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INCOME IN RESPECT OF A DECEDENT

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INTRODUCTION

From its inception in 1913, the individual income tax law has provided that an individual's taxable year terminates upon his death.[1] After death, an individual's role as a taxpayer is assumed by his estate, which in turn, is liable only for tax on income earned by the estate.[2] Such treatment of the estate poses no difficulty where the decedent-taxpayer had reported income on an accrual basis. In such a situation, all income is taxable when earned by either the taxpayer or his estate.[3] Most individual taxpayers, however, report their income on a cash basis. In this event, all income may not be accounted for, and thus, may not be taxed. The reason for this loophole is twofold: (1) the cash basis taxpayer will only be taxed for income received during his lifetime; and (2) the taxpayer's estate may only be taxed for income earned by the estate after his death. Thus, income earned by the taxpayer but received

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[1] *See* Act of Oct. 3, 1913, ch. 16, § IIG(c), 38 Stat. 175 (current version at I.R.C. § 443(a)(2)).

[2] I.R.C. § 641 (1979). This section provides that estates are liable for income tax in the same manner as are individuals. *Id.* § 641(b). Thus, an estate is liable only on income earned by the estate. *See, e.g.,* Davidson v. United States, 149 F. Supp. 208, 211 (Ct. Cl. 1957). Upon death, an individual ceases to be a taxable entity. Treas. Reg. § 1.443-1(a)(2) (1957). The individual's estate immediately springs into existence and thereafter is treated as a "separate" taxpayer. Herbert's Estate v. Commissioner, 139 F.2d 756, 757 (3d Cir. 1943), *cert. denied,* 322 U.S. 752 (1944).

[3] Estate of Davison v. United States, 292 F.2d 937, 941 (Ct. Cl.), *cert. denied,* 368 U.S. 939 (1961); Bernard v. United States, 215 F. Supp. 256, 259 (S.D.N.Y. 1963); Rev. Rul. 454, 1920-2 C.B. 170; *see* Ferguson, *Income and Deductions in Respect of Decedents and Related Problems,* 25 TAX L. REV. 5, 6 (1969); Note, *Sales Transactions and Income in Respect of a Decedent,* 3 GA. L. REV. 606, 607 (1969).

by the taxpayer's estate is attributable to no one, and hence, is taxable to no one.[4] The congressional response to this inequality between cash and accrual basis taxpayers led to the development of the concept of income in respect of a decedent (IRD), codified in section 691 of the Internal Revenue Code (IRC).[5] This Article will explore the historical background of IRD and the problems it has engendered, particularly with respect to capital sales transactions. It will conclude with some suggestions for reform of the current statutory scheme.

HISTORICAL PERSPECTIVE

Discrimination against accrual basis taxpayers first was addressed by section 42 of the Revenue Act of 1934, which required that all final individual tax returns be reported on the accrual method.[6] This reform, however, created new hardships.[7] The accrual system caused the decedent's final tax return to recognize income items which ordinarily would have been realized over an extended period of years.[8] The bunching of income was particularly

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[4] *See* Klein, *Tax Accounting: Coming to Grips With Income in Respect of a Decedent*, 5 REV. TAX. INDIVIDUALS 303, 305-06 (1981). Consider the situation of a cash basis taxpayer who, entitled to payments for services rendered, dies before receipt of the proceeds. These wages are unrealized at the time of the taxpayer's death and, therefore, are not included as gross income in the decedent's final tax return. *In re* Held, 3 B.T.A. 408, 408, *acq.* V-I C.B. 3 (1926). Similarly, the salary payment when realized would not be properly reportable on the estate's income tax return because the proceeds do not represent earnings by the estate. I.R.C. § 641 (1979).

[5] Aug. 16, 1954, ch. 736, 68A Stat. 235 (current version at I.R.C. § 691(a) (1980)). Section 691(a)(1) provides that "income in respect of a decedent" is to be included in the income tax return of the estate, beneficiary, or other person entitled to receive the amount by reason of the taxpayer's death. I.R.C. § 691(a)(1) (1980).

[6] Rev. Act of 1934, ch. 277, § 42, 48 Stat. 680 (current version at I.R.C. § 691(a) (1980)). Section 42 provided:

> In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

Id. The purpose of the legislation was to close a loophole through which slipped certain income accrued to the cash basis decedent. H.R. REP. No. 704, 73d Cong., 2d Sess. 24 (1934), *reprinted in* 1939-2 C.B. 554, 572; S. REP. No. 558, 73d Cong., 2d Sess. 28 (1934), *reprinted in* 1939-2 C.B. 586, 608.

[7] Section 42 brought its own inherent inequity in the form of bunching into a decedent's last return substantial amounts of income which became instantly subject to tax recognition because of the taxpayer's death. *See Hearings Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 89 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 83 (1942), *reprinted in* 1942-2 C.B. 504, 580.

[8] *See* note 7 *supra*. For examples of the practical harshness resulting from the accrual

burdensome in later years because of the effect of high wartime surtaxes.[9] Moreover, the Supreme Court, in *Helvering v. Estate of Enright,*[10] broadly construed the "accrual" statute as manifesting a congressional intention to "cover into income the assets of decedents, earned during their life and unreported as income," regardless of the decedent's right to receive the item and the amount thereof.[11] Because of the "bunching" problem, as well as the expansive interpretation of the concept of accrual in *Enright,* public criticism mounted and section 42 became a cause for congressional concern.

In 1942, Congress abandoned accrual in favor of an entirely new concept—income in respect of a decedent.[12] Aware of the

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method, see Helvering v. McGlue's Estate, 119 F.2d 167, 169-72 (4th Cir. 1941); First Nat'l Bank & Trust Co. v. Manning, 100 F. Supp. 892, 895-96 (D.N.J. 1951), *aff'd,* 196 F.2d 247 (3d Cir. 1952); Estate of Remington, 9 T.C. 99, 107 (1947); Estate of Ledyard, 44 B.T.A. 1056, 1065-66 (1941), *aff'd sub nom.* Commissioner v. United States Trust Co., 143 F.2d 243 (2d Cir. 1944).

[9] *See* Revenue Revision of 1942: *Hearings Before the House Comm. on Ways and Means,* 77th Cong., 2d Sess. 89 (1942). During the course of these hearings, Mr. Randolph E. Paul, tax advisor to the federal government, stated:

> Under present provisions income accrued to the date of a decedent's death must be included in the return of his last income tax period. The "bunching up" of income that may occur under this provision can work a severe hardship, as the income of the decedent may in effect be artificially raised to a much higher surtax bracket.

Id. (statement of Mr. Randolph E. Paul).

[10] 312 U.S. 636 (1941).

[11] *Id.* at 644-45. The purpose of section 42 of the Revenue Act of 1934 was to equalize the tax treatment of cash and accrual basis decedents. *See* note 6 and accompanying text *supra.* In Helvering v. Estate of Enright, 312 U.S. 636 (1941), the United States Supreme Court, relying on legislative intent, held that "items of partnership income properly accrued" should be included as gross income in the decedent's final return. *Id.* at 642. Suggesting that the term "accrued" had no fixed meaning, the Court went on to define it to include "the value of the services rendered by the decedent, capable of approximate valuation." *Id.* at 645. The Court's definition of the term "accrued" was broader than its contemporary usage in accounting practice, which did not recognize the existence of "accruals" unless there had been a determination of the right to receive an amount payable. *See* Holland, *Accrual Problems in Tax Accounting,* 48 MICH. L. REV. 149, 149-50 (1949). The Court's expanded notion of "accrued" seemed to embrace, as decedent's gross income, items which were properly estate assets. Thus, the result of *Enright* was to aggravate "pyramiding" by taxing inchoate and conjectural income. Davison v. United States, 292 F.2d 937, 939 (Ct. Cl.), *cert. denied,* 368 U.S. 939 (1961).

[12] Congress' response to the problems incurred under section 42 of the Revenue Act of 1934 was to remove the cash basis taxpayer's final return from the accrual system and to invent a new category of income—the notion of "income in respect of a decedent." The concept was introduced in the Revenue Act of 1942, *see* Rev. Act of 1942, ch. 619, § 126, 56 Stat. 798, 831-34 (1942) (current version at I.R.C. § 691), and was intended

> to reduce the income tax significance of death by treating items not properly taxa-

Helvering Court's expansion of the accrual statute, Congress, in amending the 1939 Code to include section 126, the forerunner of section 691 of the 1954 Code, avoided equating its new concept with accrual methods of accounting.[13] Thus, the statute, which is substantially the same today, provides simply that income items not properly taxable to the decedent at the time of his death shall be taxable to the decedent's successor in interest in the taxable year in which the amount is received.[14] The decedent's successor in interest is defined as his estate, distributee, legatee, or any person, who by reason of the decedent's death, acquires the right to the income.[15]

Substantial problems have arisen, however, because the statute does not define its subject, namely, whether or not an item is "income in respect of a decedent."[16] This has proven especially

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> ble to the decedent by the time of his death as income to its ultimate recipient "of the same nature and to the same extent as such amounts would be income if the decedent remained alive and received such amounts."

Ferguson, *supra* note 3, at 7 (quoting H.R. REP. No. 2333, 77th Cong., 2d Sess. 48, 83 (1942)); *see* S. REP. No. 1631, 77th Cong., 2d Sess. 100 (1942), *reprinted in* 1942-2 C.B. 504, 579 ("[t]his provision is designed to place the [recipient of income in respect of a decedent] . . . in the same position with respect to the nature of the income as the decedent enjoyed").

[13] Ferguson, *supra* note 3, at 9 & n.18; *see* S. REP. No. 1631, 77th Cong., 2d Sess. 100-05 (1942).

[14] The only substantive change in the 1954 Code was an expansion of the section's scope so as to include items of income in respect of a prior decedent. *See generally* Klein, *supra* note 4, at 307.

[15] I.R.C. § 691(a)(1)(A), (B), (C).

[16] Section 691(a)(1) does not provide a definition of income in respect of a decedent, but describes the tax consequences to the decedent's successor in interest:

> The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period . . . shall be included in the gross income, for the taxable year when received, of [the recipient].

I.R.C. § 691(a)(1). Legislative attempts to fix the meaning of IRD have failed of enactment. The Advisory Group on Subchapter J to the Subcommittee on Internal Revenue Taxation, for instance, recommended that a subsection should be inserted into section 691 which would define income in respect of a decedent. The Committee's proposed definition stated that income in respect of a decedent was "an amount . . . which equals so much of the proceeds of a sale, exchange, or other disposition of property made prior to the death of the decedent, as would have been includible in the decedent's gross income if he had received such proceeds." FINAL REPORT OF SUBCHAPTER J ADVISORY GROUP 61 (1958). Congress, however, declined to adopt the recommended definition. H.R. REP. No. 1231, 86th Cong., 2d Sess. 14 (1960). Notably, the Treasury Department has, in fact, authored a definition of income in respect of a decedent. The government's proposal states that items of income in respect of a decedent are "those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of actroublesome when the transaction giving rise to what is claimed to be income in respect of a decedent is the gain on a sale of a capital asset.[17] Accordingly, it is appropriate to assess the criteria which have been and should be employed, in lieu of notions of accrual, to determine when income in respect of a decedent has arisen upon the disposition of a capital asset.

DETERMINING THE CAPITAL SALES PROCEEDS SUBJECT TO SECTION 691 TREATMENT

Prior to 1954, it was the consensus of the tax bar that the decedent himself had to complete a sales transaction before that portion of the proceeds representing gain would be taxed to his successor as IRD.[18] This conception, however, was dispelled by the

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counting employed by the decedent." Treas. Reg. § 1.691(a)-1(b) (1957). This definition, however, does not illuminate the scope of section 691, and therefore, is of no practical significance. *See* Ferguson, *supra* note 3, at 10-11. Significantly, some items *are* statutorily defined as income in respect of a decedent. *See, e.g.*, I.R.C. § 691(a)(4) (1980) (installment obligations); *id.* § 3 (payments to a deceased partner's successor in interest). Nonetheless, in the absence of a general statutory definition of the term "income in respect of a decedent," the courts have been constrained to determine on a case-by-case basis what is and what is not such income. Estate of Davison v. United States, 292 F.2d 937, 939-40 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961). An early case, O'Daniel's Estate v. Commissioner, 173 F.2d 966 (2d Cir. 1949), held that a bonus paid to an employee's estate constituted income in respect of a decedent, irrespective of whether the decedent could have enforced a right to the bonus while he was alive. *Id.* at 968. In Commissioner v. Linde, 213 F.2d 1 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954), the court held that section 126, now section 691, contemplated that income derived from any source could be income in respect of a decedent. *Id.* at 7. Accordingly, cases have found that a wide range of sources can generate IRD. For a general discussion of the types of income items designated as income in respect of a decedent, see Miller, *Income in Respect of a Decedent—General*, TAX MGMT. (BNA) No. 32-2d, at A-23 to A-43 (1981). Interestingly, one commentator has culled four characteristics of IRD from the cases: (1) the item of income must have been attributable to decedent had he lived; (2) although the decedent must have become "entitled" to the income by his death, his rights must not have matured to the point where the item would be includible in his final income tax return; (3) what is transferred at death must be a passive right to income; and (4) the recipient of decedent's right to the income must have acquired the right solely by reason of decedent's death. Ferguson, *supra* note 3, at 12-13.

[17] *See* M. FERGUSON, J. FREELAND & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES 177-84 (1970). *See generally* Ferguson, *supra* note 3, at 7-9; Gordon, *"Income in Respect of a Decedent" and Sales Transactions*, 1961 WASH. U.L.Q. 30, 30-31; Klein, *supra* note 4, at 309; Knecht, *The Inadvertent Realization of Income*, 15 MAJOR TAX PLAN. 733, 745-46 (1963); Young, *The* Linde *Case and . . . Inventories of Grain and Livestock Held by a Deceased Cash Basis Farmer*, 44 ILL. B.J. 44, 50-51 (1955); Note, *supra* note 3, at 606-07 (1969); Note, *Income in Respect of Decedents: The Scope of Section 126*, 65 HARV. L. REV. 1024, 1031 (1952); Comment, *Federal Income Taxation: "Right to Income" as Test for Income in Respect of a Decedent*, 53 MINN. L. REV. 1359, 1362 (1969).

[18] Drye, *The Taxation of a Decedent's Income*, 8 TAX L. REV. 201, 207 (1953); Tomlin-

Ninth Circuit in *Commissioner v. Linde.*[19] In *Linde,* a cash basis farmer, who owned and operated vineyards, marketed wine grapes by delivering them to wineries owned by cooperative marketing associations, of which he was a member. His grapes were commingled with those of the other members and became part of a "wine pool," each member receiving net proceeds from the sales of the product in proportion to their percentage interest in the pool. When the farmer died, he held unliquidated interests in a number of wine pools. A valuation was placed on the products for estate tax purposes. Subsequently, the association marketed the wine on hand and distributed the proceeds to the successor in interest.[20] The Commissioner contended that the proceeds constituted income in respect of a decedent. The Tax Court rejected such a position, concluding that since the cooperative did not sell the wine until after the decedent's death, the proceeds could not be treated as section 126 income. Indeed, the court held that "[s]ince such sales were not made during decedent's lifetime there could be no distributable proceeds due him when he died. Accordingly, no right to income from this source arose during the decedent's lifetime."[21] On appeal, however, the Ninth Circuit reversed, holding that proceeds which had been realized merely as a consequence of the decedent's negotiations were taxable to the decedent's successor in interest regardless of the formal state of the transaction at the time of death.[22]

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son, *How to Handle Income in Respect of a Decedent Under Section 691,* 6 J. TAX. 250, 252 (1957); Note, *supra* note 3, at 609; *see* Young, *supra* note 17, at 46-50; Note, *Income in Respect of Decedents: The Scope of Section 126,* 65 HARV. L. REV. 1024, 1029-30 (1952). *See generally* Polisher, *Income in Respect to the Decedent—Its Federal Income and Estate Tax Implications,* 56 DICK. L. REV. 269 (1952).

[19] 213 F.2d 1 (9th Cir.), *cert. denied,* 348 U.S. 871 (1954).

[20] 213 F.2d at 2.

[21] 17 T.C. 584, 594 (1951), *rev'd,* 213 F.2d 1 (9th Cir.), *cert. denied,* 348 U.S. 871 (1954).

[22] 213 F.2d at 4. In arriving at its conclusion, the Ninth Circuit relied heavily on O'Daniel's Estate v. Commissioner, 173 F.2d 966 (2d Cir. 1949), wherein the Second Circuit held that a bonus which was neither fixed in amount during the decedent's lifetime nor paid until after his death was section 126 income. *Id.* at 967. In holding the bonus to be income in respect of the decedent, *O'Daniel's Estate* established, at least in the area of personal services, that it was not necessary for the decedent to have had an enforceable right to an item during his lifetime for that item to be section 126 income. 173 F.2d at 968; *see* Bausch's Estate v. Commissioner, 186 F.2d 313, 313-14 (2d Cir. 1951); Estate of Narischkine, 14 T.C. 1128, 1130 (1950); Treas. Reg. § 1.691(a)-1(b)(3) (1960). Thus, in holding that the amounts received by the decedent's widow were income in respect of a decedent, the *Linde* court extended the *O'Daniel's Estate* rationale to include sales proceeds as well as compensation for services. This decision, however, has prompted much criticism. *E.g.,* Krieg & Buschmann, *Section 126: "Items of Gross Income in Respect of a Decedent . . .,"* 32 TAXES 651,

Despite the fact that *Linde* involved the disposition of ordinary income property, the Internal Revenue Service (IRS) has extended its rationale to encompass sales of capital assets.[23] Hence, even though the sale of a capital asset may not have been consummated during a decedent's lifetime, the proceeds from the transaction will be income in respect of a decedent, taxable to the decedent's successor upon its ultimate disposition, if the sale was attributable to the decedent's economic activities. The criteria determinative of those economic activities which will result in a finding of IRD, however, presently defy predictability.[24] Nonetheless, the significance of such a finding is clear. The decedent's successor in interest is denied the stepped-up basis usually available to a person who acquires property from a decedent and, instead, must report as taxable income the difference between the fair market value on the date of distribution and the decedent's basis in the property.[25] The following section examines the difficulties encountered by the courts in determining whether or not the sale of an asset is attributable to the decedent's economic activities, thereby giving rise to section 691 income.

653-54 (1954); Scott, *The Strange Case of* Commissioner v. Linde, 33 TAXES 675, 676, 683 (1955).

[23] Holland, Kennedy, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft,* 53 COLUM. L. REV. 316, 370 (1953); Krieg & Buschmann, *supra* note 22, at 653; Scott, *supra* note 22, at 681-83; Scott, *A Critique of Section 126,* 26 TAXES 127, 129-30 (1948); Note, *supra* note 3, at 609. *See also* note 115 *infra.* One commentator has asserted that reference to the congressional committee reports on the bill enacted as the Revenue Act of 1942 indicates that section 126 was not intended to cover any income items "except realized income from interest, rent, dividends, compensation for services and like items which are intrinsically income." Scott, *A Critique of Section 126, supra,* at 129. *See generally* H.R. REP. No. 2333, 77th Cong., 1st Sess. 48, *reprinted in* 1942-2 C.B. 372, 411; S. REP. No. 1631, 77th Cong., 2d Sess. 100-05, *reprinted in* 1942-2 C.B. 504, 579-83 (implicitly indicates that the amendment providing section 126 amounted to nothing more than a relief provision and was not intended to apply to any items covered by the 1934 amendments).

[24] Ferguson, *supra* note 3, at 13; *see* notes 44-83 and accompanying text *infra.* It is clear, however, that "mere appreciation in the value of the decedent's property before death cannot later precipitate income in respect of a decedent." Ferguson, *supra* note 3, at 42; *see* I.R.C. § 1014(a) (1979); Rev. Rul. 58-436, 1958-2 C.B. 366-68.

[25] I.R.C. § 1014(a) (1979). Section 1014(a) provides:

> [T]he basis of property in the hands of a person acquiring the property from a decedent . . . shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be — (1) the fair market value of the property at the date of the decedent's death . . . .

Id.

Trust Company of Georgia v. Ross

Involved in *Ross*[26] was the sale of the Dinkler Hotel chain, owned by Carling Dinkler, Sr. and members of his family.[27] On August 4, 1960, an agreement was signed for the sale of the hotels to the Associated Hotel Corporation.[28] On January 30, 1961, approximately 1 month before the closing date, Carling Dinkler, Sr. died. Shortly thereafter, the Associated Hotel Corporation notified counsel for the Dinklers that it lacked $2,250,000, the funds necessary to close the deal, and inquired whether the estate of Carling Dinkler, Sr. would lend a covering amount.[29] After considerable negotiation, the principals of Associated obtained a $2,000,000 loan from the Trust Company of Georgia, in which the Trust Company as executor of the estate of Carling Dinkler, Sr. accepted a $500,000 participation. On February 23, 1961, the transaction was consummated.[30]

In the fiduciary income tax return for the fiscal year ending on June 30, 1961, the executor reflected the fair market value of the Dinkler hotel properties on the date of Carling Dinkler's death as the basis for those properties sold to Associated. Thus, no gain was reported on either the estate's or the beneficiaries' income tax returns.[31] The Commissioner, however, assessed a tax deficiency of more than $1,000,000 against the estate, the decedent's successor in interest, arguing that a gain had been realized on the sale.[32] The Commissioner's position was founded upon the assertion that it was the decedent's economic activities, not those of the estate, that had given rise to the sale, and therefore, the proceeds were within the purview of section 691.[33]

The trial court, in *Ross*, initially observed that the policy of section 691 was "'to see to it that the tax upon income which would have been derived had the decedent lived should not be lost to the treasury in consequence of his death.'"[34] Accordingly, the

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[26] 262 F. Supp. 900 (N.D. Ga. 1966), *aff'd per curiam*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968).
[27] 262 F. Supp. at 901.
[28] *Id.*
[29] *Id.* at 903.
[30] *Id.* at 903-04.
[31] *Id.* at 904.
[32] *Id.*
[33] *Id.* at 906.
[34] *Id.* at 908 (quoting Commissioner v. Linde, 213 F.2d 1, 4 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954)).

court stated that if, on the date of death, a decedent had only to await a closing to receive the sums due under a contract of sale which he had negotiated, then the proceeds from the transaction are an item of income in respect of a decedent because they are attributable to the decedent's "economic activities."[35] Although the court conceded that the sale was contingent upon the occurrence of several events which had not yet transpired on the date of Carling Dinkler's death,[36] the court, nevertheless, dismissed the extensive postdeath negotiations conducted by the executor as "merely perfunctory," and held that the proceeds received by the Dinkler estate were an item of income in respect of a decedent.[37]

Notwithstanding its affirmance of the trial court's decision, the Fifth Circuit Court of Appeals disapproved of the "open-ended" nature of the test applied.[38] In particular, the appellate court considered unworkable the "causal-connection" test that would find postmortem payments to be income in respect of a decedent if they were the result of "the economic activities of the decedent."[39] Rather, postulated the court, the crucial inquiry was whether, at death, the decedent had a "right to [the] income," as distinguished from having performed the activities which gave rise to that right.[40] The Fifth Circuit observed that its "right to income" or "entitlement" test found support in the regulations, noting that "[a]bsent such a right, no matter how great the [decedent's] activities or efforts, there would be no taxable income under [section] 691."[41] Significantly, the court found that Carling Dinkler, Sr. had

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[35] 262 F. Supp. at 908-09.

[36] *Id.* at 909. By the nature of the contract, the conditions that remained unfulfilled at the date of the decedent's death could not have been satisfied until the closing date of the contract. For example, the consent of the mortgagee was to be obtained by the purchasers at the closing. *Id.* at 910 n.3.

[37] *Id.* at 909-10.

[38] 392 F.2d 694, 695 (5th Cir. 1967), *cert. denied,* 393 U.S. 830 (1968). The court declared that not only is an economic activities test unworkable, but it is inconsistent with section 691, for it would allow income in respect of a decedent even when the decedent has not acquired a *right* to income before death. 392 F.2d at 695; *see* note 41 and accompanying text *infra.*

[39] 392 F.2d at 695 (quoting district court opinion, 262 F. Supp. at 908).

[40] 392 F.2d at 695.

[41] *Id.* at 696 (citing 26 C.F.R. § 1.691(a)-1(b) (1960)). The *Ross* court relied on example 5 in 26 C.F.R. § 1.691(a)-2 to support its contention that the "causal connection" test employed by the district court might incorrectly find the proceeds as income in respect of a decedent while the "entitlement" test would not. 392 F.2d at 696 n.3. Example 5 states:

> A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive pay-

met the "entitlement" test insofar as the August 4 contract was binding upon him before death and on his estate thereafter.[42]

Keck v. Commissioner

In *Keck*,[43] the decedent was a minority shareholder in various associated companies which had entered into an executory agreement to sell their assets to Consolidated Freightways, Inc.[44] The contract was conditioned upon the purchaser's receiving the requisite approval of the Interstate Commerce Commission (ICC) and the sellers' obtaining a favorable ruling from the Internal Revenue Service declaring the gain realized on the sale exempt from federal income taxation.[45] On April 6, 1956, in accordance with the agreement, the decedent delivered his shares to an escrow agent.[46] All dividends declared and paid with respect to these shares after this date, however, were paid to the decedent.[47] Moreover, the decedent continued to be the record owner of the shares and, until his death,

> ment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

26 C.F.R. § 1.691(a)-2 (1981). In this example, the sale to *Y* was not completed until after *A's* death. Yet, *A* had conducted the negotiations for the sale prior to his death. The regulations provide that the proceeds from the postdeath sale are not income in respect of a decedent. This view comports with the result reached upon application of the "entitlement" test since the decedent had no right to receive the income prior to his death, and therefore, the proceeds realized from the transactions are not IRD. Under the "causal connection" test employed by the district court and rejected by the Fifth Circuit, however, these proceeds would likely be classified as IRD because the sale resulted from the negotiations or services performed by *A* or from the economic activities he conducted during his lifetime. The statute, by its terms, consistently uses the phrase "right to receive the amount," and it appears that irrespective of how substantial the economic activities of the decedent are, if no right to the amount exists at the time of the decedent's death, section 691 should not apply. *See* I.R.C. § 691(a)(1)(A), (C).

[42] 392 F.2d at 696.

[43] 49 T.C. 313 (1968), *rev'd*, 415 F.2d 531 (6th Cir. 1969).

[44] 49 T.C. at 315. In a resolution adopted on May 2, 1956, the board of directors for Motor Cargo, Inc. *proposed* to sell its property to Consolidated Freightways, Inc. *Id.* at 315-16.

[45] *Id.* at 316. Section 337(a) of the IRC provides that if a corporation liquidates within 12 months of adopting a liquidation plan, there shall be no gain or loss to the corporation on the dispostion of its assets. I.R.C. § 337(a).

[46] 49 T.C. at 316.

[47] *Id.*

continued to exercise all voting rights.[48] On May 25, 1956, application was made to the ICC for approval of the sale. Final approval was received on May 5, 1960. In the interim, however, on November 27, 1958, Keck died.[49]

The Tax Court, in an opinion rendered a few days before the Fifth Circuit's decision in *Trust Company*, viewed *Keck* as consistent with the circuit court's decision in that case because, from the time of the execution of the agreement, the decedent "merely awaited final approval by the Interstate Commerce Commission" to consummate the disposition of his shares.[50] Indeed, the court, in adopting an "economic activities" test, stated, "[w]e do not believe that the activities of third parties . . . can be regarded as economic activities of [decedent's executor] so as to prevent the application of section 691 to the payments received by [the successors in interest]."[51] Upon determining that the decedent had, *before* his death, engaged in "all the significant economic activity" necessary to sell his corporate assets, the Tax Court held that the gain from the proceeds of the sale clearly constituted income in respect of a decedent.[52] Six judges vigorously dissented, arguing that the proper test should be "the status of the transaction at decedent's death, not who carried on the 'economic activity' which brought it to that status."[53]

Interestingly, the Tax Court deemed immaterial its finding of fact that the decedent was a minority shareholder and was not a party to the agreement.[54] The Court of Appeals for the Sixth Circuit reversed, finding that the decedent's position and activities were indeed significant.[55] The appellate court observed that at no time had the decedent acquired the right to income since "at the

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[48] *Id.*

[49] *Id.*

[50] *Id.* at 320. The Tax Court compared *Keck* with *Trust Co.* and noted that in each case the decedent had entered into a written agreement for the sale of stock, and thereupon, placed the stock in escrow. Moreover, both cases involved sales which were contingent on the government's approval of section 337 tax treatment. Finally, in both cases, the sales were consummated after the decedent had died. *Id.* at 322.

[51] *Id.* at 321.

[52] *Id.* at 320, 323.

[53] *Id.* at 323-24 (Featherton, J., dissenting). Judge Featherton authored an opinion in which five judges joined.

[54] *See* 49 T.C. at 316. The decedent owned approximately 10% of Motor Cargo, Inc.'s outstanding stock. The majority shareholder, Owen W. Orr, held approximately 75% of the shares. *Id.* at 314.

[55] 415 F.2d 531, 535 (6th Cir. 1969), *rev'g* 49 T.C. 313 (1968).

time of his death, neither the decedent nor the other stockholders were contractually committed to the plan to liquidate . . . [since] the majority stockholder, for reasons of his own, might have decided not to liquidate."[56] Moreover, it was noted that the sale was subject to a number of contingencies—in particular, approval by the ICC which "was neither routine nor perfunctory."[57] In holding for the taxpayer, the court relied heavily on the Fifth Circuit's rejection of the economic activities test:

> We agree with the United States Court of Appeals for the Fifth Circuit in holding that the right to income, under the provision of the statute here pertinent, is to be distinguished from the economic activities that create that right and that, absent such a right, no matter how great the activities, there is no taxable income under Section 691.[58]

Estate of Sidles v. Commissioner

In *Sidles*,[59] the decedent was the sole shareholder of Bi-State Distributing Corporation.[60] At a special meeting on February 28, 1968, Bi-State's board of directors adopted a plan of complete liquidation and dissolution pursuant to section 337 of the IRC and section 21-2083 of the Nebraska Business Corporation Act.[61] The following day, Bi-State filed a statement of intent to dissolve with the Nebraska secretary of state.[62] Prior to the decedent's death on June 12, 1968, no further action was taken on the liquidation plan. Nevertheless, in late November of 1968, the plan was implemented.[63] Thereupon, the Commissioner claimed that Bi-State's liquidating distribution was income in respect of a decedent.[64]

The Tax Court adopted the Fifth Circuit's analysis in *Trust Co.* and found that "the transaction had sufficiently matured as of

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[56] 415 F.2d at 534.

[57] *Id.*; *cf.* Falwell v. United States, 69 F. Supp. 71, 79 (W.D. Va. 1946), *aff'd per curiam*, 330 U.S. 807 (1947) (ICC approval, necessary to effectuate a purchase agreement, is not a mere matter of form and, therefore, is not perfunctory).

[58] 415 F.2d at 534-35.

[59] 65 T.C. 873 (1976), *acq.* 1976-44 I.R.B. 5, *aff'd mem.*, 553 F.2d 102 (8th Cir. 1977).

[60] 65 T.C. at 874.

[61] *Id.* at 875. Section 21-2083 of the Nebraska Business Corporation Act prescribes a formal voluntary dissolution procedure. Notably, it is provided that no filing of intent to dissolve becomes final until it has been approved by shareholders' vote. *See* NEB. REV. STAT. § 21-2083 (1977).

[62] 65 T.C. at 875.

[63] *Id.*

[64] *Id.* at 876.

decedent's death so as to create in him a right to receive the income when it was subsequently realized."[65] The postmortem resolution of the Bi-State board of directors to distribute the assets in liquidation, the declaration of the liquidating dividend, and the filing of the articles of dissolution were characterized by the court as "mere formalities."[66] Moreover, the concurring opinion noted that Nebraska law obligates the corporation to cease doing business and to distribute its assets once a statement of intent to dissolve has been filed.[67] Thus, barring any action by the board, a shareholder may sue to compel such a dissolution. Accordingly, since the filing of the statement "vested" the shareholder "with a legal right to the proceeds,"[68] the court likened this situation to the enforceable executory contract of sale in *Trust Co.*[69]

Estate of Peterson v. Commissioner

The most recent pronouncement in this area is the opinion of the Tax Court in *Estate of Peterson v. Commissioner.*[70] In *Peterson,* the decedent had contracted to deliver calves to a buyer in two installments, one on November 1, 1972 and the other on December 15.[71] The decedent died, however, on November 9, 1972 without having made delivery under the contract.[72] In order to complete the agreement, the estate "daily fed, watered, and cared for the calves from the date of decedent's death" until delivery in mid-December, 1972.[73] The Commissioner claimed that the income generated by the estate's postmortem deliveries was IRD.[74]

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[65] *Id.* at 880. The court stated that although the economic activities of the decedent are a relevant consideration, they are not dispositive to a finding of income in respect of a decedent. Indeed, for there to be IRD, the court concluded, the decedent must have acquired a right to the income prior to his death. *Id.* (citing Trust Co. of Ga. v. Ross, 392 F.2d 694, 695 (5th Cir. 1967)).

[66] 65 T.C. at 881-82. *But see* Hudspeth v. United States, 471 F.2d 275, 279 (8th Cir. 1972). *Hudspeth* involved an analogous situation, yet the court held that the facts were sufficient merely to create a presumption of intent to dissolve. *Id. See also* Kinsey v. Commissioner, 477 F.2d 1058, 1063 (2d Cir. 1973).

[67] 65 T.C. at 887 (Hall, J., concurring) (citing NEB. REV. STAT. §§ 21-2085 to 2086 (1977)).

[68] 65 T.C. at 888 (Hall, J., concurring).

[69] *Id.*

[70] 74 T.C. 630 (1980), *aff'd,* 667 F.2d 675 (8th Cir. 1981).

[71] 74 T.C. at 634.

[72] *Id.*

[73] *Id.* at 644.

[74] *Id.* at 635. In *Peterson,* the Commissioner contended that the court's inquiry should focus upon the substantial activities of the decedent and the status of those efforts at the

The Tax Court rejected the Government's contention.[75] At the outset, the court noted that the contract, upon the November 1 default in delivery, had been modified implicitly to call for a single delivery on December 15.[76] Since only two-thirds of the calves were deliverable on the date of the decedent's death, the court reasoned that, "[v]iewed in its entirety," the contract could not have been performed by the decedent while he was alive.[77] Accordingly, the acts of the estate "were not perfunctory or ministerial but [were] substantial and essential."[78] Thus, the court concluded, "the contribution by the estate [was] sufficient to remove the sale proceeds from the reach of section 691."[79]

The present relevance of *Peterson* is that the Tax Court clearly articulated the four requirements which have been applied to decide whether a decedent possessed the right to sales proceeds at the time of his death: (1) "the decedent . . . entered into a legally significant arrangement"; (2) "the decedent . . . performed the substantive (nonministerial) acts required of him as preconditions to the sale"; (3) "there existed, at the time of decedent's death, no economically material contingencies which might have disrupted the sale"; (4) "decedent, himself, would have eventually received . . . the sale proceeds if he had lived."[80] The following discussion involves a similar reexamination of the cases in search of the relevant factors used in determining whether section 691 is applicable. The formulations will provide a basis for evaluating the continuing viability of the concept of IRD.

Reexamination: In Search of Relevant Factors

1. The "Mere Formalities" Test

The *Sidles* case categorically stated that a right to income has

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time of the decedent's death. In this regard, the Commissioner postulated that the decedent was entitled to the proceeds on the sale. *Id.* at 645 n.21.

[75] *Id.* at 644.

[76] *Id.* at 635.

[77] *Id.* at 644.

[78] *Id.*

[79] *Id.* at 644-45. The court, in its conclusion, analogized its position to being "left to chart our own course in the murky waters of section 691." *Id.* at 645 n.21. Surprisingly, in *Peterson,* the Commissioner did not attempt to allocate the sale proceeds between those calves which were deliverable on the date of the decedent's death and those which were not and label only the former IRD. Had the Commissioner done so, at least one judge on the court would have supported him. *See id.* at 646-47 (Simpson, J., concurring).

[80] *Id.* at 639-41.

been acquired by the decedent if all that remained to be done at the time of death were "mere formalities: ministerial acts."[81] Unfortunately, however, the "mere formalities" test is subject to several interpretations. For example, the Sixth Circuit in *Keck* did not think that the requisite ICC approval of the sale in question was a "mere formality." Indeed, if one applies a "but for" test, no prerequisites to a completed sale will be viewed as mere formalities.[82] Nevertheless, as a matter of common sense, many conditions to sales are mere formalities.

Although the "mere formalities" test was reaffirmed by the Tax Court in *Peterson,* the court's opinion added little to its content. The court simply stated that once the "subject matter of the sale was in a deliverable state," the decedent had acquired a right to income.[83] Additionally, the court used "deliverable" to describe the situation wherein only ministerial acts remained to be performed at the time of the seller's death. Nonetheless, it is not inconceivable that a crop might be in a deliverable state while nonministerial acts remain to be performed prior to the completion of the sale. In affirming *Peterson,* the Eighth Circuit seems to have seized upon precisely this point. To separate the test from the nature of the subject matter, the court emphasized that even if the subject matter were "logs or refrigerators" there could be no IRD without "delivery."[84]

The paramount flaw in the "mere formalities" test is its hindsight application. After the fact, preconditions leading to a consummated sale appear to be mere formalities, but if the estate fails

[81] Estate of Sidles v. Commissioner, 65 T.C. 873, 881, *acq.* 1976-44 I.R.B. 5, *aff'd mem.,* 553 F.2d 102 (8th Cir. 1977). For the most recent application of the "ministerial acts" test, see Rev. Rul. 78-32, 1978-1 C.B. 198.

[82] For a classic example of the "but for" analysis, see Estate of Peterson v. Commissioner, 74 T.C. 630 (1980), *aff'd,* 667 F.2d 675 (8th Cir. 1981). Therein, the court stated that, "had the estate not daily fed, watered, and cared for the calves from the date of decedent's death until the delivery date, [the] calves would have perished." *Id.* at 644. The court's contention was that the handling of calves which were not mature enough on the date of the decedent's death to be delivered caused the estate to perform acts which "were not perfunctory or ministerial but substantial and essential." *Id.* This was also true, however, of the mature cattle. That is, even if all the cattle had been mature enough for delivery prior to the decedent's death, he or his estate would have had to continue to feed or water them until they were actually delivered. Nonetheless, the whole tenor of the court's opinion is that the right to income arose when the cattle became deliverable, not when they were actually delivered. The court's point appears to be that, after maturity, the feeding and watering of the cattle were ministerial acts, but prior to maturity they were substantial and essential.

[83] *Id.* at 640.

[84] Estate of Peterson v. Commissioner, 667 F.2d 675, 681 (8th Cir. 1981).

to perform one of these formal conditions, so as to vitiate a transaction, the mere formality becomes somewhat more substantial. In sum, the "mere formalities" test is less a guide to analysis and predictability than a label attached after a result has been obtained.

2. The "Parted with Property" Test

In explaining its determination of whether the seller had performed "the applicable substantive acts" before death, the *Peterson* court stated that one indication would be whether "the subject matter . . . [had passed] beyond . . . [the decedent's] control prior to his death."[85] Apparently, this was the basis on which the court distinguished *Linde*, wherein the decedent had delivered his crop of grapes to a cooperative marketing association and the cooperative sold the wine after the decedent's death.[86] Proceeds from the *Linde* sale were treated as IRD. Thus, while a parting of the property, absent a sale of the goods as of death, was found to add up to taxability in *Linde*, a binding contract of sale, absent a parting of the property, resulted in nontaxability in *Peterson*.

Although the factual situation involving one who has parted with property but who has not yet made a sale would seem to be rare, the *Trust Co.* case demonstrates that it can arise in a variety of instances. The *Trust Co.* court stressed the fact that Carling Dinkler, Sr., had parted with his property when he deposited his shares with an escrow agent.[87] In both *Linde* and *Trust Co.*, the respective decedents, upon parting with their property, were irrevocably committed to a sale. Thus, the *Linde/Trust Co.* rule is that although a sale is not required to generate income in respect of a decedent, what is required is a parting with the property such that the seller is irrevocably committed to a sale during his lifetime. Applying this analysis to *Sidles*, we find that Nebraska law re-

[85] 74 T.C. at 640. The *Peterson* court noted that the nature and scope of the "delivery" activities of the decedent should be tailored to the subject matter of the sale. For example, the "acts required of a decedent to make stock deliverable are generally ministerial in nature." *Id.* (citing Estate of Sidles v. Commissioner, 65 T.C. 873, 881 (1976), *acq.* 1976-44 I.R.B. 5, *aff'd mem.*, 553 F.2d 102 (8th Cir. 1977)). In contrast, the court noted, a sale which necessitates "the sweat of the decedent's brow" poses harder questions of deliverability. 74 T.C. at 640.

[86] *See* notes 19-22 and accompanying text *supra*.

[87] Trust Co. of Ga. v. Ross, 262 F. Supp. 900, 909 (N.D. 1966), *aff'd*, 392 F.2d 694, 698 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968). The district court had observed that Dinkler was "contractually bound to sell . . . to particular purchasers and was not free to sell . . . to any other persons." *Id.*

quired the corporation to cease doing business and to distribute its assets once the statement of intent to dissolve had been filed. The situation in *Sidles*, however, was not as irrevocable as the Tax Court would have it appear, for Nebraska law also provides that the shareholders can revoke a voluntary dissolution proceeding.[88] In *Sidles*, therefore, the taxpayer could have reversed the dissolution transaction, an unlikely, but nonetheless possible, event.[89] More importantly, it is probable that a sophisticated executor will renegotiate or even breach a contract after the seller-decedent's death in order to avoid an IRD characterization of the sale's proceeds.[90] Because qualifying for a section 1014(a) step-up in basis may yield a substantial tax advantage, the executor could renegotiate an agreement by passing along part of the tax savings to the buyer in the form of a lower price.[91]

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[88] NEB. REV. STAT. §§ 21-2087 to 2088 (1977). Section 21-2088 provides: "By the act of the corporation, a corporation may, at any time prior to the issuance of a certificate of dissolution . . . revoke voluntary dissolution proceedings . . . ." *Id.* § 21-2088.

[89] A breach of contract might not always be involved in an executor's refusal to perform. The simplest example would be a liquidation, as in *Sidles.* In Estate of Kriesel, 37 T.C.M. (CCH) 264 (1978), the Kriesel Company, wholly owned by the decedent, adopted a plan of complete liquidation on September 27, 1969, as a step in the sale of some of the assets of the Kriesel Company to National Car Rental Systems, Inc. The decedent died before the actual liquidation took place. "The plan of liquidation was subsequently rescinded on September 9, 1970, due to the untimely death of Ralph and the possible adverse income tax consequences to petitioner as the sole shareholder of the Kriesel Company." *Id.* at 265. Footnote five of the Tax Court opinion makes it clear that these "adverse tax consequences" were IRD treatment and loss of the section 1014 step-up in basis. "On June 30, 1972, the Kriesel Company was finally liquidated and its assets distributed to petitioner." *Id.* at 265 n.5. It would be interesting to see a court or the IRS attempt to apply this "parting with the property" analysis to the situation wherein a decedent leases property during his lifetime, with the lessee receiving an option to buy, and with the lessee exercising such option after the decedent's death. *See* Gordon, *supra* note 17, at 37.

[90] Contract rescission is not a taxable event. *See* I.R.C. § 1038; S. REP. No. 1681, 88th Cong., 2d Sess. 5 (1964) (Congress "does not believe that merely because property originally held by a seller has been restored to him should constitute grounds to taxing any appreciation in value of this property to the seller at that time"). With this in mind, an astute executor may be tempted to rescind and renegotiate an executory contract of sale in order to make available to the estate a section 1014(a) step-up in basis. In so doing, however, the executor should be aware of Knetsch v. United States, 364 U.S. 361 (1960), wherein the Court refused tax effectiveness to a rescission and renegotiation situation because the sole benefit to the taxpayer was a reduction in taxes. *Id.* at 366. Moreover, should the sale be to the same buyer, it is likely that the IRS would treat the transaction as lacking in "business purpose" and, therefore, a sham. *See* Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation,* 37 TUL. L. REV. 355, 360 (1963).

[91] *See* Brown, *Income in Respect of a Decedent,* 55 CORNELL L. REV. 211, 224 n.75 (1970); Note, *Tax Effect of Executor's Rescission and Renegotiation of Decedent's Contracts,* 51 MINN. L. REV. 251, 254 (1966). One commentator has argued that a distinction should be made between contracts which are specifically enforceable and those for which an

In light of the *Keck* decision, the *Linde/Trust Co.* rule may require still further refinement.[92] Recall that in *Keck,* the court held that the gain from the sale of the decedent's stock was not income in respect of a decedent because the ultimate decision to sell rested in the hands of a third party, the majority shareholder. The decedent, however, was irrevocably bound to sell if a sale was consummated by the majority shareholder, and like the decedents in *Linde* and *Trust Co.,* could not have rescinded the deal on his own accord. Nevertheless, the court concluded that no right to income had arisen from the predeath irrevocable commitment of the seller to perform. Thus, it can be seen that the "parted with the property" test is determinative in a case like *Linde,* but otherwise is entitled to little weight.[93]

3. Commitment of the Buyer: The "Relation Back" Test

In the recent case of *Claiborne v. United States,*[94] it was intimated that the posture of the transaction from the buyer's standpoint is a relevant consideration. Specifically, the court suggested that an inquiry should be made to determine whether the buyer was irrevocably committed to the sale.[95] In *Claiborne,* the decedent had extended a purchase option on her farm and had agreed to accept partial payment in the form of another farm if the option

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action for damages will lie. Guterman, *New Problems Under Section 126 in Income and Estate Taxes,* 24 TAXES 633, 637 (1946). For criticism of this view, see Gordon, *supra* note 17, at 38.

[92] The *Keck* decision intimates that the *Linde/Trust Co.* rule should be refined so as to give consideration to the fact that a party to the transaction, other than the seller, might not perform. Keck v. Commissioner, 415 F.2d 531, 535 (6th Cir. 1969); *see* notes 94-105 and accompanying text *infra.*

[93] Interestingly, while the *Peterson* court cited *Trust Co.* for the proposition that delivery of stock to an escrow agent is an "indicium" of a sufficiently completed sale, the court nonetheless observed that the result in *Trust Co.* "would not be any different if the decedent . . . had held his stock until death." Estate of Peterson v. Commissioner, 74 T.C. 630, 641 n.12 (1980), *aff'd,* 667 F.2d 675 (8th Cir. 1981).

[94] 449 F. Supp. 4 (W.D. Ky. 1978), *vacated and remanded,* 648 F.2d 448 (6th Cir. 1981). *Claiborne* is a unique case insofar as there had been substantial performance by both the buyer and the seller prior to completing the sale. Interestingly, the district court deemed this fact immaterial. 449 F. Supp. at 6. The Court of Appeals for the Sixth Circuit, however, thought this fact significant and vacated the lower court's decision. 648 F.2d at 451-52. Indeed, the appellate court concluded that, at the time of the decedent's death, the buyer's activities had entitled the seller to specific performance. This "equitable entitlement," the court held, was a significant factor upon which a finding of IRD could be predicated. *Id.*

[95] 449 F. Supp. at 6.

was exercised.[96] The agreement further provided that if the option was exercised, it became a binding contract upon the parties.[97] On August 12, 1967, the prospective purchaser notified the decedent that it would exercise its option.[98] On August 15, 1967, the decedent's son, acting under a power of attorney, turned over possession of the farm to the optionee.[99] The decedent died on October 1, 1967, prior to giving a deed to the buyer and prior to receipt of the optionee's consideration.[100] Arguing that only "the pro forma act of executing the deed" remained undone on the date of the decedent's death, the Commissioner claimed that the decedent was "entitled" to the income which the estate would generate by the eventual sale.[101] The court rejected this argument, stating that the Commissioner's "argument overlooks the possibility of a default by [the buyer] . . . . Mrs. Simcoe could not have compelled Houston McCord Realty Corporation to purchase the property had it elected not to perform."[102] Notably, on appeal to the Sixth Circuit, the court reversed. The circuit court found that under Kentucky law, once an optionee has taken full possession of the realty, the optionor has a right to specific performance.[103] More importantly, the court held that the test of taxability was the "enforceability of . . . [seller's] right to the full purchase price as of the date of her death," and specifically rejected the Commissioner's argument that the test for taxability was the "economic activities" test "which would exclude any consideration of enforceability as an aspect of entitlement."[104]

The difficulty with this "enforceability against the buyer" test is that, if it were applied to *Trust Co.*, it would militate in favor of the taxpayer because the Dinklers could not have compelled Associated to perform. Indeed, in *Trust Co.*, the agreement provided

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[96] *Id.* at 5.

[97] *Id.*

[98] *Id.*

[99] *Id.* Although the purchaser had taken possession of the farm and had begun renovation, the court dismissed the significance of these facts, noting that there were "serious doubt[s]" concerning the son's authority to transfer possession under his power of attorney. *Id.* at 6.

[100] *Id.* at 5.

[101] *Id.* at 6.

[102] *Id.* The court accorded substantial significance to the liquidated damages clause in the Simcoe/McCord agreement.

[103] Claiborne v. United States, 648 F.2d 448, 451 (6th Cir. 1981), *vacating and remanding* 449 F. Supp. 4 (W.D. Ky. 1978).

[104] 648 F.2d at 451-52.

for liquidated damages in the event the purchaser failed to obtain the requisite financing.[105] In the context of the buyer's posture at the time of the decedent's death, therefore, the only viable approach is to look at what actually happened after the death of the seller. If the buyer fails to perform or, for that matter, if the seller fails to perform, the situation is unlikely to appear in the law reports because the Commissioner does not attempt to assert section 691 coverage to transactions which are not completed. For example, despite the theory of the "entitlement" test espoused in *Sidles*, wherein liquidation had been completed but for a few ministerial acts at the time of the decedent's death, the Commissioner would not have asserted section 691 liability if the liquidation had been revoked. Thus, in the final analysis, a "relation back" theory is used in which the ultimate performance of the buyer is related back to the situation immediately prior to the decedent's death. Note, however, that absent a sale, there can be no relation back. Accordingly, the language in *Linde* which states that section 691 does not require a sale is somewhat misleading. To be precise, the *Linde* court should have stated that although section 691 does not require a sale before the death of the decedent, there ultimately must be a sale to make the transaction taxable. With this in mind, the *Linde/Trust Co.* test can be restated: a transaction will be considered complete for purposes of section 691 when, at the time of the decedent-seller's death, he was irrevocably committed to completing the transaction *and* the buyer eventually performed in accordance with the terms of the agreement. Unfortunately, this formulation does not account for the holding in *Keck*, wherein no section 691 liability was found even though the decedent was committed to the sale and the purchaser did perform in accordance with the terms of the agreement. Hence, another factor, the "anticipated contingency," must be added to the *Linde/Trust Co.* formula.

4. The "Anticipated Contingency" Test

In *Trust Co.*, the Fifth Circuit held that Carling Dinkler, Sr. had earned the income from the sale of his hotels because, had everything proceeded as anticipated on the date of death, the decedent would have had an unqualified right to the income. No con-

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[105] Trust Co. of Ga. v. Ross, 262 F. Supp. 900, 902 (N.D. Ga. 1966), *aff'd*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968).

tingencies were expected which would have cast uncertainty on the completion of the transaction or the subsequent receipt of the proceeds. In *Keck*, on the other hand, the sale explicitly was contingent upon ICC approval, an issue unresolved at the time of the decedent's death.

In retrospect, it is now known that the sale in *Keck* took place precisely as planned while the sale in *Trust Co.* had to be salvaged by a last-minute loan from the seller's estate. It seems ironic to credit Carling Dinkler, Sr. with having realized the income from the sale while holding that the decedent's claim to sales proceeds in *Keck* was too contingent at the time of death to have been a "right to income."[106] Accordingly, decisional law appears to dictate that the predeath anticipation of the nonoccurrence of a contingency will vitiate a finding of a completed sale for the purpose of section 691. This rule, however, is not a reasonable standard for decision-making purposes. For example, an almost universal requirement in contracts for the sale of real property is that the seller deliver good title at the closing. If this anticipated contingency were recognized as such, no contract for the sale of real property could ever give rise to income in respect of a decedent. Moreover, the "anticipated contingency" test will allow sophisticated estate planners to escape the ambit of section 691 by inserting into every contract a clause requiring a sale by the taxpayer if alive at the time of closing or a sale by the estate.[107] An even simpler method is to include a clause nullifying the sale in the event of the seller's death.[108]

To this point, analysis of the cases wherein the sale of a capital asset has not been completed before the seller's death suggests that the prerequisites for a finding of a right to income under section 691 are: (1) an irrevocable commitment on the part of the seller as evidenced by a parting with the subject property; (2) performance by the buyer and all other parties in accordance with the

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[106] *See* Chapin v. Commissioner, 180 F.2d 140, 142-43 (8th Cir. 1950). It appears that had the parties stipulated that their agreement was contingent upon the purchaser independently raising the purchase money, the result in *Trust Co.* would have been different. On the other hand, the *Trust Co.* agreement did provide that the escrow agent should return the shares if the purchaser was unable to procure financing. Brief for Appellant at 7, Trust Co. of Ga. v. Ross, 392 F.2d 694 (5th Cir. 1967), *cert. denied,* 393 U.S. 830 (1968). *See generally* Comment, *supra* note 17, at 1363 & n.30.

[107] Treas. Reg. § 1.691(a)-2(b) (ex. 4) (1960); Brown, *supra* note 91, at 229-30 & n.93. *See generally* Krieg & Buschmann, *supra* note 22, at 651.

[108] *See generally* note 91 and accompanying text *supra.*

contract as it existed at the time of the seller's death; and (3) no substantial anticipated contingency in the contract remaining unfulfilled at the time of the seller's death. As applied, this formulation is elementary in a factual setting such as that presented in *Linde*, but cumbersome, and perhaps inequitable, in the genre of cases represented by *Trust Co.* and *Sidles*. The contrast in application, however, suggests a better approach to the right to income problem.

5. The Capital v. Inventory Assets Test

If *Peterson* and *Linde* are compared to *Trust Co.*, *Keck*, and *Sidles*, one discerns that the cases are immediately distinguishable because the former involve the sale of ordinary income property while the latter involve the sale of capital assets. The courts, however, have failed to recognize a crucial distinction between these types of transactions. Sales in the ordinary course of business usually take place in a routine way. On the other hand, when capital assets are sold, the sale is of a less common property and by a seller who is not, by definition, in the business of trading in such properties. Such sales are not routine and problems often do arise. The *Trust Co.* case illustrates the common difficulty of a buyer being unable to arrange financing. What this suggests, therefore, is that the "right to income," or "entitlement," test should be confined to sales of ordinary income property where the final stages of the transactions occur as a routine matter. When the property involved is a capital asset, however, a sale transaction should be found to give rise to income in respect of a decedent only when there is a completed sale before death.[109] This approach would limit IRD treatment in capital asset cases to installment sales.

Drawing a distinction between capital assets and inventory property is not a new idea,[110] for it was asserted early that section

[109] It has been argued that Treasury Regulation § 1.691(a)-2(b), example 5, incorporates the notion that a *completed sale* is required to trigger an application of section 691.

[110] *See, e.g.*, Gordon, *supra* note 17, at 39. Professor Gordon postulated that in the context of capital sales transactions, section 691 treatment should be limited to closed transactions. *Id.* at 42. His argument was predicated on the differential effect death would have on a seller's reliance on section 1014(a):

> [A]s to [sales in the ordinary course of business], the taxpayer has little choice in timing and therefore, his reliance in the policy of section 1014 is minimal, whereas in sporadic sale situations [such as the sale of a capital asset] he may well decide to withhold because of the basis step-up advantage of that provision.

691 was not intended to apply to sales of capital assets.[111] We now know that this argument failed in the courts because no basis for drawing the distinction was found in the history of section 691 or its predecessors.[112] The point being made presently, however, is somewhat different. It is not argued that the gain from the sale of capital assets should be excluded totally from section 691 treatment, but rather, that in determining whether a transaction has taken place giving rise to such income, the "entitlement" test should be confined to sales of inventory property.[113]

The principal advantage of this approach is the substitution of a clear guideline in place of a rather cumbersome rule as presently divined from the cases. Additionally, it is advantageous insofar as the requirement for a closed transaction cannot be abused as a means of tax avoidance. All of the transactions in the subject cases were entered into by taxpayers who anticipated completion while alive. If the taxpayers had known exactly when they were going to die, good tax planners would have counseled them to forego the sale and allow their executors or heirs to sell the property and obtain the advantage of the step-up in basis. Moreover, as earlier noted, successors in interest may be tempted to avoid an incomplete sales transaction by revoking the contract and starting

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Id. at 39.

[111] *See* note 23 *supra*. Under section 42 of the Internal Revenue Code of 1934, capital assets were not reportable as "accrued" income. Estate of Burnett v. Commissioner, 2 T.C. 897, 903 (1943). Thus, since section 126 was enacted solely to alleviate the hardship inherent in bunching income items into the decedent's final tax return, *see* notes 6-11 and accompanying text *supra*, originally it was argued that Congress had not intended to place into IRD a wider range of income items than had previously been reportable under section 42. *See, e.g.*, Scott, *supra* note 23, at 130. This argument found support in the congressional committee records which revealed no intent to dispel the distinction between ownership of capital assets and ownership of ordinary rights to earned income. *See id.* at 129. Indeed, this was the initial position of the Tax Court. *See* Estate of Remington v. Commissioner, 9 T.C. 99, 107 (1947) (a specific finding that earned insurance commissions were not capital assets required before subjecting them to tax as income in respect of a decedent). This argument, however, loses a good deal of its force when it is considered that *Remington* did not face the issue of the proper tax treatment of a sale of capital assets, and *Burnett* was concerned with inventory. *See generally* Gordon, *supra* note 17, at 33 & n.23. The contemporary argument for excluding sales of capital assets from section 691 treatment equates a right to payment with the asset. One is the substitute for the other. Holland, Kennedy, Surrey & Warren, *supra* note 23, at 370. *See also* Gordon, *supra* note 17, at 41.

[112] *See* Ferguson, *supra* note 3, at 148. For a general discussion of the need to distinguish between ordinary income and capital gain items under section 691, see Holland, Kennedy, Surrey & Warren, *supra* note 23, at 367-72.

[113] Another solution to the capital asset problem—making death a realization—was suggested in 1969. *See* 1969 Treas. Proposals at 338-39, 347-48.

afresh.[114] By finding section 691 income only when there is a completed sale of a capital asset, these problems will be avoided. Additional issues are presented, however, even when it is clear that an item is income in respect of a decedent. The next section will explore the inconsistent treatment accorded to the section 691(c) deduction available to the recipients of IRD.

THE SECTION 691(c) DEDUCTION

In the ordinary course of events, income is collected prior to death and an income tax is paid thereon. Upon the death of the income earner, the *net* item is included in his gross estate for estate tax purposes.[115] In contrast, IRD is realized after the taxpayer has died and is included in his gross estate for tax purposes without being reduced by the payment of an income tax.[116] Additionally, the recipient of the IRD is subject to income taxation without the advantage of a step-up in basis.[117] Section 691(c) was designed to ameliorate the impact of this double taxation upon IRD.[118] It provides that the recipient of IRD may deduct from his income tax that portion of the estate tax which is attributable to the inclusion of the item in the decedent's estate.[119] Unusual results sometimes

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[114] *See* notes 91-92 and accompanying text *supra*.

[115] When computing the value of the gross estate, the executor is required to include the value of all property of the decedent, regardless of its nature. I.R.C. § 2033. Upon the death of the income earner, the *net* item enters the estate for tax purposes. By contrast, income in respect of a decedent is realized after the cash basis taxpayer has died. *See* I.R.C. § 691(a). Accordingly, the income item enters the taxpayer's estate for estate tax purposes without first having been reduced by the payment of an income tax. Parenthetically, no reduction in the value of the item is permitted "for whatever income tax may be assessed against its ultimate recipient." Ferguson, *supra* note 3, at 147 (footnote omitted). Income in respect of a decedent, therefore, bears a proportionately heavier share of estate tax than does predeath income.

[116] *See* note 115 *supra*.

[117] The interplay of sections 691 and 1014 works to prevent items of income in respect of a decedent from receiving a step-up in basis. *See, e.g.*, Ferguson, *supra* note 3, at 148; Klein, *supra* note 4, at 304.

[118] Congress, in enacting section 691(c), intended to mitigate the harshness of double taxation of items of income in respect of a decedent. S. REP. No. 1622, 83d Cong., 2d Sess. 87-89, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4720; *cf.* H.R. REP. No. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4137, 4360 (section 691(c) deduction allocated between estate or trust and beneficiaries). More importantly, the courts have upheld this congressional objective. *See* Read v. United States, 320 F.2d 550, 553 (5th Cir. 1963); Goodwin v. United States, 458 F.2d 108, 112 (Ct. Cl. 1972); Meissner v. United States, 364 F.2d 409, 412, 414 (Ct. Cl. 1966).

[119] Section 691(c) of the Code provides in part:

> A person who includes an amount [of income in respect of a decedent] in

obtain, however, because the deduction, used to reduce the recipient's income, is determined by reference to the *decedent's* marginal estate tax rate while the income tax for the item of income in respect of a decedent is computed at the *recipient's* rate. Nevertheless, what is particularly troublesome is the restrictive and, perhaps, inequitable limitation presently imposed upon the recipient's use of the section 691(c) deduction. This problem is best understood in light of the varied and apparently contradictory pronouncements of the Commissioner over the past several years.

In *Read v. United States*,[120] the taxpayer was an estate which had ordinary income of $30,624 and long term capital gains amounting to $1,185,318.[121] Additionally, the estate, the decedent's successor in interest, had available a section 691(c) deduction totaling $184,996.[122] In calculating the income tax due, the taxpayer first subtracted the amount of the 691(c) deduction from the total of long term capital gains and then applied the alternative tax rate of twenty-five percent to the balance.[123] This resulted in a tax due of $250,080.[124] The Commissioner maintained that the 691(c) deduction could not be used to offset a capital gain calculated under the alternate method.[125] This position was founded upon the assertion that Congress had been sufficiently generous in providing the alternative method as a means of tax relief and that, therefore, the reform's benefits should not be expanded beyond those explicitly

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> gross income . . . shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items [of income in respect of a decedent].

I.R.C. § 691(c)(1)(A). For an overview of the manner in which this deduction is computed, see Klein, *supra* note 4, at 308-09. *See also* Holland, Kennedy, Surrey & Warren, *supra* note 23, at 361-77 (ALI recommendation to Congress on section 691(c), submitted prior to passage). The ALI draft proposed that the section 691(c) deduction be limited to the estate tax paid on that portion of IRD in excess of basis. This proposal was founded upon the premise that the portion of IRD represented by basis is not taxable, and therefore, "it is improper to grant as estate tax deduction for that portion of the right." Holland, Kennedy, Surrey & Warren, *supra* note 23, at 371.

[120] 320 F.2d 550 (5th Cir. 1963).

[121] *Id.* at 551-52. The figures have been modified slightly to eliminate extraneous sources of income and to simplify the discussion.

[122] *Id.* at 550.

[123] I.R.C. § 1201(b) (repealed by Pub. L. No. 95-600, § 401(a)(1), 92 Stat. 2861, 2866, 2871 (1978)).

[124] 320 F.2d at 552. The taxpayer first took the amount of the 691(c) deduction, $184,996, from the total of long-term capital gains $1,185,318, and then applied the alternative tax rate. (($1,185,318 − $184,996) x .25 = $250,080).

[125] *Id.*

authorized.[126] Although the argument sounded reasonable, the taxpayer, given the figures in the case, would have lost the benefit of more than $150,000 in deductions, and the tax due on the capital gain would have been $296,329, an increase of $46,249. Conceivably, because these facts presented a strong case for the taxpayer, the Fifth Circuit rejected the Commissioner's argument, finding that there was no evidence in the legislative history of section 691(c) to indicate that the deduction was not to be fully available in all cases.[127] Several years later, the Court of Claims, in a factually similar case, *Meissner v. United States*,[128] agreed with the Fifth Circuit and held that a "taxpayer should be able to use the deduction in the way most advantageous to him."[129]

In 1972, *Goodwin v. United States*[130] presented the converse situation. In *Goodwin*, the taxpayer sought to use his 691(c) deduction to reduce ordinary income, even though the deduction had originated in the inclusion of a capital gains item in the estate.[131] In contrast to its position in *Read*, wherein it had asserted that the 691(c) deduction could only be used to offset ordinary income, the Government in *Goodwin* maintained that the 691(c) deduction

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[126] *Id.* The Commissioner was relying on Weil v. Commissioner, 229 F.2d 593 (6th Cir. 1956), wherein the use of a charitable deduction was disallowed as an offset to capital gains because the taxpayer had calculated his tax by applying the alternative method. *Id.* at 595-96. The *Read* court, however, distinguished *Weil*, stating that charitable deductions are not the same as deductions designed to protect capital. 320 F.2d at 552. Moreover, the court observed, the Sixth Circuit was reluctant to extend *Weil* and did allow capital charges to stand as an offset to capital gains where the alternative method was used. *Id.* (citing United States v. Memorial Corp., 244 F.2d 641, 644 (6th Cir. 1957)).

[127] 320 F.2d at 553. At the outset, the court noted that the purpose of section 691(c) is to affect the estate tax paid on income in respect of a decedent and to normalize the income tax consequences to the recipient. *Id.* This interpretation, it was posited, was supported by the legislative history of the provision, wherein Congress announced that the intention of section 691(c) was to offset any estate tax attributable to the inclusion of an item of IRD in the gross estate. *Id.*; *see* S. REP. No. 1622, 83d Cong., 2d Sess. 87-89, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4720-21; H.R. REP. No. 1337, 83d Cong., 2d Sess. 64-65, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4090-91. The *Read* court, construing section 691(c) as providing for a pro tanto cancellation of estate tax, concluded that the Government's view was tantamount to double taxation in derogation of congressional intent. 320 F.2d at 553.

[128] 364 F.2d 409 (Ct. Cl. 1966).

[129] *Id.* at 413. The *Meissner* court reviewed the history of section 691(c) and concluded that Congress desired to achieve "*approximately the same* tax consequences" as if the decedent had acquired the tax liability before he died. *Id.* at 414 (emphasis in original). *See also* Craven, *Taxation of Income of Decedents*, 102 U. PA. L. REV. 185, 187-94 (1953).

[130] 458 F.2d 108 (Ct. Cl. 1972).

[131] *Id.* at 109.

could only be used to offset capital gain.[132] To support its new position, the Government asserted that the 691(c) deduction was available solely to offset the recipient's increase in income tax which resulted from the inclusion of IRD in his or her gross income.[133] Thus, the Government postulated, a deduction related to an item of IRD generated by a capital gain could not be used to offset unrelated ordinary income.[134] The Court of Claims, however, reaffirmed its view that the taxpayer may use the 691(c) deduction in the manner most advantageous to him.[135]

The question concerning the correct use of the 691(c) deduction next arose in *United States v. Quick*.[136] The problem presented in *Quick* can be illustrated by the following hypothetical. Assume that an estate has a $100 long term capital gain item of IRD which was subject to an estate tax of $40. Accordingly, the recipient of the $100 would be entitled to a 691(c) deduction of $40. In the Government's view, the income tax due would be calculated by first reducing the capital gain by the 691(c) deduction of $40, and thereafter, by applying the capital gains section 1202 deduction, which at the time was fifty percent, thus yielding a taxable amount of $30. The taxpayer, on the other hand, argued for a calculation beginning with the 1202 deduction, thereby yielding a taxable amount of $10.[137]

Adopting the "method most advantageous to the taxpayer,"

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[132] *Id.* The Government's "new" position was to limit 691(c) deductions to capital gains as allowed by *Read*, and to disallow the deduction against ordinary income on the theory that, in the majority of cases, this would benefit taxpayers, although the present taxpayer would be penalized. *Id.* at 111. The court was wary of this turnabout and held for the taxpayer. *Id.* at 112.

[133] *Id.* at 108.

[134] *Id.* at 112. The Government was saved the embarrassment of reversing the position taken in *Read* and *Meissner* since the capital gain in *Goodwin* had not been calculated under the alternative method.

[135] *Id.* at 111; *accord*, Estate of Sidles v. Commissioner, 65 T.C. 873, 886-87 (1976), *acq.* 1976-44 I.R.B. 5, *aff'd mem.*, 553 F.2d 102 (8th Cir. 1977). In *Sidles*, the estate received a corporation's liquidating assets as income in respect of a decedent. 65 T.C. at 882. The recipients thereof elected to apply their section 691(c) deduction to reduce their ordinary income to zero before reducing the amount of long term capital gains on which the alternative tax rate was applied. *Id.* at 883. The court was faced with the question whether the section 691(c) deduction was limited to offset solely 691(a) items, or whether it could be used to offset any income item whatsoever. *Id.* The court resolved the question in favor of the recipients, holding that the estate tax deduction permitted by section 691(c) could be used by the taxpayers to their greatest advantage. *Id.* at 887.

[136] 360 F. Supp. 568 (D. Colo. 1973), *aff'd*, 503 F.2d 100 (10th Cir. 1974).

[137] The following table, compiled by two noted commentators, shows the tax effect of the respective contentions of the parties:

the Tenth Circuit Court of Appeals in *Quick* held for the taxpayer.[138] Initially, the court observed that section 691(c) provided that a deduction shall be allowed, but did not specifically state "from what."[139] In filling this void, the court reasoned that Congress intended only to cut capital gain in half and had "not [intended to] cut the deduction in half."[140] Thus, the court concluded that the income against which the section 691(c) deduction was to be applied was the statutory income,[141] which, according to the hy-

Item of Income	=		$158,090.00
Less: Section 1202	=	$79,045.00	
Less: Section 691(c)	=	20,506.84	99,551.84
Net Taxable Gain	=		$58,538.16

The Government upon audit recomputed the taxable gain as follows:

Item of Income	=	$158,090.00
Less: Section 691(c)	=	20,506.84
Net Capital Gain	=	$137,583.16
Less: Section 1202	=	68,791.58
Net Taxable Gain	=	$68,791.58

Levey & Brogan, *An Analysis of the Impact of* Quick *on Estate Planning Where There is IRD*, 42 J. TAX. 293, 295 (1975). Hence, the taxpayer would have lost more than $10,250 under the Government's computation.

[138] 503 F.2d 100, 102 (10th Cir. 1974).

[139] *Id.*

[140] *Id.*

[141] *Id.* It was suggested that after *Quick* the government would need Congress' help to succeed in delimiting the section 691(c) deduction. Levey & Brogan, *supra* note 137, at 295. In the absence of congressional assistance, the "most advantageous principle" seems the most equitable approach to taxpayer use of the deduction. *Id.* at 295; *see* Read v. United States, 320 F.2d 550, 553 (5th Cir. 1963); Meissner v. United States, 364 F.2d 409, 413-14 (Ct. Cl. 1966). Of course, the possible tax savings which could be obtained by directly offsetting capital gains with a section 691(c) deduction did not escape the eye of tax planners. *See* Seltzer, *Installment Sales in Contemplation of Death*, 42 CPA J. 945, 945 (1972). If income in respect of a decedent consists of unrealized long-term capital gain, the estate tax attributable to the full gain is deductible, even though only 40% of the gain is subject to income tax under section 1202. I.R.C. § 1202 (1981). Thus, if the estate tax bracket exceeds 40%, an overall income tax saving will result. Only 40% of the long-term capital gain will be included in income, but the estate tax deduction will be calculated on the full capital gain. For example, an estate in the 55% estate tax bracket collects an installment obligation which results in a $200 long-term gain. The gain would be reduced to $80 by the capital gain deduction. Yet, the recipient would be entitled to a 691(c) deduction of $110 (55% of $200). *Cf.* Estate of Sidles v. Commissioner, 65 T.C. 873, 893 (1976) (Tannenwald, J., dissenting) (this approach "enables [taxpayers] to have their cake and eat it too"), *acq.* 1976-44 I.R.B. 5, *aff'd mem.*, 553 F.2d 102 (8th Cir. 1977). Levey and Brogan use the following example to note the distinct advantages for planning such treatment for large estates. Assume that an elderly person, or one who has been informed that death is imminent, possesses assets with a fair market value of $6 million. Included in the assets is a parcel of undeveloped real estate which has a fair market value of $1 million and a basis of $100,000. The usual estate

pothetical, would equal $100.

Having failed to close this loophole through judicial action, the Treasury finally succeeded in having the Code amended to conform to its position in *Quick*. Section 702(b)(1) of the Revenue Act of 1978,[142] which added section 691(c)(4) to the Code, provides that "the amount of any gain [included in 691(a)] . . . shall be reduced . . . by the amount of the deduction allowable under paragraph (1) of this subsection with respect to such item."[143] Thus, in essence, the 691(c) estate tax deduction attributable to an item of capital gain must first reduce that gain before computation of the capital gain deductions permitted under other provisions of the Code.[144]

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plan for this piece of property would be to hold it until death because the property would, then, receive the section 1014 stepped up basis. I.R.C. § 1014 (1981). Thereafter, if the beneficiaries sell the property, little or no capital gain would be realized. Consider, however, the alternative of a lifetime sale of the property to another party for $1 million, payable by $40,000 down and the remainder in installments of $16,000 a month for the succeeding 5-year period. The seller would elect to recognize the gain under section 453—the installment method of recognition. *See* I.R.C. § 453 (1980). Assume that the payee dies after receiving the down payment and five monthly payments and that the installment note is the only item of income in respect of a decedent included in his estate. In this posture, the recipient would realize a net taxable capital loss of $69,120. Necessarily, this loss represents a correlative underutilization of the section 691(c) deduction. Thus, the taxpayer, under the "most advantageous" principle of *Quick*, has available a deduction of $69,120 which may be used to offset ordinary income. *See* Read v. United States, 320 F.2d 550, 552 (5th Cir. 1963).

[142] Revenue Act of 1978, Pub. L. No. 95-600, § 702(b)(1), 92 Stat. 2925 (codified at 26 U.S.C. § 691(c)(4) (Supp. III 1979)). This enactment, which added section 691(c)(4) to the Code, became effective on November 6, 1978. For an analysis of the Revenue Act of 1978 and its effect on income in respect of a decedent generally, see Klein, *supra* note 4, at 377-79.

[143] I.R.C. § 691(c)(4) (1978). Section 691(c)(4) was originally introduced by a House of Representatives bill entitled the Technical Corrections Act of 1977, the purpose of which was to correct technical errors in the Tax Reform Act of 1976. *See Technical Corrections Act of 1977: Hearings on H.R. 6715 Before the Comm. on Ways and Means*, 95th Cong., 1st Sess. 1 (1977). The problem sought to be resolved was created by the enactment of the carryover basis rule. *Id. See generally* Klein, *supra* note 4.

[144] Although the enactment of section 691(c)(4) appears to settle the issue, a cautionary note should be sounded because the 1978 amendment was intimately related to the carryover basis provisions of the 1976 Tax Reform Act. U.S. CONGRESS JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF REVENUE ACT OF 1978, 409 (1979) [hereinafter cited as JOINT COMMITTEE BLUEBOOK]. Under the carryover basis provisions, the basis of property acquired from the decedent dying after December 31, 1976 was to be "carried over" to the estate or beneficiary for the purpose of determining a gain or loss on the disposition of the property. I.R.C. § 1023 (repealed by the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 299 (1980)). Heirs were permitted a basis adjustment for federal and state death taxes which were attributable to appreciation. *Id.* This adjustment was considered to be analogous to the section 691(c) deduction permitted recipients of IRD. JOINT COMMITTEE BLUEBOOK, *supra*, at 409. Experience, however, proved otherwise. Indeed, as

The Ultimate Reform: Repeal

The Whimsical Nature of Section 691

Permeating the discussion of the effect of the section 691(c) deduction on the sale of capital assets is the fact that the ultimate value of this deduction depends upon the income tax bracket of the *recipient* of the IRD item. The recipient's tax rate, however, bears no relation to the decedent's tax rate. Thus, the whimsical nature of the current tax scheme is apparent, for the income tax rate at which an item of income in respect of a decedent is returned has absolutely no connection with the decedent's tax rate. Indeed, given the capacity of an executor to distribute an item of income in respect of a decedent to one of several beneficiaries, the present system, in effect, amounts to something akin to fiscal roulette.[145]

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noted by the Joint Committee:

> In the case of a sale before death, some courts have held that an individual is entitled to both the deduction for estate taxes attributable to the gain and the long-term capital gain deduction based on the amount of gain undiminished by the deduction for estate taxes. However, in the case of a sale of inherited property by an heir, the basis adjustments for death taxes attributable to appreciation would be taken into account in determining the amount of gain to which the long-term capital gain deduction applies.

Id. (footnote omitted). Congress, believing that the dichotomy in treatment was unjust, enacted section 691(c)(4) in order to rectify the discrimination against the sale of inherited property. *See Technical Corrections Act of 1977: Hearings on H.R. 6715 Before the Comm. on Ways and Means,* 95th Cong., 1st Sess. 1 (1977). With the demise of the carryover basis rule, however, the injustice has disappeared. Presently, gains realized by heirs upon the sale of inherited property are treated more favorably than gains recognized by the recipients of IRD. *See generally* JOINT COMMITTEE BLUEBOOK, *supra,* at 409.

[145] *See generally* M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 296-97. This fantasy treatment is compounded when one considers the section 691(c) deduction which, in theory, is designed to compensate for the inclusion of the gross item of income in respect of a decedent in the estate tax return. Optimally, of course, it would be desirable to reduce the gross estate by the amount of income tax that the decedent would have paid had he received the item of income in respect of a decedent while alive. *See* Klein, *supra* note 4, at 304. This cannot be done, however, because one cannot reasonably guess the tax treatment the item would have been accorded in the decedent's hands. Instead, the item of income in respect of a decedent is reduced by section 691(b) deductions in respect of a decedent. *See* I.R.C. § 691(b) (allowing deductions under sections 162, 163, 164, 212, and 611). The resulting net income in respect of a decedent is the foundation upon which the section 691(c) deduction is computed. Nonetheless, this formula ignores the premise of section 691 which is to minimize the effect of death. *See* H.R. REP. No. 2333, 77th Cong., 2d Sess. 48, 83 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 120 (1942). Indeed, "if the decedent had paid section 691(b) deductions during his life, his gross estate would have been proportionately smaller and hence no net effect on his taxable estate would have been discernible." Ferguson, *supra* note 3, at 149. Additionally, the netting requirement is unsatisfactory insofar as

It is submitted that, instead of a randomly selected income tax rate and an equally arbitrary section 691(c) deduction, a better approach might be to apply a flat income tax rate of twenty or thirty percent on all items of income in respect of a decedent. This amount would be paid by the executor and deducted prior to the inclusion of the item in the gross estate. Surely, one objection to this simple system is that a flat rate would favor wealthy taxpayers. Accordingly, rather than instigate a new layer of encrustation—a graduated rate schedule for income in respect of a decedent—it is suggested that the concept of income in respect of a decedent, and section 691, should be abolished altogether. The result of this proposal would be to free items of income in respect of a decedent from income taxation and to subject them to estate tax at gross amounts. Clearly, neither the history of section 691[146] nor the inscrutable revenue effect of such a proposal would seem to be substantial barriers to its acceptance.[147]

A Call for Repeal

Presently, section 691 reinforces the "lock-in" effect of section 1014(a)'s step-up in basis.[148] Indeed, it is clear to every tax planner that the best course for the elderly client who desires to "sell-out" of the family business is to hold the asset until death so as to take advantage of section 1014(a). Even if the client were willing to forego the advantages of the step-up in basis, the risk that death might ensue during the course of the transaction militates against

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the recipient of income in respect of a decedent is not necessarily the party who receives the benefit of the section 691(b) deductions. *Id.* at 149-50. As a result, the available section 691(c) deduction may be unjustifiably reduced. *See id.* at 148-51; M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 286-88.

[146] *See* notes 6-14 and accompanying text *supra*. The purpose of the statutory predecessors of section 691 was to rectify the disparity between accrual and cash basis taxpayers. *See* M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 140. In reality, however, such disparity may have been more apparent than real. Interestingly, in this regard, the Internal Revenue Service does not record how many taxpayers keep their books on an accrual basis. Moreover, there is no evidence that Congress, in enacting its initial remedial provision, *see* Revenue Act of 1934, ch. 277, § 42, 48 Stat. 694, engaged in an empirical study pertaining to the perceived differential tax results of death on cash and accrual basis taxpayers. *See* S. REP. No. 558, 73d Cong., 2d Sess. 28 (1934), *reprinted in* 1939-2 C.B. (pt. 2) 586, 608. Hence, it is conceivable that the alleged discrimination between cash and accrual basis taxpayers is actually at a de minimis level and does not rationally support the section 691 superstructure.

[147] *See generally* notes 151-180 and accompanying text *infra*.

[148] *See* note 25 *supra*. For a discussion of the interaction between I.R.C. section 691 and section 1014, see M. FERGUSON, J. FREELAND, & R. STEPHENS, *supra* note 17, at 177-84.

an inter vivos disposition. Thus, from a policy point of view, if sales are to be encouraged during the seller's lifetime, the concept of income in respect of a decedent should be abandoned.

Additionally, in the context of sales of capital goods, dispensing with section 691 treatment would remove the unfairness engendered by the provision. Notably, the incidence of income in respect of a decedent arises only when the cash basis taxpayer has had the misfortune to die before receiving the proceeds of an otherwise completed transaction. Because such taxpayer has been deprived of the enjoyment of the proceeds and has eschewed the tax advantages of section 1014(a), it appears fitting *not* to impose an additional tax burden.[149]

Finally, repeal of section 691 would eliminate the substantial compliance costs associated with identifying items of income in respect of a decedent—a consideration receiving increasing recognition in tax literature. Every estate, no matter how small, may, and most likely does, contain several items of income in respect of a decedent. The most common items, one would surmise, are postmortem receipts of earned income and accrued interest. In each of these situations, the executor or administrator must isolate the item and inform the beneficiary that, unlike other distributions which are income tax free, the IRD item must be included in the beneficiary's income tax return. Clearly, the location, identification, and separate distribution of items of income in respect of a decedent must, by necessity, increase administrative expenses and will involve some cost to estate beneficiaries. Considering the multitude of diminutive payments of income in respect of a decedent which enter small estates, compliance costs may outweigh the revenue effects of section 691. Parenthetically, if it is assumed that compliance costs are de minimis because small estates are inexpensively administered, the corollary might be a failure to identify and report items of income in respect of a decedent, thereby frustrating the revenue purpose of section 691.[150]

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[149] For a series of calculations illustrating how the section 691(c) deduction can vary depending upon the marital deduction provision of a will or trust, see A. J. CASNER, ESTATE PLANNING 82 (Supp. 1981).

[150] Income in respect of a decedent, to the extent that it is reported at all, is reported on either Form 1040 or Form 1041, neither of which contains a separate line for the item. Hence, one's ability to ascertain the revenues generated by section 691 is complicated. Indeed, even information on the dollar volume of IRD reported on estate income tax returns cannot be obtained because the Internal Revenue Service does not compile such data. Letter from William J. Smith, Jr., Acting Chief, Statistics of Income Branch II, Internal Revenue

In sum, section 691 theoretically is unsound, inherently unfair, onerous in view of the compliance costs, and antithetic to the policy espoused in section 1014(a). For these reasons, Congress should critically examine the concept of income in respect of a decedent with a view toward repeal. In any event, an empirical study should be conducted to determine the effectiveness of section 691 as a revenue source and as a remedial provision against perceived discrimination. Indeed, as will be discussed below, such an examination will yield the conclusion that the effect of repeal on revenues would be marginal.

The Revenue Effect of Repeal

Although data is lacking with which one may precisely predict the outcome of the present proposal with respect to taxable estates, several estimates, based upon the data available in the

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Service, to Gilbert P. Verbit (April 10, 1980). The only available information is the volume of section 691(c) deductions. *See* INTERNAL REVENUE SERVICE, DEP'T OF THE TREASURY, STATISTICS OF INCOME 1974: FIDUCIARY INCOME TAX RETURNS 17-23 (1977). Of a total of 336,475 estate income tax returns filed in 1974, 20,474 took a total of $41,521,000 in section 691(c) deductions. *Id.* at 20. Most of these deductions were taken by estates with income of greater than $7,000:

	No. of Estates	Amount
$7,000 - 10,000	2536	$1,566,000
10,000 - 15,000	2762	2,576,000
15,000 - 25,000	2974	4,498,000
25,000 - 50,000	2601	8,158,000
50,000 - 100,000	1411	8,036,000
100,000 - 200,000	488	4,427,000
200,000 - 500,000	190	3,997,000
500,000 - 1,000,000	37	1,086,000
1,000,000 - or more	16	2,691,000

Id. Additionally, in 1974, a total of 4,916 trusts reported a total of $11,513,000 in section 691(c) deductions. Of this total, the vast majority were reported by taxable trusts reporting income in excess of $10,000:

	No. of Trusts	Amount
$10,000 - 15,000	489	$510,000
15,000 - 25,000	774	925,000
25,000 - 50,000	604	1,720,000
50,000 - 100,000	269	1,669,000
100,000 - 200,000	94	1,034,000
200,000 - 500,000	45	1,108,000
500,000 - or more	4	1,994,000

Id. at 27.

cases, may be constructed. *Sun First National Bank v. United States*[151] provides an interesting starting point. In *Sun First National Bank,* the value of the trust assets included in the decedent's estate was $4,853,196.[152] On this amount, the Commissioner assessed an estate tax of $3,070,532.[153] Accordingly, the decedent's daughter, the ultimate recipient of the IRD, received a section 691(c) credit of $3,070,532 on a capital gain of $4,842,196.[154] Pursuant to section 691(c)(4), the 691(c) credit must be deducted from the amount of the gain before taking the capital gains deduction.[155] Thus, the calculation would be $4,842,196 − $3,070,532 = $1,771,664. The gain, reduced by the section 1202 deduction, would be $1,771,664 − $1,062,998 = $708,666. Assuming the new maximum income tax rate of fifty percent, the total tax due would be $354,333.[156] Should section 691 be repealed, this amount would not be paid and would thus be a revenue loss to the Treasury and a gain to the taxpayer. But would it be a windfall? If the purpose of section 691 is to tax the gain as if it had been received by the decedent while alive, the answer would be no because, had the decedent completed the sale and received full pay-

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[151] 607 F.2d 1347 (Ct. Cl. 1979), *withdrawing and replacing* 587 F.2d 1073 (Ct. Cl. 1978). In *Sun First Nat'l Bank,* the grantor-decedent was the beneficiary of a trust which, prior to her death, sold a portion of the corpus for a downpayment in cash and 15 promissory notes payable annually. 607 F.2d at 1349. The decedent's successor in interest attempted to claim the benefit of the section 691(c) deduction. The Court of Claims, after initially ruling to the contrary, held that if a grantor trust makes an installment sale prior to the grantor's death, the income from the receipt of the installments made after death constitutes IRD. *Id.* at 1354-55. While the case illustrates the problems courts have had in interpreting IRD, it also may be viewed as a potential impediment to the continued use of the inter vivos revocable trust in estate planning. The interpretative gymnastics manifested by the Court of Claims in its two opinions and the potential loss of the section 691(c) deduction may give pause to any tax planner thinking of using the revocable trust as a tax planning device. For a critique of the withdrawn opinion, see Bellows, *Grantor Trusts: Court of Claims Founders in Its Attempt to Navigate in Murky Income in Respect of a Decedent Waters,* 3 REV. TAX. INDIVIDUALS 344, 344-49 (1979).

[152] Estate of Andersen v. Commissioner, 32 T.C.M. (CCH) 1164, 1164-66 (1973). The parties stipulated that the fair market value of the assets in trust at the date of the settlor's death was $4,853,196. *Id.* at 1166. *See generally* Cleary, *Revision in Deductions for IRD Items Create New Planning Possibilities,* 53 J. TAX. 70, 72 (1980); Klein, *supra* note 4, at 377-78.

[153] 32 T.C.M. (CCH) at 1164.

[154] 607 F.2d at 1349.

[155] *See* notes 142-144 and accompanying text *supra.*

[156] The computation for determining tax due is: Total Gain ($4,842,196) − 691(c) deduction ($3,070,532) = $1,771,664. The section 1202 deduction, 60% of $1,771,664, is $1,062,998, leaving a taxable gain of $708,666. Thus, the tax liability, assuming a 50% tax rate, is $354,333.

ment while alive, the maximum tax on her long-term gain would have been $1,355,815. Moreover, the tax payment would have reduced her estate by an equal amount.[157]

Although we do not know the total value of the decedent's estate, we do know that the inclusion of the stock valued at $4,853,196 resulted in an additional tax of $3,070,532.[158] Given the rate schedule in force prior to 1976,[159] the total taxable estate would have amounted to approximately $8,500,000. Even under the decreased maximum estate tax rate of fifty percent, not scheduled to take effect until 1986, the estate tax due would have decreased by $677,908 due to the elimination of $1,355,815 from an estate of $8,500,000. Thus, the $354,333 loss in income taxes to the Treasury would have been more than offset by the additional estate tax which the estate would have had to pay.[160] Therefore, if a windfall occurred as a result of the death of the taxpayer before the completion of the sale, that windfall is garnered by the Treasury, not the taxpayer.

The Treasury would suffer a loss, however, if these same assumptions are applied to other cases from which data can be drawn. In *Meissner v. United States*,[161] for example, the item of income in respect of a decedent was included in an estate valued at $4,200,000.[162] The item constituted almost half of the gross estate.[163] Premised on the assumption that the item represented all gain, its predeath sale would attract a long-term capital gains tax of roughly $420,000. On the simplifying assumption that the item

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[157] *See* Chastain v. Commissioner, 59 T.C. 461, 465-66 (1972).

[158] *See* 32 T.C.M. (CCH) at 1164.

[159] Prior to 1976, if the taxable estate was over $8 million but not greater than $10 million, the tax was $4,568,200, plus 76% of the excess over $8 million. Int. Rev. Code of 1954, ch. 11, § 2001, 68A Stat. 373 (current version at I.R.C. § 2001 (1978)).

[160] Tax receipts from the income transaction vary depending upon three hypotheses:

(1) If Jeanette Andersen had lived, she would have paid an income tax of $1,355,815, but her ultimate estate tax burden would have been reduced by $677,908 because the amount of income tax paid would have been eliminated from her gross estate. Thus, the total federal tax burden of the transaction is $677,908.

(2) Under the facts as they exist, the inclusion of the IRD amounts results in the Andersen estate paying $677,908 more in estate tax, while the remainderman, Mrs. Andersen's daughter, pays an income tax of $354,333 when she receives the payments. In this situation, the Treasury collects $1,032,241.

(3) Under the proposal in the text, the Treasury would collect the $677,908 in additional estate tax, but no income tax. Thus, the total revenue collection is $677,908.

[161] 364 F.2d 409 (Ct. Cl. 1966).

[162] *See id.* at 410 & n.2.

[163] *See id.* at 410.

was in fact one half of a gross estate, the present treatment of income in respect of a decedent reduced the estate tax by approximately $263,000. Thus, under the proposal, the Treasury would collect an added $263,000 in estate taxes and lose long term capital gains taxes of approximately $420,000. Note, however, that this loss of income tax is premised upon the ultimate recipient's having to pay tax at the maximum income tax rate of fifty percent. If, instead, the recipient paid tax at a thirty percent rate, the Treasury would collect only $252,000 in income tax, as against an additional estate tax collection of $263,000.[164]

Notwithstanding the fact that one cannot accurately predict the recipient's tax rate, the varying tax situations of recipients are a recognized item of postmortem estate planning, a cardinal tenet of which is to distribute items of income in respect of a decedent to low bracket taxpayers. Thus, it can safely be assumed that items of income in respect of a decedent will not be taxed at the maximum rate of fifty percent. The net revenue loss to the Treasury, if any, would rarely approximate that which would have occurred in the above example.

Nevertheless, there are situations in which the Treasury clearly will lose revenue. In *Sidles*, for example, the item of income in respect of a decedent had a basis of $29,710, was valued at $702,830, and generated a section 691(c) deduction of $94,448.[165] These figures would indicate that the taxable estate was slightly in excess of $800,000. If the sale of the stock had been completed before death, there would have been a taxable gain of $673,129 on which a tax of $134,626 would be assessed, assuming a sixty percent capital gains deduction and a fifty percent tax rate.[166] Reducing Sidles' estimated estate by this amount, assuming a $600,000 exemption equivalent, would decrease his estate taxes by approximately $40,000, and the item's recipient would pay $134,626 in tax. Again, this assumes a recipient tax rate of fifty percent. In *Sidles*, the recipient would have to pay an effective rate below twenty percent for the Treasury not to lose under the present proposal. Here,

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[164] *See* Drye, *supra* note 18, at 213. The ultimate tax burden may be reduced further by averaging section 691 income. *See* Rev. Rul. 467, 1970-2 C.B. 169.

[165] Estate of Sidles v. Commissioner, 65 T.C. 873, 876-77 (1976), *acq.* 1976-44 I.R.B. 5, *aff'd mem.*, 553 F.2d 102 (8th Cir. 1977).

[166] The computation of tax liability would be: Total Gain ($673,129) − 60% of Total Gain ($403,877) = Taxable Gain ($269,252). Assuming a 50% rate, the tax liability is $134,476.

then, the Treasury loss is based not upon the assumption of a high recipient tax rate, but rather upon a low estate tax bracket.

It is clear, therefore, that the Treasury will lose revenue when items of income in respect of a decedent are not subject to estate tax and that the loss will decrease as the taxable estate and the estate tax paid increase. At the highest levels, however, the Treasury clearly collects more from section 691 treatment than it would collect had the decedent paid income tax on the item of IRD before death.[167] A comparison of the estimated results of the proposed elimination of section 691 to the system as it presently exists indicates that the section 691(c) deduction plays an important role in the total tax picture. Whenever the estate tax rate exceeds the recipient's income tax rate, the deduction effectively eliminates income tax payment by the recipient. The major effect of the proposed change, therefore, will be to reduce the taxes paid by the recipients of items of income in respect of a decedent arising from small and medium sized estates while keeping tax collection from large estates at approximately the same level.

The revenue loss, however, would be greater if the items of income in respect of a decedent represented ordinary income rather than capital gain, because the former is subject to higher levels of taxation.[168] Nevertheless, for the classic item—earned but unpaid salary—the loss of federal revenue should not loom large.[169] Indeed, the principal area of concern would be the loss of tax receipts on the post mortem realization of large amounts of deferred compensation or retirement benefits.[170]

The treatment of retirement benefits is extremely complex and one can only hope that any summary will not be misleading. Benefits received from a nonqualified deferred compensation arrangement clearly would constitute income in respect of a dece-

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[167] It should be noted that, under the present scheme, an executor may effectively assure the nonincome taxability of an item by distributing such to a tax exempt entity. *See* M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 371; 3 J. LASSER, ESTATE TAX TECHNIQUES 1935 (1981).

[168] *Compare* I.R.C. § 1 (1978) *with* I.R.C. § 2001(c) (1978).

[169] Earned but unpaid salary has often been described as "the most obvious example of income in respect of a decedent." Ferguson, *supra* note 3, at 28. It is probable, however, that such items of income in respect of a decedent will be insignificant, and therefore, any federal revenue loss will be negligible. *See* J. LASSER, *supra* note 167, at 1935. On the contrary, significant revenues may be lost when the items include income from installment obligations, partnership income, executory contracts, and the like. *Id.*

[170] *See* M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 162-77 (application of section 691 to various forms of deferred income and death benefits).

dent.[171] Recognizing this, however, tax planners presently advise clients to name their children or grandchildren the beneficiaries of such arrangements, thereby minimizing the tax effect of death[172] because the payments received after death are excluded from the taxable estate and are only subject to income tax at the beneficiary's rate. If, on the other hand, section 691 is repealed, the beneficiaries would receive the payments free of income tax. The government, however, will not sustain a significant revenue loss because the payments would be subject to estate taxes.[173]

In the context of a qualified plan,[174] an employee may receive his benefits in the form of an annuity or in a lump sum. A question has arisen as to whether receipts from the qualified plan in an annuity ever constitute income in respect of a decedent. The issue concerns the preemptive effect of section 72 of the Internal Revenue Code, which deals with the taxation of annuities.[175] If annuity distributions from qualified plans are taxable under section 72, they would not be affected by the present proposal. Moreover, annuity distributions from qualified plans are largely excluded from the gross estate, thus precluding application of section 691.[176] The alternative form of distribution from a qualified plan is a lump sum. Although a lump sum is included in the taxable estate and treated as ordinary income, the recipient, pursuant to section 402(e)(1)(c), may elect the benefits of the special 10-year forward income averaging method.[177] It is significant to note that the 10-

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[171] *See* Rev. Rul. 31, 1960-1 C.B. 174, 178-81; *cf.* Latendresse v. Commissioner, 26 T.C. 318, 328 (1956), *aff'd*, 243 F.2d 577 (7th Cir. 1957) (renewal commissions earned by decedent but not payable at time of death are items of income in respect of a decedent to recipient).

[172] *E.g., Estate Planning for the Corporate Executive*, TAX MGMT. (BNA) No. 22s-3rd, at A-16 (1979).

[173] *See* notes 166-167 and accompanying text *supra*.

[174] A qualified plan, which is tax exempt under I.R.C. § 501(a), is an employees' trust created by an employer for the exclusive benefit of his employees or their beneficiaries. *See* I.R.C. § 402(a) (1980).

[175] Hess v. Commissioner, 271 F.2d 104, 108-09 (3d Cir. 1959) (annuity payments from qualified plans are income in respect of decedents). *But see* Lacomble v. United States, 177 F. Supp. 373, 375-76 (N.D. Cal. 1959) (joint and survivor annuity distributions are taxable income under section 72 and not income in respect of a decedent under section 691). Section 691(d)(1), however, specifically gives a section 691(c) deduction to survivor receipts to the extent that the annuity value is included in the taxable estate under section 72. *See* I.R.C. § 691(c) (1981).

[176] I.R.C. § 2039(c) (1978). This section excludes from the gross estate the value of certain annuities. *Id.* Section 1.691(a)-1(d) of the Regulations provide that any item excluded from gross income is not IRD. Treas. Reg. § 1.691(a)-1(d) (1960).

[177] I.R.C. § 402(e)(1)(c) (1978).

year averaging period was chosen by Congress because it represents the approximate life expectancy of a 65-year-old person.[178] Thus, Congress did not expect that lump-sum retirement benefits would be received after death. Moreover, the additional tax assessment for the 10-year period is calculated in the year the lump-sum payment is received.[179] Accordingly, section 691 treatment is not necessary in such a case, for subsections (a) and (c) of section 691 were devised to compensate for that situation wherein the income tax which the decedent would have paid had he received the item while alive could not be accurately calculated. Because the section 402(e)(1) election provides a way in which to calculate the tax that the decedent would have paid had he received the distribution, the section 691 fiction need not be used.

Necessarily, therefore, the problem of income in respect of a decedent can only arise if the lump sum is distributed after the death of the person who earned it. Until 1976, a postmortem lump-sum distribution from a qualified plan was not included in the gross estate, and thus section 691 did not apply. When the Code was amended in 1976 to include lump-sum distributions in the taxable estate, the change also made these distributions subject to section 691 treatment. The revenue effects of this change, however, are not as clear as expected, for in some circumstances, the section 691(c) deduction generated by including the lump-sum distribution in the estate may exceed the income tax payable by the recipient. This would be true if the taxable estate was large and the distribution small. In contrast, the benefits of the section 691(c) deduction may be lost to the low income recipient because section 402(e)(3) indicates that lump-sum distributions are not included in the taxpayer's adjusted gross income. This means that the section 691(c) deduction can only be used to offset other income, which income may not be sufficient to permit optional use of the deduction.[180]

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[178] H.R. REP. No. 779, 93d Cong., 2d Sess. 149 (1974), *reprinted in* 1974-3 C.B. 392.

[179] *See* Proposed Treas. Reg. § 1.402(e)(2)(b)(4), *reprinted in* 40 Fed. Reg. 18,798, 18,802 (1975). For a discussion of the rules concerning lump-sum distributions, see M. FERGUSON, J. FREELAND & R. STEPHENS, *supra* note 17, at 174-75.

[180] *See* Cleary, *supra* note 152, at 73. Lump-sum distributions from a qualified pension or profit-sharing plan are a source of income subject to favorable income taxation treatment. Recently, such proceeds became includible in the estate for estate tax purposes. Distributions that are not lump sum, while not included in the estate for estate tax purposes, are subject to income tax. Hence, there is a resultant trade-off. *Id.*; *see* A. J. CASNER, ESTATE PLANNING 367-418 (4th ed. 1979); Kochis, *How to Handle Distributions From Employee Benefit Plans*, 117 TRS. & ESTS. 476 (1978); Nasuti, *How to Coordinate Income and Estate*

Thus, the revenue impact of removing retirement benefits from section 691 treatment is far from clear. What is clear is that the carefully developed rules for the income taxation of retirement benefits become inapplicable and are replaced by the cumbersome system of income in respect of a decedent when the retiree dies before the actuaries expected.

CONCLUSION

Upon review of section 691, its legislative history, and several of the provision's significant problems, it is apparent that, in the absence of either a uniform judicial interpretation or an adequate legislative response, the concept of income in respect of a decedent will continue to be particularly troublesome in the context of capital sales transactions. Pending congressional action, the courts may mitigate the difficulties by unambiguously defining the term "right to income." It is suggested that IRD should result only when the decedent had closed the transaction during his lifetime, or if incomplete, only when the decedent held out the asset for sale in the ordinary course of his business. Nevertheless, Congress should ultimately confront the problems that it has created by enacting section 691. In so doing, repeal would be the appropriate response. If, however, the concept of income in respect of a decedent is to be perpetuated, Congress, at the very least, should define the ambit of section 691(a) and should restore vitality to section 691(c).

Tax Planning for Qualified Plan Distributions, 49 J. TAX. 194, 195 (1978).