent. This rule may afford some opportunity to direct items of deduction to persons in high income tax brackets, by preliminary distributions of property subject to liabilities which would give them the benefit of additional deductions. It should be noted that if allowable deductions in respect of a decedent exceed gross income in respect of a decedent, no deduction under section 691(c) for the estate tax attributable to such income is allowed to that recipient.

Double Deductions

Although normally expenses may not be deducted on both the federal estate tax return and on the fiduciary income tax return, this

⁶⁴ I.R.C. § 691(b).

⁶⁵ I.R.C. § 162.

⁶⁶ I.R.C. § 212.

⁶⁷ I.R.C. § 163.

⁶⁸ I.R.C. § 164.

⁶⁹ I.R.C. § 611.

⁷⁰ Rev. Rul. 54-207 (C.B. 1954-1, 147).

⁷¹ I.R.C. § 691(b)(1)(B).

prohibition does not apply to deductions in respect of a decedent.⁷² For example, state income taxes due for a decedent's final taxable year are deductible for federal estate tax purposes as debts of the decedent. They are also deductible by the estate for income tax purposes for the year of payment.

The reason for this exception is to equate the tax results to an accrual and to a cash basis decedent. If such expenses were not allowed as deductions when paid in the case of the cash basis taxpayer, there would be an inequity since they could be deducted on the final return of an accrual basis decedent.

Double deductions are allowed even though there is no income in respect of a decedent. This exception should be kept in mind inasmuch as a further tax advantage may accrue to the distributees of an estate in the year of termination if such deductions exceed income. The excess deductions are allowed as a carryover deduction to the distributees in the taxable year in which or with which the estate is terminated.⁷³

Deduction for the Federal Estate Tax

Absent the provisions of section 691(c), income in respect of a decedent would be subjected to both the federal estate and the federal income tax. Section 691(c) ameliorates this hardship in part by allowing the recipient of such income an income tax deduction for the portion of the federal estate tax attributable to the inclusion of that item in the decedent's gross estate.⁷⁴ "Estate tax" under section 691(c) does not include foreign death taxes.⁷⁵ Since double taxation would be more completely eliminated by granting the recipient a credit for the amount of federal estate tax rather than a deduction, an additional explanation for section 691(c) is that the provision is another attempt to equalize the treatment of cash and accrual basis taxpayers in the event of death.

Computation of Deduction

The mechanics of computing the amount of the deduction are as follows:

- (1) Determine net income in respect of a decedent (section 691(a) less section 691(b));

⁷² I.R.C. § 691(b); I.R.C. § 642(g).

⁷³ I.R.C. § 642(h).

⁷⁴ See *Estate of Rodolfo Ogarrio*, 40 T.C. No. 29 (5/7/63), where the court said "to the extent that the same item is included in both the gross estate and taxable income received after the decedent's death, Congress has provided relief in § 691 by granting an income tax deduction based upon the estate tax imposed in respect of the same item."

⁷⁵ Helen Rich Findlay, note 20 supra.

(2) Determine the federal estate tax liability without taking into account net income in respect of a decedent. Reduce the amount of the redetermined liability by any credits allowable against the tax,⁷⁶

(3) The difference between the redetermined estate tax liability under (2) and the amount of tax paid or reported is the deduction allowable under section 691(c).

Undistributed Subchapter S Income

In the case of a deceased shareholder of a Subchapter S corporation, to the extent that all or any portion of income had not been withdrawn prior to death, the value of the decedent's stock in the corporation would be increased, thus resulting in federal estate tax on that increment in value. Neither the Code nor Regulations gives any indication whether section 691(c) deductions would be allowable to the recipient with reference to the increase in value of the shares of a Subchapter S corporation caused by the unwithdrawn portion of income earned prior to the date of a shareholder's death. However, the Service has ruled that since no part of the undistributed taxable income of the corporation which is includable in the estate's gross income, is income in respect of a decedent no deduction is allowable under section 691(c).^{76a} It is submitted that the section 691(c) deduction should be allowed even though the gross income of the estate is not income in respect of a decedent, since the shareholder, on the last day of the corporation's taxable year, will be taxed on such income in its entirety and the decedent's estate will have paid estate tax on the increment in value implicit in the stock prior to death.

Qualified Employee-Plan Distributions

In the case of qualified employee-plan distributions which are excluded from the decedent's gross estate under section 2039, the *Hess* decision⁷⁷ is academic inasmuch as the deduction for federal estate tax under section 691(c) is predicated on the value of the gross estate less exclusions. However, to the extent that such distributions are included in the decedent's gross estate, the *Hess* case would permit the section 691(c) deduction.

When Deduction May Be Taken

The deduction under section 691(c) is allowed to the recipient only for the taxable year within which the income was actually

⁷⁶ Credit for State Death Taxes I.R.C. § 2011; Credit for Gift Tax I.R.C. § 2012; Credit for Tax on Prior Transfers I.R.C. § 2013; Credit for Foreign Death Taxes I.R.C. § 2014; Credit for Death Taxes on Remainders I.R.C. § 2015.

^{76a} Rev. Rul. 64-308 (I.R.B. 1964-48, 12).

⁷⁷ Note 16 *supra*.

received.⁷⁸ Certain mechanical problems arise if the income is received prior to the date on which its federal estate tax value is finally determined. This is especially troublesome when it is considered that the estate tax liability is not finally determined until audit and acceptance of the return.

In the year of receipt of the income tentative computations of the estate tax liability should be made and the section 691(c) deduction based thereon. After the federal estate tax values are finally determined, these computations should be reexamined to determine whether the filing of an amended return or claims for refund should be undertaken.

Allocation of Deduction

The decedent's personal representative is afforded some flexibility in determining which tax entity will be responsible for the tax or income in respect of a decedent by proper planning of distributions.

Although the section 691(c) deduction is predicated on the net income in respect of a decedent, the allocation of the deduction among various recipients is determined by reference to the proportionate share of gross income in respect of a decedent received by each. Thus a section 691(c) deduction may be allowable to the recipient whose income in respect of a decedent bore no portion of the federal estate tax because of an equivalent amount of section 691(b) deductions.

A proposal by the advisory group on Subchapter J to amend section 691 in this particular was not included in H.R. 9662, which failed of passage in the Eighty-Sixth Congress.

Deductibility of Tax on Capital Gain Income

In the case of income in respect of a decedent reportable as long-term capital gain, the Treasury has ruled that 100 percent of the estate tax attributable to such gain is deductible under section 691(c) notwithstanding the fact that only one-half of the gain is reportable for income tax purposes.⁷⁹ Where the alternative tax method is used to compute the tax on such income, it has been recently decided that the full section 691(c) deduction is available.⁸⁰ The court based its decision on the theory that section 691(c) was designed to prevent the same items from being subjected to both a federal estate and income tax on the full amount and that this made

⁷⁸ I.R.C. § 691(c)(1)(A).

⁷⁹ Rev. Rul. 55-481 (C.B. 1955-2, 279).

⁸⁰ *Read v. United States*, 320 F.2d 550 (C.A. 5, 1963).

mandatory the allowance of the section 691(c) deduction notwithstanding the fact that the alternative tax method was used to compute the tax.

Marital Deduction and Section 691(c)

The interaction between the estate tax marital deduction and the income tax deduction afforded by section 691(c) may have significant tax consequences and should be carefully considered in planning an estate which includes income in respect of a decedent. The regulations require that in computing the estate tax exclusive of the net value of income in respect of a decedent, any estate tax deduction "such as the marital deduction" which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of income in respect of a decedent.⁸¹

If all of the income in respect of a decedent is left to the surviving spouse, together with other property that qualifies for the marital deduction, and the combination of such bequests does not exceed the maximum marital deduction allowable, no income tax deduction under section 691(c) would be allowed. This result is caused by the fact that the exclusion of net income in respect of a decedent on the recomputation eliminates the marital deduction in the gross estate attributable thereto.

If the converse it attempted, that is, elimination of any of such income from the share passing to the surviving spouse, 50 percent of the section 691(c) deduction will be lost where the will contains a formula whereunder the surviving spouse will receive an amount equal to the maximum marital deduction allowable. This result is caused by the fact that on the recomputation the exclusion of the net income in respect of a decedent will reduce the maximum marital deduction allowable under the formula.

To obtain a maximum section 691(c) deduction it is necessary to do both of the following:

First, exclude any income in respect of a decedent from the marital deduction gift;

Second, reduce the amount of the marital deduction gift itself by an amount equal to one-half of net income in respect of a decedent.

The effect of reducing the marital deduction gift in order to maximize the section 691(c) deduction will be to increase the amount of the federal estate tax payable by the decedent's estate.

⁸¹ Reg. § 1.691(c)-1(a)(2).

Balancing Tax Advantages

To the extent that the comparative income and estate tax burdens can be forecast, it may be advisable to forego the estate tax saving that would result from a maximum marital deduction. The smaller amount of property passing to the surviving spouse will reduce the estate taxes on his or her subsequent death and this, coupled with the income tax saving resulting from the maximum section 691(c) deduction, may justify the added estate tax costs on the death of the first spouse to die.

Marital Deduction Does Not Exclude Section 691(c)

In connection with the relationship of section 691(c) to the marital deduction, it should be noted that even though a portion of the income received by the surviving spouse is not subjected to estate taxation because of the marital deduction, the section 691(c) deduction is nonetheless available to him or her. In *Helen Rich Findlay*⁸² the Commissioner argued that all of the section 691(c) deduction should be allocated to the recipients, exclusive of the surviving spouse, who received income in respect of a decedent. The court held to the contrary, indicating that the section 691(c) deduction should be allocated on the basis of gross income in respect of a decedent received, notwithstanding the fact that such income in the hands of the recipient does not bear any portion of the estate tax liability.

Stock Option and Section 691(c)

Under section 421(c)(2), if gross income is recognized by the estate or the decedent's successor in interest, upon the exercise of a stock option a deduction is allowed identical in construction and effect with that permitted under section 691(c).

PRE-DEATH AND POST-DEATH PLANNING TECHNIQUES

Proper estate planning dictates, in the first instance, a careful and comprehensive compilation of the client's assets. This is most important with reference to income in respect of a decedent inasmuch as a proper plan for its disposition must necessarily be preceded by its recognition.

Spreading Income

In order to lessen the impact of income taxation on such income items, they should be directed to beneficiaries who are in the

⁸² Note 20 supra.

lowest personal income tax brackets. Similarly, the income should be spread over as many taxable entities as possible. In this connection, multiple inter vivos or testamentary trusts could be appropriate receptacles.

The interaction between the section 691(c) deduction and the federal estate tax marital deduction would suggest that consideration be given to directing such income to the non-marital deduction trust or beneficiary other than the surviving spouse. If the trustee of the nonmarital deduction trust is given discretion to sprinkle income among various beneficiaries a better income tax result may be produced by careful exercise of that power by the trustee.

Distribution to Charity

To the extent that a charitable pledge remains partially unsatisfied at the time of death, an appropriate direction in the decedent's will should direct the satisfaction thereof out of income in respect of a decedent. A similar direction should be inserted for purposes of satisfying a charitable bequest contained in the will. In both cases the result would be a considerable reduction in the cost of the charitable gift since such income would escape both income and estate taxation. If, however, a client desires to make a gift of only income to a charity, it would be undesirable to use income in respect of a decedent for this purpose because the portion of the section 691(c) deduction attributable to such income would be lost.

Keeping Partnership Interest out of Section 691

The impact of section 691 should be carefully considered when drafting partnership or business continuation agreements. The relationship between section 736(a), 753, and 691, requires the exercise of great care, since to the extent that a payment to a deceased partner's successor in interest is for goodwill, it would not fall within section 736(a) and would be treated as capital gain. To obtain this result the partnership agreement itself must contain a provision for payment of an amount for goodwill.⁸³

However, the price of a conversion from ordinary income to capital gain is that the partnership may not deduct any amount paid for goodwill. Thus, whether a specific allocation to goodwill may be made will depend upon the taxable income of the continuing partnership and the income tax brackets of the remaining partners.

Selecting Proper Taxable Year

The appropriate selection of a taxable year for the estate can result in considerable tax savings. The estate may select a calendar

⁸³ I.R.C. § 736(b)(2)(B).

year or a fiscal year which may end with the last day of any month not more than twelve months after death. Thus, the first fiscal year may be less than twelve months.⁸⁴ This selection should be made consistent with the objectives of securing a maximum number of \$600 annual exemptions,⁸⁵ and the equalization of income tax rates among various taxable years.

Maximum flexibility in avoiding income bunching is normally accomplished by the use of a fiscal taxable period. This enables the personal representative to accumulate deductions after the receipt of a substantial amount of income or, in the alternative, allows the ending of the first taxable year before the receipt of a substantial nonrecurring income item.

Transfer of Right to Receive Income

The transfer of a right to receive income in respect of a decedent by the estate or by a beneficiary can cause severe income bunching. A transfer of the right will cause the greater of the consideration received, or the fair market value of the right at the time of the transfer, to be included in the gross income of the transferor for the period within which the transfer occurs.⁸⁶ The transfer need not be for consideration and thus a gift of the right to receive income in respect of a decedent will cause this adverse tax result.⁸⁷

However, certain payments are excluded from the operation of this rule and thus are not "prohibited transfers."⁸⁸ These include: the distribution of income in respect of a decedent to a specific legatee in satisfaction of a specific bequest; the distribution of such income to a testamentary trustee to whom the right had been bequeathed; or the distribution of such income to a residuary beneficiary, if the income is included in the residue of the decedent's estate.

If such a transfer has inadvertently occurred, the income tax consequences may be mitigated, in part, by the selection of the appropriate taxable year and by the election to deduct certain administrative expenses on the fiduciary income tax return rather than on the federal estate tax return.⁸⁹

A distribution by the estate of a right to income in respect of a decedent will carry distributable net income of the estate to the recipient in the same manner as a distribution of other estate prop-

⁸⁴ I.R.C. §§ 441, 443(a)(2).

⁸⁵ I.R.C. § 642(n).

⁸⁶ I.R.C. § 691(a)(2).

⁸⁷ Reg. § 1.691(a)-4(a).

⁸⁸ Reg. § 1.691(a)-4(b).

⁸⁹ I.R.C. § 642.

erty. In certain situations this would seem to enable taxable income to be distributed free of tax.

If a distribution of a right to receive income in respect of a decedent which is part of the residuary estate is distributed to a residuary legatee during a year when the estate has other taxable income, the distribution will be taxable to the recipient to the extent of the estate's distributable net income. The recipient will acquire a basis for the right to receive income in respect of a decedent equal to the amount of distributable net income taxed to him for that year. When the income in respect of a decedent is later realized by the distributee, a portion (equal to the basis of the right in the hands of the distributee) will be recovered tax-free, thus resulting in a somewhat lower tax than would be done on the full amount of income in respect of a decedent and the distributable net income of the estate.

Timing of Distribution

Proper planning of estate distributions can substantially lessen the income tax impact of income in respect of a decedent. If the income tax bracket of the estate is higher than that of its beneficiaries consideration should be given to preliminary distribution of income in respect of a decedent in order to equalize the taxes paid by the estate and the beneficiaries.

However, only if income in respect of a decedent is distributed in the same year as the year of receipt by the estate would the recipient be afforded the benefit of the section 691(c) deduction. If the estate realized income in respect of a decedent in one year and distributed an amount to a beneficiary in the following year, only the estate would be entitled to the deduction. Thus if the distributee is a person to whom the section 691(c) deduction is beneficial, the distribution should always be made in the same taxable year when the income was received.