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INCOME IN RESPECT TO THE DECEDENT—ITS FEDERAL INCOME AND ESTATE TAX IMPLICATIONS

By EDWARD N. POLISHER*

INTRODUCTION

The death of a taxpayer does not necessarily put at rest the duty to pay income tax on income attributable to the decedent. There may still be earned but uncollected items of income; or his employer may voluntarily make payments to his widow after his death. Had the decedent lived, he would have received these amounts and paid income tax thereon. After his death, his estate or his designated beneficiaries will be the recipients. The treatment of such items for Federal income and estate tax has given rise to a number of complex problems.

Shall they be includible as assets of the gross estate, subject to the Federal estate tax?

Shall they be deemed income in the last taxable period of the decedent?

Are they to be dealt with as income of the estate or the person who eventually received them?

If both income and estate taxes are applicable, what equitable adjustment should be allowed the estate or the recipients to soften the impact of the double burden of taxation on the identical item?

These problems and their attempted solution have resulted in a series of amendments to the Internal Revenue Code, culminating in the enactment of Section 126. The scope of this article is to consider how Section 126 endeavors to deal with the problem of income in respect of a decedent, how the Section has been interpreted and whether it actually serves its intended purpose.

A. Background of Section 126

(1). Prior to 1934

Prior to 1934, any income of a decedent on a cash basis, which had not been received at the time of his death, was not income. This was so even though his estate or beneficiaries were entitled to collect the item after his death. Upon the decedent's death, the right to this income became part of his gross estate, having as its basis the value at the time of death. When the amount was collected

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by the estate, it was a realization of its value without gain. This was so despite the
fact that the same amount would have been credited to income and included in
the decedent's last return, had he been on an accrual basis.\footnote{Nichols v. United States, 64 Ct. Cls. 241, (1927), cert. denied, 277 U. S. 584 (1928); J. Howland Auchincloss, Exec. 11 B. T. A. 947, (1928); Estate of A. Plummer Austin, 10 B. T. A. 1055 (1928).}

(2). The Act of 1934

The Revenue Act of 1934 attempted to eliminate the above disparity and to
remedy this situation. Its plan was to subject to income taxation, the amounts owing
to the cash basis decedent at his death, but payable thereafter. This was done by
amending Section 42 of the Internal Revenue Code to read (in part) as follows:

"... 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."\footnote{Section 42, Internal Revenue Code, 1941.}

The purpose of this amendment apparently was to create a uniform rule for
computing the income for the last taxable period of the decedent. This was
achieved by placing him upon an accrual basis for computation of the last re-
turn, irrespective of his usual method of accounting, whether cash or accrual.

Little difficulty was encountered with this until Commissioner v. Enright\footnote{Helvering v. John M. Enright, 312 U. S. 636, (1941) (Certiorari from 112 F.2d 919); see
also the companion case of Pfaff v. Commissioner ,312 U. S. 646 (1941) (Certiorari from 113 F.2d 114); certiorari was granted in these two cases because of the conflicting decisions rendered by the Second and Fourth Circuits.}
was decided by the Supreme Court in 1941.

(3). The Enright Case

Enright had been a member of a law partnership. Both he and the partner-
ship kept their accounts on the cash receipts basis. The partners had agreed that
upon the death of either of them, the estate of the deceased should receive his
partnership percentage in the "net moneys then in the firm treasury, and in the
outstanding accounts and . . . the earned proportion of the estimated receipts
from unfinished business." When Enright died on November 19, 1934, his share
in the uncollected amounts was valued at $2,000.00, and in the unfinished work
at $40,000.00. Both amounts were reported by his executor as an asset of the
estate. The Commissioner assessed an income tax deficiency on the theory that
these were within the scope of Section 42, being "accrued" at the date of Enright's
death. The Board of Tax Appeals upheld the Commissioner.\footnote{B. T. A., Memo Op. CCH Dec. 10,808 B, (1939). While admitting that the purpose of Section 42 was "to place the taxpayer on an accrual basis," the Court differed with the Estate as to what items were "accrued."
Court of Appeals for the Fourth Circuit reversed. The court held that the partnership, being a tax computing unit separate from the decedent under Section 182, was not affected by Section 42. Thus, the only amounts which were accrued to the decedent under Section 42, were those that could be classed as "the distributive share of income of the partnership." The decedent had no right to receive anything from the firm except his proportionate share of the cash receipts. As it was the right to receive payment which made an earning accrue under Section 42, these items were not accrued income. The Supreme Court granted certiorari and reversed the Circuit Court of Appeals. The reasoning of the Court may be summed up in the following extracts from its opinion:

"... It has been frequently said, and correctly, that Section 42 was aimed at putting the cash receipts taxpayer upon an accrual method basis. But that statement does not answer the meaning of accrual in this section... Accruals here, are to be construed... to convert into income the assets of decedents, earned during their life, and unreported as income which on a cash basis would appear in the estate returns... Accrued income under Section 42 for uncompleted operations includes the value of the services rendered by the decedent capable of approximate valuation, whether based on the agreed compensation or on quantum meruit. The requirements of valuation comprehends the elements of collectibility.

The items here meet these tests and are subject to accrual."  

This was a broad definition. It comprehended any assets earned during life and possessed by the decedent at his death and not previously subjected to income tax. Thus, items would be included as income even though they would not have been considered income for that period under an accrual method. Such a broad interpretation of "accrued amounts" obviously created harsh and unjust results. The amendment to Section 42, as previously mentioned, was merely directed at insuring the collection of income tax on those amounts which would have escaped taxation simply because the decedent was on a cash basis. The Enright decision, however, if followed to its logical conclusion, would have made all rights arising from services performed by the taxpayer before his death, capable of approximate valuation, taxable as income upon his death. Amounts which normally would have constituted income to the decedent over several years had he lived, would be deemed "accrued" income taxable in his last return. With our system of a graduated tax pattern, under which each larger income bracket is subject to an increasing rate of tax, the injustice of this is apparent.

There is evidence that some lower courts, at least, realized the inequities inherent in the Enright decision. Subsequent decisions, dealing with fact situations

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5 112 F.2d 919 (1940). In this case, Biggs, J. dissented. He adopted the position that the purpose of Section 42 was to place the decedent upon an accrual basis, but for the purpose of taxing those amounts accrued prior to the death of the decedent, "such income having frequently been held by the courts to be received by the estate as capital. The main contention between the parties seems to have been whether, under the particular agreement, his death made the amounts presently collectible, and thus 'accrued' under the normal accounting practice."

6 312 U. S. 636, 641 (1941).
arising under Section 42 as it stood at the time of the Enright decision, indicated a tendency to restrict its doctrine. Burnett v. Commissioner,7 for example, may well be interpreted as an indication of this. Burnett had been a cattle raiser and breeder, operating on the cash receipts basis. As he purchased cattle and feed, he charged the amounts to expenses. When he sold the cattle he had purchased and bred, he credited those amounts to income. At his death, he left some $150,000.00 worth of cattle that had not been sold. The court held that their value was not an amount “accrued” under Section 42 (even though deductions had been taken for the expenses of raising and purchasing them). In so holding, the court stated that Section 42 was not intended to apply to such a situation and that the Enright decision had no application.

B. The Enactment and Provisions of Section 126

Congress did not wait to find out whether the broad interpretation announced in the Enright decision would be followed in subsequent cases. It sought to remedy the inequities apparent in Enright by enacting Section 134 of the Revenue Act of 1942.8 This section amended Section 42 of the Code and added Section 126. Its objective, in part, was to insure that amounts which, under the decedent’s normal method of accounting, would not have been considered income in his last return had he lived, would not be included in that return.9 Instead, such amounts were to be treated in the hands of the person receiving them as income of the same nature, and to the same extent, as such amounts would have been considered had the decedent lived. The amendment sought to prevent amounts which the taxpayer was not entitled to receive until some time after his death from being lumped as income in his last return. To accomplish this, Section 42 was amended by deleting the reference to the taxpayer on a cash basis and by inserting a provision that amounts accrued only by reason of the death of the taxpayer, should not be included in the last return of an accrual basis taxpayer. As a result, items of income to be included in the last return of a decedent on the ac-

7 2 T. C. 897 (1943); cf. Helvering v. McGlue, 119 F.2d 167 (CCA-4 1941) (involving payment of dividends declared before date of death, but payable to record holders of date after death; held; “accrued” within meaning of Enright decision). As to limits of Enright doctrine, see Estate of C. Meinecke, 47 B. T. A. 634 (1942) (profits arising from sale after death, in accordance with contract to sell before death, not accrued); Estate of Wm. Purves, B. T. A. Memo Op. Dkt. 106086, (1942), affirmed on motion (CCA-6 1944). As to accrual of dividends, see Estate of Putnam v. Commissioner, 324 U. S. 393 (1945) (reversing in part, 144 F.2d 756 (1944). For a case involving the taxability of a commission paid the widow of a deceased insurance broker, for accounts secured prior to his death, see Estate of Thomas Remington, 9 T. C. 99 (1947).

8 The changes wrought by the Revenue Act of 1942 were made retroactive by Section 134 (g) of that Act. Although this provision in the Act is no longer of importance, it provided in essence, that any return to be filed or that had been filed, that would ordinarily be governed by the law existing from 1934 to 1942, could be made subject to the provisions of Section 126 and a refund granted or income computed upon that basis, in the case of new returns. This was accomplished by the parties filing a statement consenting to be bound by the provisions of that Act. All parties of interest had to file statements, or if they were dead, their heirs or representatives had to do so, and comply with the regulations set up by the Commissioner in the subject, before such consents became effective. Estate of Larkin, T. C. Memo Dec. Dkt., 11366 (1947), Estate of Ingrahm 8 T. C. 701 (1947) (applicability of the above to charitable organizations).

9 See discussion infra, (1) (a), “The purpose of Section 126.”
crual basis are those properly includible under that method of accounting, unaf-
fected by the decedent's intervening death. On the other hand, if the decedent
was on a cash basis, or followed no approved method of accounting, only amounts
received during the taxable year are to be included.\textsuperscript{10}

However, it was necessary to make some provision for the taxation of those
amounts which, by this amendment, would escape taxation altogether, unless
specifically provided for. To do this required a redefinition of the concept of
"property acquired by gift, bequest, devise or inheritance" which was specifically
excluded from gross income under Section 22 (b) (3) of the Code, as this Sec-
tion read before the enactment of the 1942 Revenue Act. As a result, Section 22
(b) (3) of the Code was amended to remove from the exclusion, "the income
from property" where this right to income itself was the subject matter of the
gift, bequest, devise or inheritance.\textsuperscript{11}

The 1942 Revenue Act (by Section 134) also added Section 126 to the Code
which reads as follows:

"Section 126. Income in respect of Decedents

(a). Inclusion in Gross Income

(1). General Rule—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
in a prior period shall be included in the gross income, for the
taxable year when received, of;

(A). The estate of the decedent, if the right to receive the
amount is acquired by the decedent's estate from the decedent;

(B). The person who, by reason of the death of the dece-
dent, acquires the right to receive the amount, if the right to receive
the amount is not acquired by the decedent's estate from the dece-
dent, or

(C). The person who acquires from the decedent the right
to receive the amount by bequest, devise, or inheritance, if the
amount is received after a distribution by the decedent's estate of
such right."\textsuperscript{12}

With the adoption of these amendments, the question of what items would
be considered "accrued" under Section 42 may still remain of some collateral im-

\textsuperscript{10} Section 42, Internal Revenue Code (1942).
\textsuperscript{11} Report House Ways and Means Committee on 1942 Revenue Act p. 83, Senate Finance Com-
mittee Report, p. 120. O'Daniel's Estate v. Commissioner of Internal Revenue 173 F.2d 966,
(CCA-2 1949), affirming 10 T. C. 631 (1949); cf. Estate of Basch 9 T. C. 627 (1947). The re-
ports state: "The right to income is treated in the hands of the decedent differently from his other
property, and when his estate or his legatee takes his place with respect to this amount, it is
proper to continue to treat this right in their hands in the same manner as it would be treated in
the hands of the decedent."
\textsuperscript{12} Section 126, Internal Revenue Code (1942).
portance, as will appear later. However, the immediate questions which arise under these amendments, and more particularly, Section 126, may be divided into the following categories:

(1). What items are to be considered as constituting "income in respect of a decedent";

(2). To whom are they deemed income;

(3). What is the effect of a transfer of the right to receive such items;

(4). What may be taken in the nature of deductions on the items; and

(5). What application, if any, has the estate tax to the items?

(1). What Items Are To Be Considered "Income In Respect Of A Decedent"

(a). The purpose of Section 126:

One of the major purposes of Section 126, as inserted by the Revenue Act of 1942, was to eliminate the hardship which resulted in many cases from the application of the Enright rule, by including in the income for the decedent's last return amounts which ordinarily would be reportable over a period of several years. This section changed the existing law by providing that such amounts should not be included as income in the decedent's last return but should be treated, in the hands of the persons receiving them, as income of the same nature and to the same extent as such amounts would be income, had the decedent remained alive and received such amounts.14

It has been contended by some that the scope of the section was restricted to amounts which the decedent, at the time of his death, had a legally enforceable right to receive.15

However, a more careful reading of the Senate and House Committee reports reveals that the intention of Congress in enacting Section 126 was much broader and the scope of the section was designed to be more comprehensive. Thus, both committee reports state:

"All amounts of gross income which are not includible in the income of the decedent will, when received, be includible in the income of the person receiving such amounts by inheritance or survivorship from the decedent under Section 126 . . . ."16


The implications of this statement in the committee reports are that Section 126 would apply to any amounts received by the decedent's estate or his beneficiaries for services rendered by him in his lifetime, which he would have received had he lived until the time the payments were actually made; and this, irrespective of the existence at the time of his death, of a legal right, which could have been enforced. Thus, had the decedent been alive at the time such payments were made to his estate, he would have been obliged, under Section 22 (a) of the Code, to include such amounts in gross income.

The Tax Court, in Estate of Edgar V. O'Daniel, adopted this concept of the scope of Section 126 and refused to restrict its application to amounts received after the decedent's death as to which he had a legally enforceable right. The Court of Appeals for the Second Circuit affirmed this rationale.

This case involved a question as to the nature of payments received by the estate under a bonus plan, instituted by the company which had employed the decedent before his death. It was agreed that no right to any bonus amount existed until the allotment to each employee was made and designated by the proper officer. The amount to be divided among the employees as a bonus was not predetermined. The allotment for the year previous to the death of the decedent was not made until several months after his death. It was paid to his estate at that time. It was conceded that the decedent had no interest in or right to the amount at the time of his death. Nevertheless, the Court of Appeals for the Second Circuit, in affirming the Tax Court which had declared it to be income in respect of a decedent, made the following observations at pp. 967-968:

"... the amount ... was plainly gross income in respect of the decedent which had to be included in the taxable year when received for the reason that the right to receive it was 'acquired by the decedent's estate from the decedent' within the meaning of Section 126(a) (1) (A) ... the payment clearly represented compensation for his services and any right to receive it that was realized by his estate was acquired through him and never arose in any other way or through any other source ... It seems apparent from what we have already said that 'the right ... acquired by the decedent's estate from the decedent' which is referred to in section 126(a) (1) (A) is not necessarily a legally enforceable right, but merely any right derived through his services, rendered while living ...""

This concept of the decedent's "right" to receive the amount of the bonus is not in accord with common law principles, under which it could not have been legally enforced. However, it is consistent with the realism applied throughout the field of tax law. The latter will not allow the incidence of taxation to be diverted by technicalities, while the taxpayer or his beneficiaries enjoy the benefits of a transaction which are, in fact, attributable to him.

17 10 T. C. 631 (1949).
The adoption of the rationale that the tax life of the decedent is to be extended to include those items which he would have reported ultimately as income, had death not intervened, is obviously a somewhat different proposition than the concept of "accrued items" in the Enright decision. It does, however, conform with the spirit and the wording of Section 126, and also with the Reports of the House Ways and Means Committee and the Senate Committee on Finance.

Section 126 also contains the provision that, "The right, described in paragraph (1) . . . shall be treated, in the hands of the estate or such person (as is entitled to receive it) as if it had been acquired by the estate or person in the transaction by which the decedent acquired such right; and shall be considered to have the character which it would have had in the hands of the decedent if the latter had lived and received such amount." This contemplates a fictitious extension of the decedent's personality beyond his death in order to bring about as normal a winding up of his affairs, tax-wise, as possible. Thus, there is minimized the disturbance that death brings to the usual incidence of taxation.

(b). Payments by Employer of Decedent

Some difficulty has been experienced in determining the nature of payments made by the former employer of the decedent, either under statute, contract, or voluntarily, to the decedent's estate or widow. The Bureau first took the position that voluntary payments were not taxable as income, but were gifts. This was so even though the employer took a deduction for such payments. The cases upon the subject, however, are confusing. In Louise K. Aprill, a corporation made payments to the wife of a deceased officer of the corporation. The payments, voted by resolution of the board of directors after the officer's death, and ratified by the stockholders, had been made in pursuance of a resolution of the company. This resolution specifically stated that it was the intention of the corporation to make a gift to Mrs. Aprill under the provisions of I. T. 3329 (which expressed the position of the Bureau in respect to such items, noted above). The Tax Court held that the payments were gifts.

In Bausch v. Commissioner, a similar situation was involved, but was decided subsequent to the Aprill case. There, the Bausch and Lomb Optical Company paid to each of the "estates" of two of its deceased officers, the sum of $1,500.00 a month for about a year subsequent to their death. There was no obligation on the part of the company of any kind to make the payments. However,

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19 Section 126 (a) (3) Internal Revenue Code.
20 I. T. 3329 (C. B. 1939-2, 153) Allowing a deduction for a "limited period" which was construed by the Courts to be about 2 years. See April, 13 T. C. 707 (1949), Putnam, Inc. 15 T. C. 86 (1950).
21 13 T. C. 707 (1949); Undoubtedly the attitude of the Court in this case may be partially explained by the fact that the gift in question was made upon express reliance of the Commissioner's ruling.
it was apparently the policy of that company to make some such payments in similar situations in the past. The Tax Court held the payments to be income in respect of the decedents. It distinguished the Aprill case on the grounds that there is a distinction between payments to the “estates” of deceased officers of a corporation, which undoubtedly “would have been taxable to decedents as compensation for past services if they had been living,” and payments made to the widow of such an officer expressly as a gift to her. But perhaps more significant than the attempted distinction is the statement of the court that “the principle of the Estate of O’Daniel v. Commissioner controls here.” In the latter case, the court stated that the right referred to in Section 126(a) is not necessarily an enforceable right existing at the time of the death. It was any right derived through the services of the decedent, rendered while living. In the Aprill case, the company went to great lengths to indicate that it intended to give the payments to the widow purely as a donation. Thus, it might be argued that the wife did not acquire the right to the property through the husband. In the Bausch decision, however, the court expressly stated that the amounts would have been received by him and would have constituted his income had he lived. Such a distinction seems rather tenuous.

There are also those situations where, because of some prior contractual or statutory obligation, such payments as we have been considering have been made to widows of decedents. In Varnedoe v. Allen, the widow of a Georgia fireman received monthly payments after his death, pursuant to a Georgia statute. The court there held that as she had a statutory right to the sums, it constituted income to her, under Section 22 (a) of the Code.

However, in a recent income Tax Ruling, effective January 1, 1951, the Commissioner has revised his position and now holds that:

“Payments made by an employer of the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for Federal Income Tax purposes . . .”

The Commissioner asserts, under this ruling, that the determining factor as to whether such payments are gifts or income is whether services have been rendered to the payer. It is immaterial that the payments were voluntarily made to one who did not render the services. However, the ruling does not resolve the issue of whether the income referred to is to be considered as income to the wife directly, or as income in respect of a decedent, includible in the wife’s gross income. The inference

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23 158 F.2d 467 (1946), cert. denied, 330 U. S. 821; See also Flarsheim v. U. S., 156 F.2d 105 (1946), which held that payments received by the widow of a deceased employee pursuant to a contract between the decedent and his employer, were taxable as income to the widow under Section 22 (a). Obviously it is often important to determine whether income is to be treated as income in respect of a decedent, or personal income of the survivor because of the possibility of claiming deductions in the former which would not be possible to the survivor personally.

24 I. T. 4027 (I. R. B. 1950, 21). This ruling contains an excellent collection of the previous rulings and decisions upon the subject from the point of view of gifts versus income but does not mention the possible application of Section 126.
is that it is considered income to the wife. In connection with this, however, an earlier Treasury decision issued in 1946, should be considered. In that instance, the Commissioner adopted the view that lump sum payments, received from the Federal government by a widow of a naval officer, in accordance with the statute, were taxable under Section 126(a). The statute in question provided that the widows of deceased officers in the armed forces should, under certain circumstances, receive $500.00 for each year of active service the husband had served in any branch of the armed forces prior to his death. It also provided for similar payments to officers released from active duty. The Commissioner ruled that the amount received by the widow was within the purview of Section 126. Therefore, it retained the character which it would have had in the hands of the decedent, had he lived and received such amount. Emphasis again was placed on the fact that the payments were made as a result of the decedent's services and that, had he lived, he would have received the payments and would have been taxable upon them.

Less than a year after the Bureau ruled that voluntary payments by employers to beneficiaries of deceased employees were taxable as income to such beneficiaries, Congress inserted in the Revenue Act of 1951, Section 302, amending Section 22 (b) (1) of the Code. This new section allows any one beneficiary or several beneficiaries jointly, of a deceased employee to exclude from gross income, death benefits not in excess of $5,000.00 received from the employer pursuant to a pre-existing contract. However, the new provision does not exempt the proceeds of voluntary payments. In the light of this legislation, it appears obvious that the Bureau's ruling must, by force of simple logic, be modified to provide similar treatment to voluntary payments.

Neither the Commissioner nor the court has yet faced the question of whether Section 126 is applicable to voluntary payments made to widows of deceased employees. The majority of cases upon the general problem here discussed have been concerned solely with the issue of gift versus income. Once having reached the conclusion that the amounts in dispute were income, it seems to be assumed that it was the income of the wife under Section 22 (a). Under the doctrine of the O'Daniel case, as it interprets Section 126, it is possible that in those instances where the Commissioner has ruled the amounts to be income, he will also contend that it is "income in respect of a decedent."

Where the payments are voluntary, whether income received by the widow, heir, or beneficiary of a decedent is income to such recipient under Section 126 or 22 (a) is unimportant. The reason for this is that since such voluntary payments are not includible in the gross estate for estate tax, the deduction benefits of Sec. 126 (c) have no application.

25 I. T. 3801 (C. B. 1946-1, 109); but see I. T. 3840 (C. B. 1947-1, 7) implying that payments to the widow or heirs of an employee under a voluntary death benefit plan constitutes income in respect of a decedent when received. See also C. C. H. 50-1, Para. 52.472; Oberndofer, Payments to Widows of Deceased Employees, 25 Taxes 711 (1947).
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However, where the payments are received pursuant to contract or statute, and their value has been included in the decedent’s gross estate, it is important to determine under which of the above Code sections the payments fall. If the payments are deemed Section 126 income, the benefits of Section 126 (c) apply and a deduction of the amount of the estate tax attributable to such payments may be taken from the gross income of the recipients. This benefit does not inure to a recipient of Sec. 22 (a) income, even though the value of such income was included in the decedent’s gross estate. In this latter category are pensions and annuities received by reason of the decedent’s death\textsuperscript{25a} and after-death payments made to a deceased employee’s widow pursuant to an employment contract,\textsuperscript{25b} which have been held taxable to the recipient under Section 22 (a). Although the value of such payments are includible in the decedent’s gross estate, the Code makes no provision for a deduction from gross income of the estate or the recipient for the estate tax attributable to the inclusion of such income. The equitable solution of this inconsistent treatment demands an amendment by Congress to the Code so as to extend the benefits of Section 126 (c) to what is now technically Section 22 (a) income. However, an amendment may become unnecessary, should the Courts take the position that such payments, received by reason of a decedent’s death, are includible in the recipients gross income under Section 126.

\textbf{(c) Sale of shares in Close Corporations or Interests in Partnerships}

Another problem that may arise is in respect of the usual agreement among stockholders of a close corporation that upon the death of one of them, the corporation or the surviving shareholders agree to purchase his shares of the stock. Let us suppose that such a stockholder dies. Pursuant to the agreement, the stock is purchased from his estate at an amount considerably in excess of the cost to him. For tax purposes, the nature of this excess then becomes important. Originally, the Bureau ruled that because it “accrued only by reason of death,” the amount was not includible in the last return of the decedent. It further held that the difference between the contract price and the cost to the decedent was subject to capital gains tax to the estate, under the provisions of Section 126.\textsuperscript{26} The reason given for this was that it was not includible in the last return of the decedent, accruing only by reason of death; and since it would have constituted capital gain to the decedent, had he lived, it would be considered capital gain under the provisions of Section 126 (a) (3). This ruling was much criticized.\textsuperscript{27}

\textsuperscript{25a} Varnedoe v. Allen, note 23 supra; Bureau letter, October 9, 1946, 474 CCH 6132; and Ella Higgs 16 T. C. 2 (1951). But see Regulations 29.22 (b) (2) 5 which seems to imply that joint and survivorship annuities are taxable to the survivor under Section 22 (b) or Section 126 (a).
\textsuperscript{25b} Flarsheim v. U. S., Note 23 supra.
\textsuperscript{26} T. D. 5439, (C. B. 1945, 193), amending Section 29.126-1 of Internal Revenue Regulations 111. For a discussion of this problem see Polisher, “Estate Planning and Estate Tax Saving” (2nd ed. 1948), 323-326.
The Bureau has partially reversed its position upon this. It now holds that Section 126 is not applicable; and that the basis for determining capital gain to the estate is not the value the property had in the hands of the decedent, but its value at the time of death, in accordance with Section 113 (a)-5.\(^2\)

There is a closely related situation which should be considered as a concomitant of the preceding problem. It involves the tax implications of agreements among members of a partnership controlling the disposition of a partner's interest in the partnership at his death. Often, such agreements provide that upon the death of one of the partners, the survivors shall purchase his interest, by the payment of a fixed or ascertainable price, either in a lump sum, or in a series of payments over a period of time. The issue revolves about the nature of those payments. At first, the Regulations stated:

"... Upon his death referring to the deceased partner, the payments by the surviving partners must be included in the widow's income to the extent they exceed the adjusted basis of such assets in the hands of the decedent immediately prior to his death."\(^2\)

This, however, was later amended and the same section now reads:

"... Upon his death, the payments by the surviving partners must be included in the widow's income to the extent they are attributable to the earnings of the partnership accrued only by reason of his death."\(^8\)

Both the partnership agreement to sell, and the stock purchase agreements in close corporations binding upon the estate, present analogous situations; and under both, the interest of the party is to be sold upon his death for a determinable amount. The problem has two facets: First, the basis to be used for the determination of gain; and second, whether any portion of the purchase price represents "income in respect to a decedent."

(1) The Basis Problem

On the matter of basis, to determine whether and to what extent income was realized by the sale, the provisions of Section 113 (a) (5) are pertinent: "If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition . . . ."

Nevertheless, the Treasury took the view, from 1943 until 1945,\(^8\) that where the partner or stockholder had agreed, prior to his death, that his interest would

\(^{28}\) See Note 26 Supra, By a special letter ruling, T. D. 5459 was interpreted to be applicable to stock transfer agreements. Letter, August 23, 1945, Norman D. Cann, Deputy Commissioner, (symbols 1: T:PT: 2:VM:5); 454 CCH Sec. 6301. The valuation at the time of death applies equally to the optional valuation date allowed by Section 811 (j) of the Code.

\(^{29}\) Regulations 111, Sec. 29.126-1 (1943).

\(^{30}\) Regulations 111, Sec. 29.126-1 as amended by T. D. 5459 (C. B. 1945, 193). See also Note 26 supra.

\(^{81}\) This, perhaps, is more in line with the theory that all items considered "accrued" prior to 1942 would come within the scope of Section 126.
be sold, Section 113 did not control. Instead Section 126 (a) (3) applied, the amounts being treated "as though they had been received by the decedent." After 1945, there was a retreat from this position, but not a complete one. If the basis for computing capital gain is at issue in an instance where a binding sale (as distinguished from an executory contract to sell) was executed by the decedent prior to his death, the regulations still provide that Section 126, and not 113, applies and the basis is that which the decedent would have used, had he lived, in computing gain and not its value at the time of his death.\(^3\)

This is illustrated in the regulations, in another connection, by an example which points up the distinction apparently made between present enforceable rights to the amount arising under an executed contract and rights under an executory contract to secure such amounts (contracts of sale and to sell).\(^3\) For example, suppose the members of a partnership have an agreement that upon the death of any one of them, the survivors shall make certain payments for the decedent's interest in the partnership; and further, that at his death, the partnership is possessed of the following: tangible assets of a value considerably in excess of their costs, certain uncompleted business in which the decedent had a share, and the rights to proceeds from the sale of partnership assets consummated at a gain, prior to the decedent's death. The Regulations state that no capital gain shall be recognized on that portion of the payments which represent the decedent's share in the tangible assets which have appreciated in value. However, the portion of the payments attributable to the decedent's share in the uncompleted business shall be considered "income in respect of a decedent;" and, further, the portion of the payments that represent the decedent's share in the gain of the completed sale of the assets, and which would have constituted capital gain to him, shall be treated as capital gain under Section 126.\(^4\)

In this area of the problem, the Treasury has taken the position that unless a present right exists at the decedent's death to an amount which would have constituted capital gain or ordinary income in his hands, such amount is not covered by Section 126 (a); and the basis of the property is to be determined under Section 113 (a) (5).\(^5\)

(2). Portion of Purchase Price Which Is "income in respect of decedent"

In contrast with the situations considered under the previous heading ("Payments by Employer of Decedent"), the results here seem to be in harmony with the rationale developed under the Enright decision that income in respect of a decedent is synonymous with "amounts accrued." In the last example, the capital gain realized on the assets represented by payments of the partners, which are still

\(^3\) Regulations 111, Sec. 29.126-1.

\(^3\) Although seemingly, under Enright both would have been treated the same, being considered as "accrued."

\(^4\) Supra. note 32. Similarly, the appreciation in the value of inventory over book value at death of the decedent is not income realized in respect of the decedent: Burnett 2 T. C. 897 (1944).

\(^5\) Regulations 111, Sec. 29.126-1.
in the hands of the partnership, would not have been considered income under Section 42 prior to the 1942 amendment. In Commissioner v. Alldis' Estate, the decedent had an agreement with the Chrysler Management Trust whereby, upon the decedent's death, the Trust would purchase his shares for their book value. The stock was purchased from the estate in 1938. The Commissioner attempted to levy an income tax upon the difference between the cost of the stock to the decedent, and the amount received by the estate. His theory was that it was an amount accrued under Section 42. Although the contract with the Trust provided the rights to the stock and the amount of payment would pass "upon the death" of the decedent, the court held that they were not within the scope of the Enright decision. It stated that at the time of the death, there was no present right to the amount. Therefore, it was simply an asset of the estate. The application of the Enright doctrine was specifically rejected.

(d). Scope of Section 126

Section 126 fails to indicate clearly what items are to be considered income in respect of a decedent. The only guides are those set forth in Section 126 (a) (3) which refers to the items being received by virtue of some "right to receive" them, derived from the decedent.

As previously discussed, one viewpoint that has been offered is that this "right to income" comprehends only the right to receive those items which, according to the Enright decision, would have been considered accrued under Section 42. It must be conceded that Section 126 was adopted as a result of the inequity of the Enright case. But it does not follow that the scope of Section 126 was limited to this area alone. Section 126 would seem to be much broader and more inclusive than the "accrued" income, as defined in the Enright decision. This is illustrated by the O'Daniel case discussed at pages , supra. It remains to be seen whether other circuit courts will accept this rationale for Section 126.

(e). Effect of Section 107

Another problem arises in respect of the relation of Section 107, dealing with long term compensation, to Section 126.

Section 107 provides, in effect, that if eighty per cent of the total compensation for personal services covering a period of thirty-six calendar months is received in one taxable year, the tax attributable to such compensation, included in the gross income of an individual for that year, shall not be greater than it would have been if the amount had been reported ratably over the entire period preceding the date of payment (or accrual, if the taxpayer follows that method). A partner, entitled to a percentage of the profits of a partnership, is included and may take

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37 See Note 15, supra.
advantage of the provisions of this section, even though he may not have performed the services himself. There seems to be little doubt that items falling under Section 126 could be reported by taking advantage of these provisions. While the text of Section 126 contains no express provision for the application of Section 107, its entire tenor would indicate that the section does apply. The Commissioner has taken this position. The Regulations on Section 126, contain the following statement:

"... If the amount received would be subject to special treatment under section 107 if the decedent had lived and included such amounts in his gross income, section 107 applies..."

The question is not as to the applicability of Section 107, but rather as to the method of its application and of computing the tax due. The most logical method would be to compute it on the basis of the past returns of the decedent for the years prior to his death. But it is also possible that an individual receiving the right to the amount by legacy from the decedent might compute the tax on the basis of his own returns for the years during which the services were rendered.

The legislative history of the 1942 Revenue Act supports the view that the former method is to be used. The House Ways and Means Committee Report on the Act stated:

"If the amounts are compensation for personal services over a period of 36 months, and would be within the provisions of section 107 if the decedent had lived, and included such amounts in his gross income, section 107 applies. That is, the tax of the person including this amount in gross income attributable to the inclusion of such amount in his income shall not exceed the aggregate of the taxes of the decedent, which would be attributable to such amount if it had been received by the decedent in equal portions in each of the months included in the period in which the personal services were rendered..." (Italics supplied)

This excerpt from the House Committee Report, together with other similar statements pertaining to the application of Sections 105 and 106, was incorporated verbatim into the first Regulations by the Treasury. However, T. D. 5389 (1944 CB 196), amended the first Regulations on Section 126 and replaced this with the simple statement first set forth above. It might be that the deliberate omission of this reference indicates uncertainty on the part of the Treasury as to the proper application of Section 107. If this is true, the uncertainty is probably the result of the inconsistent implications of the provisions of Section 126 (a) (3) which state:

89 Reg. 111, Sec. 29.126-1 (last paragraph).
"The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the decedent or any person who acquired such right . . . as if it had been acquired by the estate or such person in the transaction by which the decedent acquired such right . . . ."

There would thus seem to be some uncertainty introduced by this change as to whether an individual could use his own returns for the past applicable years to compute the amount of tax due on amounts received from services performed by a decedent before his death. This calls for clarification by the Treasury to eliminate any doubts.

(2). To Whom are Section 126 Items Considered Income

The section is reasonably clear as to who must report the amounts received that are income in respect of a decedent, and when such amounts are to be reported. The general rules are set forth in Section 126 (a), which is quoted in full under sub-chapter (B) above—"The Enactment and Provisions of Section 126." 41

The amounts are reported for the taxable period in which they are received, irrespective of whether the recipient or the decedent followed the accrual basis of accounting. Thus, if part of the income is received by the estate, and part by a legatee subsequently, after the estate distributed to him the right to the amounts, each would report that portion received as income in respect of a decedent for the year in which they receive the amounts. 42

The application of those criteria is not likely to create serious difficulty. It should be noted, however, that Section 126 (a) (1) (B) applies to those situations where the right, accruing to the person from the decedent, does not pass to him under the laws of descent and devolution, or similar methods, but comprehends the instance where the right accrues from some other source. This is illustrated by an example given in both the House and Senate Reports and adopted verbatim into the regulations on Section 126. 43 The example concerns a cash basis decedent who owned a bond with his wife as co-owner or beneficiary. If he died before the bond became due, then not only the amount accruing after the death of the decedent, but the entire amount accruing on the bond and not includible in the income of the

41 Internal Revenue Code, Section 126. It will be noted that, regardless of the accounting method followed by the person receiving the amounts, income in respect of a decedent is always reported when actually received. In this respect, also, the Bureau has taken the position that the right of a Louisiana widow to the usufruct of a bonus payment due the decedent is sufficient to make the amount includible in her return, when received, as income in respect of a decedent. I. T. 3931, (C. B. 1948-2, 87) Thus it might seem that even though the person receiving it does not have what would be classed as absolute ownership of the amounts, nevertheless, he is the "person receiving" them within the meaning of Section 126 (a).

42 Regulations, 111, Sec. 29.126-1. However, if the decedent was on an accrual basis, items of income as yet not received, but previously reported as accrued, will be excluded from consideration as income in respect of a decedent.

43 Reports of House Ways and Means and Senate Finance Committees, see Note 14, supra. For a case involving post-death commissions on renewal premiums, payable to estate of a life insurance agent, on policies placed by him during life, see Remington Estate 9 T. C. 99 (1947).
decedent, would be income in respect of a decedent to his wife when the bond is paid. However, since only such part of the redemption value of the bond which represent the increment in value up to the decedent's death is includible in the gross estate for Federal Estate tax, the benefits of Section 126 (c) will be limited to such part of the bond increment only, when the bond is later redeemed.

(a). Planning for income from U. S. Bonds and life insurance renewal commissions

Section 42 (b) of the Code allows an election to a cash basis taxpayer owning U. S. increment bonds to treat the increase in the redemption price of such bonds as income received in such taxable year, instead of deferring the income until the bond is redeemed. Once the election is exercised, it applies to all bonds owned by the taxpayer and for all subsequent years unless a change is approved by the Commissioner. This election appears to be foreclosed by Regulations 111, Section 29.126-(1) which only permits Section 126 income to be returned, when received. However, if it should be interpreted that Code Section 42 (b) supersedes Regulations, Section 29.126-(1), in so far as U. S. increment bonds are concerned, this situation will provide an opportunity for reducing, by proper planning, the burden of income taxation on the increment of U. S. Bonds, purchasable at discounts from their face amount and redeemable at par. Thus the executor, during the period of administration of the estate, may elect to treat a portion of the increment on the bonds, not previously reported by the decedent during his lifetime, as income of the estate. Or the co-owner and the executor may jointly elect to include a portion of the increment in the decedent's last return; and the co-owner or beneficiary may elect to report the balance of the increment in such manner as will result in the payment of the least amount of tax.

Another planning approach is to have the income in respect of the decedent made payable after his death, whether by will or contract, to several beneficiaries so that the amount recoverable in any taxable period would be divided among several taxpayers and thus become subject to tax at lower rates. This has particular pertinence to renewal commissions of a life insurance underwriter which become payable after his death on policies put in force by him during his lifetime.48a

(b). When Section 126 Income is Trust Corpus

Income in respect of a decedent, received by the estate or trustee under a will, and immediately distributed to the legatees or beneficiaries, is taxable to the recipient and not to the distributees. The underlying theory of such treatment is that, although the items in the hands of the estate or trustee are income in respect

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48a Prior to the enactment of Section 126, ARM 115, 4 CB 77, 79 (1921) held renewal commissions of a decedent as income to the recipient under Section 22 (a). More recently, the Tax Court in Estate of Thomas Remington, Note 7 supra, by way of dictum, held such commissions to be income in respect to the decedent under Section 126 (a).
of the decedent, the distribution to the legatees and beneficiaries are distributions of corpus and not income.44

Furthermore, the trustees or executors may not take a deduction under Section 162 for items of 126 income distributed to beneficiaries. Section 126 is a remedial provision, enacted for the benefit of a decedent in connection with his final income tax return, and relates to income earned by the decedent but not as yet received at the time of his death; while Section 162 refers to income earned by an estate during its administration and does not apply to items which are income because of Section 126. Thus, 126 income, being part of the corpus of the estate rather than its income, does not qualify as a deduction under Section 162.45

(3). Effect Of A Transfer of the Right To Receive Such Items

Once the amounts are properly characterized, there should be little difficulty in the determination of the tax problem. However, problems will be encountered if, instead of receiving the amounts, the estate, or person entitled to receive the amount, "transfers" the right to receive it to a third party. Section 126 (a) (2) states, in essence, that if the estate of the decedent or a person having the right to receive the amount under Section 126 (a) (1), transfers the right before receiving the amount, then

"... there shall be included in the gross income of the estate or of such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer, plus the amount by which any consideration for the transfer exceeds such fair market value." (Italics supplied)

The Regulations further provide that,

"Similarly, if the right to receive the income is disposed of, as by gift or bequest, the fair market value of such right at the time of such disposition must be included in the gross income of the donor testator, or other transferor."46

"Transfer," within the scope of this section is defined to include "sale, exchange or other disposition." It does not, however, include "a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent." This latter provision simply rephrases the primary provision of Section 126 so that no conflict will result.

44 Estate of Ralph R. Huesman, 16 T. C. 656 (1951); Rose J. Linde, 17 T. C. No. 63 (1951).
45 Ibid.
46 Regulations 111, Sec. 29.126-1, implementing Section 126 (a) (2), Internal Revenue Code. A problem might arise, in a state such as Louisiana, where the courts have held that a person renouncing an estate in favor of another, under some circumstances, in fact accepts the succession and donates his share to the person in whose favor he renounces. (La. Rev. Civil Code of 1870, Article 1003). Under the rule discussed previously, such action might accrue as present income all of the income in respect of a decedent. See also, lanthe B. Hardenbergh, 17 T. C., No. 20 (1951) holding a renunciation by a widow and daughter of a decedent to their interstate shares of his estate constitutes a gift of their interests.
Thus, it would seem that if the person who has a right to receive income with respect to a decedent, which would normally have been received and reported over a period of years, transfers the right to the amount, the transfer is considered as accruing all of the amount to be received into the income of the taxable period when the transfer is made. This may result, in some instances, in the same undesirable effects, tax-wise, as were inherent in the Enright decision, viz, that of telescoping amounts, which would normally have been spread over a period of years, into the taxable income for the single year.

Any complete assignment or sale, by the estate or the person entitled to receive the same, of amounts receivable over a period of years as income in respect of a decedent, would be deemed a transfer and render the proceeds taxable in a lump sum in the year received.\(^47\) However, where the assignment, instead of being an absolute disposition, is a bona fide collateral for a loan, the rigors of this subsection may be avoided.\(^48\) Where the transfer is made of only part of the amounts received, only that portion transferred is affected by this subsection.

What will happen if the person entitled to receive the amounts, which are income in respect of the decedent, dies before the total amount is received and disposes of the balance by will to his beneficiaries? Under the subsection, this disposition would be deemed a transfer which would cause the fair market value of the right transferred to be included in the testator's gross income for the taxable period in which the transfer occurred.\(^49\)

Proper planning, to avoid this realization of income at the death of the first beneficiary designated by the decedent to receive the payments, will eliminate this burden. Thus, if the income in respect of the decedent were left in trust with the amounts received after the decedent's death payable to the first beneficiary for life as income, and upon the death of such beneficiary, to continue the payments to successive beneficiaries, there would be no disposition or transfer of the amount on the death of the first beneficiary; and there would be no realization of income for the balance remaining unpaid at that time.

Similarly, a gift is a transfer within the meaning of this subsection. Thus, if the legatee should make a gift of his share in the income to a third party, he (the legatee) would be obliged to report the fair market value of the right.


\(^{48}\) Elmer v. Com. 65 F.2d 568 (1933), Miller Saw-Trimmer Co. v. Com. 32 B. T. A. 931 (1935), and Gerald Nickoll-TCM-(1951). These cases involving the disposition of installment obligations under Section 44 (5), an analogous situation, indicate that if the transactions had been loans, there would have been no disposition. See also 51-2 CCH Par. 454.03.

\(^{49}\) See, Estate of Meyer Goldberg 15 T. C. 10 (1950) holding that the death of a partner caused a transmission or disposition of the decedent's interest in installment obligations owing to the partnership, resulting in taxable income to the deceased partner or his estate.
given away in his gross income for the period in which the gift was made; and he would also be liable for gift tax.

(4). What Deductions May Be Taken

(a). Background

In 1934, when Section 42 was amended to include amounts accrued to the date of the death of the taxpayer on a cash basis, a companion and parallel provision was added to Section 43 (dealing with the period for which deductions are taken) which provided:

"... In the case of the death of a taxpayer there shall be allowed as deductions and credits 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 allowable in respect of such period or prior period." (Italics supplied)

This was intended to make available those deductions which, had the cash basis taxpayer been on an accrual basis, would have been allowed in his last return under normal accounting procedures. With the Enright decision, the breadth of the definition of "accrued" income there established was accordingly extended to deductions and credits "accrued" under Section 43. However, under the broad concept of accrual by the Enright rule, many more difficulties arose in determining what deductions were accrued than in the corresponding problem relating to income. If the question concerned a presently enforceable obligation of the decedent, existing at the time of his death, the answer is obvious. More often than not, however, deductions depend upon future contingencies. The courts, applying the Enright principle, reached the conclusion that liabilities that were not fixed at the date of death, or at least which were not determinable as of that time, were not "accrued." The Tax Court attempted to expand this slightly. In one case, it went so far as to allow the deduction of a judgment against the decedent rendered after his death. This was on the theory that the facts determining the liability had occurred prior to death, and that "just as compensation for the decedent's services ... was rendered definite by the payment of fees therefor after his death," so the amount of liability was rendered certain after his death. The Court of Appeals reversed, however, insisting that the deductions must be determinable or certain at the time of death.

In 1942, with the enactment of Section 126 and the change of Section 42, Section 43 was amended correspondingly. The Section insofar as it applies here, now reads:

50 Regulations 111, Sec. 29.126-1.
51 Revenue Act of 1934, Sec. 43.
52 Estate of Leyard, 44 B. T. A. 1056 (1941). As to the scope of this rule and as to what amounts the deductions would be considered "accrued" see, Estate of Lamber, 40 B. T. A. 801 (1939) (expenses accrued in settling estate); Herder v. Helvering, 106 F.2d 153 (1939); Estate of Sobel, 47 B. T. A. 971, (1942); and also I. T. 3801 (C. B. 1946-2, 109) (Payment to widow of navy officer allowed deductions which officer could have taken had he received payment).
"... In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing the net income for the period in which falls the date of the taxpayer's death." (Italics supplied).

This was necessary to conform with the provisions of Section 42. So far as the decedent's last return is concerned, his death now should make no difference either in gross income, under Section 42 or in the allowance of credits and deductions under Section 43.

Paragraph (b) of Section 126 makes extensive provision for the allowance of certain deductions and credits on those amounts of income in respect of a decedent and other property passing to the estate or third persons. By the terms of this paragraph, deductions allowed by Sections 23 (a), (b), (c) and (m) which relate to expenses, interest, taxes and depletion, and Section 31 (allowing credit on foreign taxes, will be allowed to the estate or person receiving property from the decedent, under certain circumstances.

(b). Expenses, Interest, Taxes and Foreign Tax Credits

Section 126 (b) of the Code provides that interest, taxes, and expenses, allowed as deductions under Section 23 (a), (b) or (c) and the foreign tax credit specified in Section 31, will be allowed to the estate in the taxable year when paid, if the estate was liable for the discharge of the obligation to which the credit or deduction relates. If the estate was not liable, the deductions may be taken by the person who, by reason of the death of the decedent, or by bequest, devise or inheritance, acquires from the decedent an interest in property, subject to the obligation claimed as a deduction. It will be noted that there is a distinction between the factors necessary to make the estate eligible for the deduction, and those which will entitle an individual to do so. If the estate is liable for the obligation claimed as a deduction, that is all that is necessary; and upon paying it, a deduction or credit may be claimed. However, for an individual to do so, it is a prerequisite that the estate is not liable to pay such obligation and that he must have had the obligation imposed upon him because he acquired the property, subject to the obligation, from the decedent by reason of his death or by bequest, devise or inheritance.54

The Regulations furnish the following example:

"... If the decedent, who reported income on the basis of cash receipts and disbursements, owned real property on which no income had accrued, but on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of the decedent's estate, the heir, upon paying such taxes may take the same deduction under section 23 (c) that would have been allowed to the decedent, if, while alive, he had made such payment."55

54 Regulations 111, Sec. 29.126-2.
55 Ibid.
This illustration merely demonstrates the application of the principles of Section 126 (b) as they relate to deductions. Any other charges falling within the allowable deductions could be taken by the estate, or if it is not liable, by the person receiving the property subject to the obligation.

The Regulations state further that the "property interest" referred to includes the right to income. However, it is not necessary for any person who comes within the definition of the class defined in Section 126 (b) to receive any income in respect of the decedent, to be entitled to the deduction. This latter point, considered in the light of the previous observations made in this article as to the purpose of Section 126, lends considerable weight to the argument that the Section was intended to accomplish more than merely overruling the Enright decision and re-establishing the pre-Enright status. Indeed, it supports the contention first advanced that the purpose of Section 126 is to insure that there will be as little disturbance as possible in the tax incidence because of the death of a taxpayer; and that in matters relative to his income, the tax is to be as nearly as possible that which would have been incurred had he lived.

The recipient of income, subject to a foreign tax credit under Section 31 of the Code, may claim the credit when he pays it.

(c). Depletion

The deduction for percentage depletion under Section 23 (m) of the Code, is allowed to the person receiving the income in respect of the decedent to which the deduction relates, regardless of whether he is the person receiving the property from which the income is derived.

Section 23 (m) provides for two types of depletion deduction. The first is that allowed under Section 114 (b) (1) (cost depletion) and Section 114 (b) (2) (discovery depletion) which accrues independent of income, and is computed, like depreciation, during the ownership of the property; and the second is that allowed under Section 114 (b) (3) and (4) (percentage depletion) which is based upon a percentage of gross income. The first type would not appear to be affected by Section 126 because, irrespective of the method of accounting followed by the decedent, all such depletion to which the decedent was entitled to the date of the death, would be allowable in his last return. No other person can take this depletion deduction. It is to percentage depletion that the Section 126 refers; for this, being a deduction from gross income, would only be allowed in the last return to the extent that the income in the last return of the decedent is included. The proportion of income accrued by reason of his death during the last period of the decedent, but not included in his last return, would determine the

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66 Ibid.
67 Ibid.
68 Section 126 (b) (2), Internal Revenue Code, Regulations 111, Sec. 29.126-2.
69 Ibid.
amount of deduction for depletion allowed to the recipient of the income from the decedent.

(5). Effect Of The Estate Tax on Section 126

When items received as income in respect of the decedent are taxable in the hands of the recipient under Section 126, the value of such income will be includible in the decedent's gross estate under Section 811 of the Code; and thus also be subject to Federal estate tax, if the decedent at the time of his death had a vested right to receive such items or to have such items paid to a beneficiary after his death. However, if the decedent had no enforceable or determinable right to income at the time of his death, the value of any payments made after death will not be included in his gross estate, even though such payments may be income in respect of the decedent under Section 126. Thus, after-death payments made voluntarily or pursuant to a discretionary pension plan have been held not to represent property or a property right of the decedent and therefore not includible in his gross estate.

Obviously, when income in respect of the decedent is received, if it were subject to income tax, and had been previously taxed for Federal estate tax as part of the gross estate, it would result in an income tax being levied upon the amount paid as estate tax. To avoid this, Section 126 (c) creates an equitable recoupment and sets forth a procedure for deducting that portion of the total estate tax, resulting from the inclusion of the value of gross income in the decedent’s estate, from the gross income of the recipient at the time the income tax is computed.

The procedure for computing this, as set forth by the Regulations, follows:

1. First, the estate tax is computed on the basis of all of the assets, (including the net value of the right to the amounts under Section 126).
2. From that is deducted, the amount of the estate tax which would have been payable, had the items under Section 126 not been included.
3. The amount arrived at by this deduction represents the portion of the estate tax that is being levied on Section 126 (a) items.
4. Then, from the gross income received during the taxable year for which the deduction is being computed, there is deducted the same proportion of the amount in (3) as the amount of income, in respect of a decedent received during the taxable period, bears to the total amount of such income included in the estate.

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60 Estate of William L. Nevin 11 T. C. 59 (1948), Estate of Paul G. Leoni 7 T. C. M. 759 (1948), Estate of Ralph R. Huesman 16 T. C. 656 (1951); Section 811 (a) provides "the value of the gross estate of the decedent shall be determined by including the value at the time of death of all property real or personal, tangible or intangible, to the extent of the interest therein of the decedent at the time of death.

61 Estate of Jack Messing 7 T. C. M. 568 (1948).


63 Section 126 (c) (2), Internal Revenue Code; Regulations 111, Sec. 29, 126-3.
tax returns. The amount of income received during the taxable period means the value of the income items returned for estate tax purposes, or the amount actually received, whichever is smaller.

It would seem that the same method of computing the deductions is used if, instead of income in respect of a decedent, the items included as Section 126 (a) items, are in reality capital gain. There is a problem, however, in determining whether only that amount which would be taxable as income, or the total amount representing the capital gain, is taken into account in determining the deduction. The Regulations seem to indicate that only that amount subject to income tax is includible for purposes of computing the deduction, but they are not clear.64

The income tax deduction for estate tax paid, allowed by subsection (c), may not always inure to the benefit of those who paid the estate tax. The deduction can be taken only by those persons receiving income in respect of the decedent, irrespective of whether such persons paid any part of the estate tax. Thus, where the burden of payment of the estate tax is imposed on the residuary legatees, but the income in respect of the decedent is distributable to other beneficiaries, the latter will enjoy the benefit of the income tax deduction, for estate tax paid, allocable to the income received by them, although they never contributed to the payment of the estate tax.

C. Effective Date of Section 126

The provisions of Section 126 became effective with respect to the final income tax returns of decedents for taxable years beginning after December 31, 1942. However, its benefits were made available to returns of decedents dying after December 31, 1933, if the persons entitled to the income filed consents and recomputed their tax for the taxable years involved, as though the provisions of Section 126 were part of the applicable revenue statutes.65

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64 This position is supported by the rationale of the Supreme Court in its recent decision, in which it held that the base on which to compute the deduction from income for charitable contributions is the net amount includible in gross income under the Code and not the gross profit enjoyed; Benedict v. U. S., 318 U. S. 692 (1950). See also Bureau letter, dated April 13, 1945, 454 CCH 6203, dealing with this point. Later T. D. 5459 was issued superseding this letter on other phases of the problem but it did not touch the issue here involved.

65 Section 134G, Revenue Act of 1942; Regulations 111, Sec. 29.126-4.