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INCOME IN RESPECT OF A DECEDENT

John S. Brown†

A taxpayer's death ends his taxation year.[1] Income realized thereafter attributable in whole or in part to the decedent's lifetime activities is taxable, if at all, to his successors in interest. This income has been the subject of three different schemes of income taxation.

Before the 1934 Revenue Act,[2] a decedent's final income tax return included only income reportable under his lifetime accounting method.[3] A cash basis decedent reported income received; an accrual basis decedent reported both income received and income accrued.[4] Income not reported on the decedent's final return was never taxed.[5] Nontaxation resulted from the combined effect of two sections, one of which provided an exclusion from income and the other a new income tax basis equal to the value of the property at taxpayer's death for property, including interests in future income, acquired from a decedent.[6] Subsequent receipts by decedent's successors were income only to the extent they exceeded the value of the property at decedent's death.[7]

Equality between cash and accrual basis decedents was achieved by section 42 of the Revenue Act of 1934, which required that a taxpayer's final return include all "amounts accrued up to the date of his death."[8] Rights to nonaccruable income, which were includible

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1 INTERNAL REVENUE CODE OF 1954, § 443; Treas. Reg. § 1.451-1(b)(1) (1969) [all section references hereinafter are to the 1954 Code and the regulations thereunder unless otherwise indicated]. The decedent and his estate are separate tax entities for which the executor makes separate income tax returns. §§ 6012(b)(1), (b)(4).

2 48 Stat. 680 (1934).

3 Antoinette B. Held, 3 B.T.A. 408 (1926), *acquiesced in*, V-1 CUM. BULL. 3 (1926); O.D. 454, 2 CUM. BULL. 170 (1920).

4 *See* Drye, *The Taxation of a Decedent's Income*, 8 TAX L. REV. 201 (1953); Latham, *Income and Deductions of a Decedent*, 2 U. SO. CAL. 1950 TAX. INST. 513, 517.

5 *E.g.*, United States v. Carter, 19 F.2d 121 (5th Cir. 1927); 2 J. MERTENS, FEDERAL INCOME TAXATION § 12.100 (1967).

6 Section 102, *formerly* § 22(b)(3), 53 Stat. 10 (1939); § 1014(a), *formerly* § 113(a)(5), 53 Stat. 41 (1939); Nichols v. United States, 64 Ct. Cl. 241 (1927), *cert. denied*, 277 U.S. 584 (1928).

7 GCM 11473, XII-I CUM. BULL. 91 (1933); GCM 8826, IX-2 CUM. BULL. 194 (1930). In determining the amount of a decedent's gross estate, executors are required to accrue all income of the decedent up to the date of his death and treat it as a capital item in the federal estate tax return. Treas. Reg. § 20.2033-1(b) (1963).

8 48 Stat. 694 (1934). *See* H.R. REP. No. 704, 73d Cong., 2d Sess. 24 (1934), reprinted

in decedent's estate, continued untaxed. Inevitably the scope of the statutory term "accrued" was litigated,[9] and the issue reached the Supreme Court in *Helvering v. Enright*.[10] In that case, a lawyer on the cash basis had been a member of a partnership, also on the cash basis. The partnership agreement provided that the successor of a deceased partner would receive his partnership percentage of the earned portion of estimated receipts from unfinished partnership business. This amount, the appraised value of decedent's services to the date of death, was held to be "accruable" within the meaning of section 42.[11] In general, under *Helvering v. Enright* and the lower court decisions that followed,[12] any income rights reflected in decedent's gross estate were considered accrued under section 42. This caused inclusion in a taxpayer's final return of amounts that a living taxpayer could have reported over several years and the collection of which was deferred or uncertain.[13]

In order to continue to tax all income accrued up to the date of death and to eliminate the hardship resulting from including in the decedent's last taxation year amounts receivable over several years, Congress in 1942 repealed section 42,[14] restored normal cash and accrual accounting rules to decedents' final income tax returns, and enacted section 126, which provided that "the amount of all items of gross income in respect of a decedent" would be taxed to the person

in 1939-1 CUM. BULL. (Part 2) 554, 572; S. REP. No. 558, 73d Cong., 2d Sess. 28 (1934), reprinted in 1939-1 CUM. BULL. (Part 2) 586, 608; CONFERENCE REPORT ON H.R. 7835, H.R. REP. No. 1385, 73d Cong., 2d Sess. 18 (1934), reprinted in 1939-1 CUM. BULL. (Part 2) 627, 629.

9 *See* Parlin, *Accruals to Date of Death for Income Tax Purposes*, 87 U. PA. L. REV. 295 (1939).

10 312 U.S. 636 (1941).

11 The Court reasoned that accrual of compensation for work in progress was sound in view of the purpose of § 42, which was "to cover into income the assets of decedents, earned during their life and unreported as income, which on a cash return, would appear in the estate returns." *Id.* at 644-45. The decision is said to be consistent with the percentage-of-completion method of accrual accounting. Anderson & Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX L. REV. 285, 337 & n.185 (1960).

12 *E.g.*, Helvering v. McGlue, 119 F.2d 167 (4th Cir. 1941); Frederick C. Kirchner, 46 B.T.A. 578 (1942); Lewis C. Ledyard, 44 B.T.A. 1056 (1941), *aff'd*, 143 F.2d 243 (2d Cir.), *cert. denied*, 323 U.S. 727 (1944); George W. Wickersham, 44 B.T.A. 619 (1941).

13 The boundary of the applicability of § 42 was indicated in Tom L. Burnett, 2 T.C. 897 (1943), where the Tax Court held that the date-of-death value of crops and livestock produced and owned by a cash basis decedent, unlike the date-of-death value of a cash basis decedent's services, was not accruable in the taxpayer's final income tax return. *Id.* at 903, *acquiesced in*, 1944 CUM. BULL. 4. *Cf.* Perry v. United States, 58-2 USTC ¶ 9587 (N.D. Miss. 1958); Rev. Rul. 58-436, 1958-2 CUM. BULL. 366, 367.

14 56 Stat. 830 (1942).

who actually received it, when he received it, as income of the same nature and to the same extent as such amount would be income if the decedent remained alive and received it.[15] This treatment is continued by section 691(a)(1) of the current law,[16] which provides that "[t]he 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 successor in interest[17] who acquires from the decedent "the right to receive the amount." Under section 691(a)(3) income in respect of a decedent retains the same character in the hands of decedent's successor as it would have had if the decedent had lived and received it. Under section 1014(c) property representing a right to receive income in respect of a decedent retains decedent's basis in the hands of the successor.[18] Under section 691(b) enumerated deductions not allowed to the decedent because not paid or accrued prior to death are allowed to decedent's successor when the items are paid by him. Section 691(c) allows decedent's successor an income tax deduction for the estate tax attributable to the net value for estate tax purposes of items of income in respect of a decedent.[19]

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15 H.R. REP. No. 2333, 77th Cong., 2d Sess. 145 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 82 (1942). The changes were made by amending § 42 and § 43 and adding § 126 to the 1939 Code. Equal treatment for cash and accrual basis taxpayers was achieved by amending § 42 to exclude from a deceased accrual basis taxpayer's last income tax return amounts accruable only by reason of death. The changes were suggested by the Treasury. *See* statement of Randolph E. Paul, Tax Adviser to the Secretary of the Treasury, in *Hearings on H.R. 7387 (Revenue Revision of 1942) Before House Comm. on Ways and Means*, 77th Cong., 2d Sess. 81, 89 (1942). An additional Treasury recommendation, the adoption of a carryover basis rule for property acquired from a decedent, was not enacted. *See generally* Note, *Income In Respect of Decedents: The Scope of Section 126*, 65 HARV. L. REV. 1024 (1952).

16 H.R. REP. No. 1337, 83d Cong., 2d Sess. 64-65, Appendix 218-20 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 87-89, 373-76 (1954).

17 § 691(a)(1). The categories of successors in interest are (*1*) the decedent's estate, (*2*) a person entitled to receive the amount directly from the decedent, or (*3*) a person entitled to receive the amount as a beneficiary through the decedent's estate. Transfer of the unrealized right to receive income in respect of a decedent between the enumerated successors in interest is not a taxable event. However, § 691(a)(2) provides for a tax on the value of the right if prior to realization there is a transfer to an outsider. Presumably tax-free transfers of rights to income in respect of a decedent under § 351 or § 721 are not possible. Treas. Reg. § 1.691(a)-4 (1960). *Compare* § 453(d), *as amplified by* Treas. Reg. § 1.453-9(c)(2) (1965) and *id.* § 1.721-1(a) (1960).

18 Section 1014(c) was preceded by Treas. Reg. 118, § 19.126(a)-1(e) (1943), *adopted*, 1943-1 CUM. BULL. 198, 205.

19 Presumably, the deduction for estate taxes was intended to provide approximately the same tax consequences in the case of a decedent whose gross estate includes claims to income as in the case of a decedent all of whose income receivables had been collected

Section 691 dictates how income in respect of a decedent is to be taxed, but the key statutory phrase, "items of gross income in respect of a decedent," is not defined in the Internal Revenue Code.[20] The missing definition is vital to an understanding of the relationship between sections 1014(a) and 691. Section 1014(a) provides that property at decedent's death receives a basis equal to its value at death; property covered by section 691 constitutes the main exception to this rule as such property retains the decedent's basis. Legatees of appreciated property recover its date-of-death value free from income tax because this value is their basis for gain, loss, or depreciation; legatees of appreciated property treated as the right to receive income in respect of a decedent include in income the excess in value over decedent's basis when they receive it.

The regulations assume the pertinent property interest is an item of gross income, as distinguished from other kinds of property, and then define "income in respect of a decedent" as

> 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 accounting employed by the decedent.[21]

The reference to "amounts to which a decedent was entitled as gross income" presumably refers to property representing gain as distinguished from property representing the decedent's invested capital, which may be returned free from income tax.

The primary rule under section 691 is that any income accrued but not received at the date of the death of a decedent on the cash

(and income tax paid thereon) prior to his death. 2 MERTENS, *supra* note 5, at § 12.102(b). The literal application of § 691(c)(1)(A) in a situation where the maximum amount of a § 691(a) item payable in installments is indeterminate could result in an income tax saving in excess of the estate tax paid. For discussion of the deduction see 2 ALI FED. INCOME TAX STAT. 476 (Feb. 1954 Draft); 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, 371 (1953) [hereinafter cited as Holland]. The American Bar Association's Section of Taxation has recommended substitution of a tax credit for the allowed deduction. XIV ABA SECTION OF TAXATION BULL. 105 (1960).

20 Section 691(a)(4) provides that an amount equal to the excess of the face amount of an installment obligation under § 453 over its basis in decedent's hands is income in respect of a decedent. For proposed definitions of "income in respect of a decedent," see FINAL REPORT OF SUBCHAPTER J ADVISORY GROUP, *Hearings on H.R. 3041 Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 323 (1959); 2 ALI FED. INCOME TAX STAT. § X890, 150 (Feb. 1954 Draft); XVI ABA SECTION OF TAXATION BULL. 182 (1963).

21 Treas. Reg. § 1.691(a)-1(b) (1965). *See* Rev. Rul. 58-436, 1958-2 CUM. BULL. 366, 368, *modified*, Rev. Rul. 64-289, 1964-2 CUM. BULL. 173.

basis constitutes income in respect of a decedent.[22] Thus, section 691 covers such accrued income as fees for professional services,[23] salary,[24] interest,[25] rent,[26] alimony,[27] royalties,[28] declared dividends where the record date precedes death,[29] and most rights to payments received from completed sales.[30] The regulations indicate that the definition of "income in respect of a decedent" extends beyond accrual accounting concepts to include income to which the decedent had only a contingent claim at the time of his death.[31]

In describing the current concept of income in respect of a decedent it is convenient to organize the judicial and administrative materials around transactions or sources of income. Whether payments to decedent's successors will be treated as income in respect of a decedent depends, in the first instance, on a characterization of the payment as compensation, gain on a sale, rent, or royalty income. In characterizing income, preparatory activities are disregarded even though a substantial part of the income results therefrom. For example, where a taxpayer owns property produced by his own services, the income from the property will not be treated as compensation, but as rent or royalties or as gain from the sale of property. After character-

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22 Treas. Reg. §§ 1.691(a)-1(b)(1), (2) (1965). Regulation § 1.451-1(a) provides: "Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

23 Midland Nat'l Bank of Billings v. United States, 168 F. Supp. 736 (D. Mont. 1959).

24 Ralph R. Huesman, 16 T.C. 656 (1951), *aff'd on other grounds*, 198 F.2d 133 (9th Cir. 1952); Rev. Rul. 64-150, 1964-1 CUM. BULL. (Part 1) 448; Rev. Rul. 59-64, 1959-1 CUM. BULL. 31; Rev. Rul. 55-229, 1955-1 CUM. BULL. 75.

25 Levin v. United States, 373 F.2d 434 (1st Cir. 1967) (accrued discount income); Richardson v. United States, 294 F.2d 593 (6th Cir. 1961), *cert. denied*, 369 U.S. 802 (1962); Marshal L. Noel, 50 T.C. 702 (1968) (accrued interest and discount income); Herbert Payson, Jr., 18 T.C.M. 686 (1959); Treas. Reg. § 1.691(a)-2(b), example (3) (1960); *id.* § 1.483-1(b)(3) (1966) (imputed interest); Rev. Rul. 64-104, 1964-1 CUM. BULL. 223.

26 Rev. Rul. 64-289, 1964-2 CUM. BULL. 173.

27 Sarah L. Narischkine, 14 T.C. 1128 (1950), *aff'd per curiam*, 189 F.2d 257 (2d Cir. 1951).

28 Rev. Rul. 60-227, 1960-1 CUM. BULL. 262; Rev. Rul. 57-544, 1957-2 CUM. BULL. 361.

29 While regulation § 1.301-1(b) taxes dividends when received, the stockholder is the owner of the dividend after the record date. *See* Putnam v. Commissioner, 324 U.S. 393 (1945); Hattie L. McNary, 47 T.C. 467, 470-71 (1967); *cf.* Rev. Rul. 64-308, 1964-2 CUM. BULL. 176.

30 Wilcox v. United States, 185 F. Supp. 388 (E.D. Ohio 1960); Dixon v. United States, 96 F. Supp. 986 (E.D. Ky. 1950), *aff'd per curiam*, 192 F.2d 82 (6th Cir. 1951); John A. Biewer, 41 T.C. 191 (1963), *aff'd*, 341 F.2d 394 (6th Cir. 1965). Section 691(a)(4) defines "income in respect of a decedent" to include the excess of the face amount of an installment obligation over the decedent's basis therefor.

31 Treas. Reg. § 1.691(a)-1(b)(3) (1965).

ization, tests appropriate to the type of income involved are applied to determine if it is income in respect of a decedent.

RIGHTS TO INCOME FROM PERSONAL SERVICES

Any inherited right to income attributable to decedent's personal services is an item of income in respect of a decedent. Thus accrued income,[32] income not accrued at death but to which the decedent had a legally enforceable right to payment in the future,[33] and income to which decedent had no enforceable right[34] have all been held to be income in respect of a decedent. The courts have simply concluded that any income derived as a result of a decedent's services is, in the hands of decedent's successor, income in respect of a decedent.[35]

The partnership sections of the Code define the payments by a partnership to a deceased partner's successor that will be treated as in-

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32 *E.g.*, Midland Nat'l Bank of Billings v. United States, 168 F. Supp. 736 (D. Mont. 1959); Ralph R. Huesman, 16 T.C. 656 (1951), *aff'd on other grounds*, 198 F.2d 133 (9th Cir. 1952); Treas. Reg. §§ 1.691(a)-1(b)(1), (2) (1965); Rev. Rul. 64-150, 1964-1 CUM. BULL. (Part 1) 448.

33 *E.g.*, Miller v. United States, 389 F.2d 656 (5th Cir. 1968); Findlay v. Commissioner, 332 F.2d 620 (2d Cir. 1964); Marian Essenfeld, 37 T.C. 117, 124 (1961), *aff'd*, 311 F.2d 208 (2d Cir. 1962); Latendresse v. Commissioner, 243 F.2d 577 (7th Cir.), *cert. denied*, 355 U.S. 830 (1957); Hansberry v. All, 68-1 USTC ¶ 9185 (N.D. Ill. 1967); Bernard v. United States, 215 F. Supp. 256 (S.D.N.Y. 1963); Florence E. Carr, 37 T.C. 1173 (1962); Fred Basch, 9 T.C. 627 (1947), *acquiesced in*, 1948-1 CUM. BULL. 1; Thomas F. Remington, 9 T.C. 99 (1947); Rev. Rul. 68-124, 1968-1 CUM. BULL. 44.

34 Bausch v. Commissioner, 186 F.2d 313 (2d Cir. 1951); O'Daniel v. Commissioner, 173 F.2d 966 (2d Cir. 1949); I.T. 3840, 1947-1 CUM. BULL. 7. Such voluntary payments would not be includible in the gross estate for estate tax purposes. *See, e.g.*, Raymond W. Albright, 42 T.C. 643 (1964), *rev'd on other grounds*, 356 F.2d 319 (2d Cir. 1966); William E. Barr, 40 T.C. 227 (1963), *acquiesced in*, 1964-1 CUM. BULL. (Part 1) 4. Thus § 691 includes payments excludible from the coverage of § 2033. Nevertheless, several decisions have stated that the § 691(c) deduction for the estate tax attributable to items of income in respect of a decedent implies that such items are includible in the gross estate. *See* United States v. Ellis, 264 F.2d 325 (2d Cir. 1959); Riegelman v. Commissioner, 253 F.2d 315 (2d Cir. 1958); Arthur H. Hull, 38 T.C. 512, 522 & n.5 (1962), *rev'd on other grounds*, 325 F.2d 367 (3d Cir. 1963), *acquiesced in*, 1964-2 CUM. BULL. 6; Rev. Rul. 66-20, 1966-1 CUM. BULL. 214. Exclusion from the gross estate because there is no inheritable interest under § 2033 means there is neither a § 1014(a) fair market value basis nor an estate tax paid with respect to the item. Therefore, the application of § 691(a) merely applies § 61(a)(14) to the exclusion of § 102(a).

35 *E.g.*, O'Daniel v. Commissioner, 173 F.2d 966 (2d Cir. 1949):

> 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.

Id. at 968.

come in respect of a decedent.[36] Concerning rights to income from personal services, the judicial definition of "income in respect of a decedent" under section 691 is extended by the partnership statutory definition to include any right to payment for "services rendered or to be rendered."[37]

A few special situations involving compensation deserve discussion. Where an employee during life gratuitously transfers his right to deferred compensation, the value of such right will sometimes be includible in the deceased employee's gross estate.[38] In such cases the assignee's contract right will probably receive a section 1014(c) decedent's basis rather than a section 1014(a) fair market value basis. The assignee's right to income for services rendered by decedent is income in respect of a decedent if the assignee is a "person who, by reason of the death of the decedent, acquire[d] the right to receive the amount."[39] Although the assignee acquired his right to the deferred compensation while decedent was alive, the Ninth Circuit in another

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[36] Section 753 provides that § 736(a) payments to the successor in interest of a deceased partner are income in respect of a decedent. Section 736(b)(2)(A) provides that payments for unrealized receivables, defined in § 751(c), are § 736(a) payments. The value of § 736(a) payments to a deceased partner's successor is includible in the deceased partner's gross estate. *See, e.g.*, Riegelman v. Commissioner, 253 F.2d 315 (2d Cir. 1958); Arthur H. Hull, 38 T.C. 512 (1962), *acquiesced in*, 1964-2 CUM. BULL. 6, *rev'd on other grounds*, 325 F.2d 367 (3d Cir. 1963); Rev. Rul. 66-20, 1966-1 CUM. BULL. 214. Concerning the acquisition of a § 1014(a) basis for that part of the value of a deceased partner's partnership interest attributable to § 736(a) payments, see note 98 *infra*.

[37] § 751(c)(2). *See, e.g.*, United States v. Woolsey, 326 F.2d 287 (5th Cir. 1963) (management contract representing the right to receive future income is an unrealized receivable). Proposed § 776(c)(4)(B) of H.R. 9662 defined "unrealized receivables" as unreported rights to payments for services rendered. H.R. REP. No. 1231, 86th Cong., 2d Sess. 158 (1960).

In 1954 the American Law Institnte proposed a definition of "income in respect of a decedent" which included "[a] right to a payment attributable to personal services" explaining that "it is not thought that the death basis provisions will be seriously undermined by bringing under the purview of [section 691] . . . rights derived from personal services, even though not accruable," because "personal service income unlike appreciation in the value of property cannot properly claim the exempting benefits of section [1014(a)]. . . ." 2 ALI FED. INCOME TAX STAT. § X890(a)(5)(A), 151, 470-71 (Feb. 1954 Draft). *See also* Holland, *supra* note 19, at 369. In 1958 the Subchapter J Advisory Group's proposed definition of "income in respect of a decedent" included "an amount . . . which represents compensation for services rendered by the decedent." This proposed elimination of any possible requirement that even a contingent right to the payment exist is consistent with present case law, and is explained by the statement that "[t]his rule is designed to carry out the general policy of the Code that earned income should not escape taxation." FINAL REPORT OF SUBCHAPTER J ADVISORY GROUP, *supra* note 20, at 327-28; XVI ABA SECTION OF TAXATION BULL. 182, 193 (1963).

[38] Inclusion in the gross estate will result if the transfer was in contemplation of death. § 2035.

[39] § 691(a)(1)(B).

context has held that section 1014(b), which provides that certain property interests shall for purposes of section 1014(a) "be considered to have been acquired from . . . the decedent,"[40] makes the same property interests, if otherwise described in section 691, income in respect of a decedent for purposes of section 1014(a).[41]

Distributions from qualified employee benefit plans to a deceased employee's successors are income in respect of a decedent.[42] Section 691 classification in conjunction with section 1014(c) prevents the value of such payment includible in decedent's gross estate[43] from acquiring a section 1014(a) fair market value basis. Where a qualified trust distributes securities of the employer corporation to the employee, or after his death to his successor, in a distribution qualifying for capital gains treatment[44] the difference between the value of the securities distributed and their basis to the trust is excluded from the

40 Regulation § 1.1014-2(b)(2) states that § 1014(b)(9) covers generally all property acquired from a decedent which is includible in the decedent's gross estate, including property transferred by gift in contemplation of death.

41 Stanley v. Commissioner, 338 F.2d 434 (9th Cir. 1964), held that a surviving spouse's one-half community property interest in installment obligations did not receive a stepped-up basis under § 1014(b)(6) because § 1014(b)(6)'s rule that a surviving spouse's one-half share of community property held by the decedent and the surviving spouse "shall be considered to have been acquired from . . . the decedent" makes such property income in respect of a decedent under § 691. Section 1014(c) in turn applies to all items of the type described in § 691 and falling within any category of § 1014(b).

42 Hess v. Commissioner, 271 F.2d 104 (3d Cir. 1959); Rev. Rul. 69-297, 1969 INT. REV. BULL. No. 23, at 12; Rev. Rul. 68-506, 1968 INT. REV. BULL. No. 38, at 18; Rev. Rul. 54-601, 1954-2 CUM. BULL. 197. In taxing distributions from qualified plans § 402 makes no distinction between an employee and his successor in interest.

43 Section 2039(c) provides that the value of payments received by any beneficiary (other than the executor) of a deceased employee under a qualified plan is excluded from the employee's gross estate except to the extent that payments are attributable to the decedent's contributions. Revenue ruling 56-1, 1956-1 CUM. BULL. 444, ruled that for purposes of § 2039(c) earnings attributable to the employee's contribution are considered part of the employee's contribution. Revenue ruling 67-278, 1967-2 CUM. BULL. 323, ruled that the value of a deceased spouse's vested community property interest in a qualified plan is includible in her gross estate under § 2033 and that § 2039(c) is inapplicable to exclude such interest where the deceased spouse was not an employee-participant in the qualified plan.

44 § 402(a)(2); Treas. Reg. § 1.402(a)-1(a)(6) (1966). Section 691(a)(3)'s prescription that "the amount includible in gross income under . . . [§§ 691(a)] (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount" creates a semantic problem where a distribution qualifies for capital gains treatment under § 402(a)(2) because paid on account of the employee's death. Revenue ruling 69-297, 1969 INT. REV. BULL. No. 23, at 12, however, held that a § 402(a)(2) distribution to a deceased employee's estate was reportable as income in respect of a decedent and as long-term capital gain.

distributee's income.[45] The untaxed appreciation in value of the securities from their purchase until their distribution, referred to as net unrealized appreciation, is not included in the basis of the securities in the hands of the distributee.[46] Securities distributed to the employee and retained until death will be subject to an estate tax at their then value and will presumably receive a section 1014(a) fair market value basis, thereby eliminating any income tax on appreciation of the securities between acquisition by the trust and the employee's death.[47] The acquisition of a section 1014(a) fair market value basis is uncertain, however, because in a situation where the securities were distributed to a deceased employee's successor, the Internal Revenue Service ruled that the unrealized appreciation would be includible in gross income when the securities were disposed of in a taxable transaction and that the transferor would be allowed a section 691(c) deduction.[48] By implication such securities, perhaps unlike securities distributed to the employee, cannot obtain a section 1014(a) fair market value basis upon inclusion in a distributee's gross estate since the net unrealized appreciation excluded from income upon distribution to the employee's successor is income in respect of a decedent.

Property (other than options to purchase property) received as compensation for services subject to a restriction that has a significant effect on its value is taxable when the restriction lapses or when the property is sold, whichever occurs earlier.[49] The amount of compensation is the lesser of the unrestricted value of the property when received or either the value of the property when the restriction lapses or the consideration received upon the sale, whichever is applicable.[50] Apparently, where a taxpayer dies before realizing compensation in-

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[45] § 402(a)(2); Treas. Reg. § 1.402(a)-1(b)(1) (1966). Unrealized appreciation on employer securities to the extent attributable to contributions by the employee is not taxed at the time of distribution regardless of the time or form of the distribution. § 402(a)(1). Revenue ruling 69-297, 1969 INT. REV. BULL. No. 23, at 12, ruled that the exclusion from income applies to a distribution to a deceased employee's estate. *See also* Treas. Reg. § 1.691(a)-1(d) (1960).

[46] § 402(a)(2); Treas. Reg. § 1.402(a)-1(b)(1)(i) (1966).

[47] C. HAVIGHURST, DEFERRED COMPENSATION FOR KEY EMPLOYEES 75, 333 (1964); H. SELLIN, TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 369 (1960).

[48] Rev. Rul. 69-297, 1969 INT. REV. BULL. No. 23, at 12. The § 691(c) income tax deduction applies to § 691(a) items. The reference in revenue ruling 69-297 to "a taxable transaction" is confusing because § 691(a)(2) specifically defines taxable transfers of a right to receive income in respect of a decedent.

[49] Treas. Reg. § 1.61-2(d)(5) (1966); *id.* § 1.421-6(d)(2) (1966); Rev. Rul. 68-86, 1968-1 CUM. BULL. 184.

[50] Treas. Reg. § 1.421-6(d)(2)(i) (1966).

come in connection with restricted property, the Internal Revenue Service treats the restricted property as income in respect of a decedent so that decedent's successors realize compensation income in the same manner that the decedent would have.[51]

The partnership regulations provide that transfers of partnership capital as compensation for services constitute ordinary income to the recipient.[52] The amount of compensation is the fair market value of the interest in capital transferred, "either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services."[53] The regulations provide that the time when such income is realized depends on "all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest."[54] A restricted partnership interest is taxable when the restriction lapses or the property is disposed of, whichever event first occurs.[55]

The partnership regulations also provide:

> To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the

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[51] Regulation § 1.61-2(d)(5) applies only the rules of regulation § 1.421-6(d)(2) to restricted property. Regulation § 1.61-15 applies all of regulation § 1.421-6, including § 1.421-6(d)(5), to compensatory nonstatutory options to purchase property. Regulation § 1.421-6(d)(5) provides that where such optionee dies without realizing compensation his successors will realize compensation in the same manner as he would have. It is reported that the Internal Revenue Service applies a similar rule to restricted property except that a successor realizes compensation income in the amount of the lesser of the unrestricted value of the property when acquired, the value when the restriction lapses, or the value on the date of death. *See* Rothschild & Salwen, *The 'Restricted Stock' Plan Arrangement: A Practical Analysis of Its Current Use*, 28 J. TAXATION 328, 329 (1968); Rustigan, *A Deferred Income Plan for the Corporate Executive*, 54 A.B.A.J. 506, 508 (1968).

[52] Treas. Reg. § 1.721-1(b)(1) (1960).

[53] *Id.* § 1.721-1(b)(1) (1960). Presumably the rule of regulation § 1.421-6(d)(2) (compensation equals the lesser value at acquisition or value when restrictions lapse) does not apply. *See* note 55 *infra*.

[54] Treas. Reg. § 1.721-1(b)(1) (1960). Regulation § 1.421-6(d)(2)(ii), applicable by reason of regulation § 1.61-2(d)(5), offers several examples of restrictions having a significant effect on value.

[55] Treas. Reg. § 1.421-6(d)(2)(i) (1966), applicable by reason of regulation § 1.61-2(d)(5) (1966). Proposed regulation § 1.721-1(b) stated that the value of the interest in partnership capital acquired as compensation for services

> is taxable to such partner at such time as there are no substantial restrictions or conditions on his right to withdraw or otherwise dispose of such amount, or when in fact he does obtain such amount (either through a distribution or by sale or exchange of his partnership interest), whichever event first occurs.

20 Fed. Reg. 5866 (1955).

> fair market value of such interest is income in respect of a decedent under section 691.[56]

If a restricted interest in partnership capital is transferred to a service partner before death and passes to the service partner's successor at his death without having been taxed, it is unclear whether the property is an item of income in respect of a decedent in the hands of the deceased partner's successor in interest.[57] The treatment of crops and livestock received by a farm landlord as share rents, which pass on death to his successor in interest as income in respect of a decedent because the items represent rent earned but not reported prior to death, indicates the correct treatment for the unreported compensation in employer securities and a restricted interest in partnership capital received by an employee or service partner before death.[58]

Nonstatutory stock options received as compensation represent taxable income upon receipt if the option has a readily ascertainable fair market value.[59] If the option does not have a readily ascertainable fair market value at the time it is granted, as is usually the case, the grantee realizes income when he transfers the option,[60] or upon exercise[61] unless the option property is subject to a restriction which has a significant effect on its value. In this case the grantee realizes income when the restriction lapses or the property is sold, whichever event first occurs.[62] Where the optionee dies before realizing income

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56 Treas. Reg. § 1.721-1(b)(1) (1960).

57 Willis, in his *Handbook of Partnership Taxation* at 60 (1957), states that an untaxed restricted interest in partnership capital transferred to the service partner prior to his death is an item of income in respect of a decedent. *Cf.* Herman M. Hale, 24 T.C.M. 1497, 1509-11 (1965), holding the value of a partnership interest acquired in return for services an unrealized receivable under § 751(c)(2).

Proposed § 770(c)(1)(B) of H.R. 9662 would have taxed a deceased partner's successor when the restrictions lapsed or upon transfer of the interest other than by death. Where the restrictions terminated upon death, the amount of compensation (the smaller of the value of the services or the unrestricted value of the partnership interest at the time of the exchange) would have been includible in the decedent's final income tax return. H.R. REP. No. 1231, 86th Cong., 2d Sess. 93-95, 156 (1960).

58 Davis v. United States, 68-2 USTC ¶ 9483 (S.D. Ill. 1968); Davison v. United States, 292 F.2d 937 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961); Rev. Rul. 64-289, 1964-2 CUM. BULL. 173; Rev. Rul. 58-436, 1958-2 CUM. BULL. 366. *Cf.* Tatum v. United States, 400 F.2d 242 (5th Cir. 1968).

59 Treas. Reg. § 1.61-15 (1968); *id.* § 1.421-6(c)(1) (1966). The amount of compensation is the excess of the value of the option over the amount paid for it. Regulations §§ 1.421-6(c)(2), (3) define "readily ascertainable fair market value." *See also id.* § 1.421-7(b)(1).

60 *Id.* § 1.421-6(d)(3) (1966). The amount of compensation is the gain resulting from the transfer.

61 *Id.* § 1.421-6(d)(1) (1966). The amount of compensation is the excess of the value of the property over the amount paid for it.

62 *Id.* § 1.421-6(d)(2)(i) (1966). The amount of compensation is the lesser of (*a*) the ex-

in connection with a nonstatutory stock option, the rules governing income in respect of a decedent apply so that the deceased optionee's successors will realize compensation income in the same manner that the decedent would have.[63]

The exercise of a qualified stock option granted at an option price less than the fair market value of the stock subject to the option on the date of grant may result in the realization of ordinary income at the time of exercise under section 422(c)(1).[64] An unexercised qualified stock option is, in the hands of a deceased optionee's successors in interest, property which constitutes a right to receive an item of income in respect of a decedent.[65] Where a qualified stock option is exercised by the deceased optionee's successors in interest any amount includible in income under section 422(c)(1) is considered income in respect of a decedent.[66]

The disposition of stock acquired by the exercise of an option granted under an employee stock purchase plan at less than the fair market value of the stock subject to the option on the date of grant may also result in the realization of ordinary income.[67] Realization of ordinary income is caused by a disposition of the stock or the death of the owner of the stock acquired under the option.[68] An unexercised option issued under an employee stock purchase plan is, in the hands of a deceased optionee's successors in interest, property which consti-

cess of the unrestricted value of the property when acquired over the amount paid for it or (*b*) either the excess of the value of the property when the restriction lapses over the amount paid for it or the excess of the consideration received upon a sale of the property over the amount paid for it.

63 *Id.* § 1.421-6(d)(5) (1966). There is one exception. If the option has been exercised by the employee before his death but no income has been realized because the option property was acquired subject to a restriction, and if such restriction is removed as a consequence of the employee's death, compensation income will be considered to have been realized by such employee in the taxable year ending with his death. *Id.* § 1.421-6 (d)(2)(ii), example (2) (1966).

64 Under § 422(c)(1) the person exercising the option includes as compensation in the year the option is exercised an amount equal to the lesser of (*1*) 150% of the difference between the option price and the fair market value of the stock at the time the option was granted; or (*2*) the difference between the option price and the fair market value of the shares at the time of exercise of the option.

65 Treas. Reg. § 1.421-8(c)(4)(iii) (1966).

66 § 421(c); Treas. Reg. § 1.421-8(c)(3)(i) (1966).

67 Under § 423(c) the amount of ordinary income is the amount by which the option price is exceeded by the lesser of (*1*) the fair market value of the stock at the time of disposition or death, or (*2*) the fair market value of the stock at the time the option was granted.

68 § 423(c); Treas. Reg. § 1.423-2(k) (1966). Thus if an optionee exercises a stock option issued under an employee stock purchase plan and owns the stock at his death any compensation income is includible in his final income tax return.

tutes a right to receive an item of income in respect of a decedent.[69] Where the deceased optionee's successors in interest exercise an option issued under an employee stock purchase plan, there is no income tax consequence until a disposition of the stock occurs.[70] Upon a disposition of the stock the difference between the option price and the value of the stock when the option was granted is treated as income in respect of a decedent.[71]

RIGHTS TO INCOME FROM COMPLETED SALES

Rights to payments under installment obligations[72] and any unreported income inherent in other rights to payment received upon a sale or exchange of property completed during decedent's life are income in respect of a decedent in the hands of decedent's successors in interest.[73] Reference to an exclusive accrual accounting test has been rejected and, consistent with the treatment of rights to payments for decedent's services, rights to payments for sales completed by decedent represent income in respect of a decedent whether or not ac-

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69 Treas. Reg. § 1.421-8(c)(4)(iii) (1966).

70 § 421(c); § 423(c).

71 Treas. Reg. § 1.421-8(c)(3)(i) (1966).

72 Section 691(a)(4) defines "income in respect of a decedent" to include the excess of the face amount of an installmeut obligation over the decedent's basis therefor.

73 Where during decedent's life the sale was considered closed for income tax purposes and gain was recognized, any income received in excess of decedent's basis (the value of the obligations received) less pre-death collections is income in respect of a decedent. *See* Wilcox v. United States, 185 F. Supp. 388 (E.D. Ohio 1960); Abraham Goldstein, 33 T.C. 1032 (1960), *acquiesced in*, 1960-2 CUM. BULL. 5.

To the contrary is Grill v. United States, 303 F.2d 922 (Ct. Cl. 1962), where decedent, who died in 1944, owned a right to payments based on net profits under a movie distribution contract received in the liquidation of a corporation in 1942. The liquidation was treated as closed for income tax purposes and decedent recognized gain in 1942. At decedent's death in 1944 the right to payments acquired a § 1014(a) fair market value basis without dispute, and after subsequently recovering this basis the decedent's successors reported payments received in 1950 as capital gain arguing that the 1942 liquidation was an open transaction and that the right to payments was property which constituted a right to receive income in respect of a decedent. The court held that the 1942 corporate liquidation was a closed transaction, thus establishing the character of the payments, and that in any event the payments were not income in respect of a decedent because attributable to rentals earned after death.

Where during decedent's life the sale was considered open for income tax purposes and gain was not recognized, because of the nature of the obligation received, the decedent's accounting method, or both, the rights to payments are also rights to income iu respect of a decedent. *See* Dixon v. United States, 96 F. Supp. 986 (E.D. Ky. 1950), *aff'd per curiam*, 192 F.2d 82 (6th Cir. 1951); Stephen H. Dorsey, 49 T.C. 606, 632-33 (1968); John A. Biewer, 41 T.C. 191 (1963), *aff'd*, 341 F.2d 394 (6th Cir. 1965); Rev. Rul. 57-544, 1957-2 CUM. BULL. 361, *as amplified by* Rev. Rul. 60-227, 1960-1 CUM. BULL. 262.

cruable at decedent's death and regardless of the nature of the asset sold.[74]

RIGHTS TO INCOME UNDER EXECUTORY SALES CONTRACTS

Inherited assets subject to executory sales contracts are property which constitutes a right to receive an item of income in respect of a decedent except where the sales contract specifies that the sale is to occur only after decedent's death.[75] The decisions stress two criteria for resolving the section 691 classification issue: decedent's possession of a right to the proceeds and the relationship between decedent's activities and the receipt of the proceeds.

In *Commissioner v. Linde*[76] the decedent, a grape grower, had delivered grapes to a co-operative marketing association which processed them into wine to be sold by the co-operative. Under decedent's marketing contract the co-operative was an agent; decedent retained title until the co-operative sold the wine, at which time he received payment. Sale of the wine occurred after decedent's death. Rejecting as irrelevant the lack of a sale before decedent's death, the Ninth Circuit held that the payments to decedent's successor were income in respect of a decedent because the income was the product of decedent's efforts and contracts.[77] As authority for its classification of the

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74 The proposed ALI definition of "income in respect of a decedent" included all rights to payments under installment obligations and accruable rights to payments from sales prior to decedent's death of stock in trade, property held for sale in the ordinary course of business, or rights to income. Excluded were nonaccruable rights to payments from sales prior to decedent's death and accruable rights to payments from sales prior to decedent's death of capital assets or noncapital assets other than stock in trade or rights to income. 2 ALI FED. INCOME TAX STAT. § X890(a)(5), 151 (Feb. 1954 Draft).

The proposed Subchapter J Advisory Group definition of "income in respect of a decedent" rejected reference to accrual accounting, asset classification, and completion of the sale before death. Included as income in respect of a decedent were "proceeds of a sale, exchange, or other disposition of property made prior to the death of the decedent," the excess of the face amount of an installment obligation over the decedent's basis therefor, and amounts "which would have been taxable to the decedent if he had lived to receive it . . . and which he failed to receive solely by reason of his death, to the extent that the value of the right to receive such amount is includible in the gross estate for Federal estate tax purposes." FINAL REPORT OF SUBCHAPTER J ADVISORY GROUP, *supra* note 20, at 323-24. *See* XVI ABA SECTION OF TAXATION BULL. 182 (1963).

75 Because of this rule a successor in interest to an asset encumbered by an executory sales contract will be motivated to break the contract and independently dispose of the asset in order to obtain a § 1014(a) fair market value basis instead of a § 1014(c) decedent's basis for purposes of determining gain upon the sale. *See* Note, *Tax Effect of Executor's Rescission and Renegotiation of Decedent's Contracts*, 51 MINN. L. REV. 251 (1966).

76 213 F.2d 1 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954).

77 *Id.* at 3-4. *Cf.* Rev. Rul. 58-436, 1958-2 CUM. BULL. 366, 368, *modified*, Rev. Rul. 64-289, 1964-2 CUM. BULL. 173.

payments as income in respect of a decedent despite the absence of an unconditional right to the payments at the date of decedent's death, the court cited *O'Daniel v. Commissioner*,[78] in which the Second Circuit held that voluntary payments by a former employer to a deceased employee's estate were income in respect of a decedent although the employer was not obliged to pay anything.

The Fifth Circuit held in *Trust Co. of Georgia v. Ross*[79] that where at death decedent owns stock subject to an executory sales contract, the sales proceeds, received upon consummation of the contract by his executor, are income in respect of a decedent. The court viewed the contract as creating a right to the sales proceeds which was not destroyed by the requirement that the executor perform certain closing conditions in order to perfect such right. Unlike the Ninth Circuit in *Linde*, the court specifically subordinated the requirement of a causal relationship between decedent's activities and receipt of the income to the requirement that a right to the income, albeit subject to conditions, exist at decedent's death: "Absent such a right, no matter how great the activities or efforts, there would be no taxable income under § 691."[80]

Finally, in *George C. Keck*[81] decedent owned minority stock interests in corporations that had contracted to sell their assets. After taxpayer's death and the completion of certain closing conditions, the corporations sold their assets and were liquidated by their shareholders. The Tax Court held that the liquidation proceeds received by decedent's successor were income in respect of a decedent because attributable to the decedent's economic activities. Although no formal action had been taken before decedent's death to liquidate the corporations, the Tax Court found "that the liquidation of the three selling corporations . . . after the sale of the assets was carried out was an

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78 173 F.2d 966 (2d Cir. 1949).

79 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968).

80 *Id.* at 695. Before taxpayer's death, the stock and $500,000 of the purchase price were placed in escrow with the latter amount to be liquidated damages if the buyer defaulted. After taxpayer's death, his executor performed certain acts in connection with closing the sales contract including altering the contract to provide for a cash and credit sale instead of a cash sale. Taxpayers argued unsuccessfully that the executor's activities demonstrated that the decedent had no right to the sales proceeds and that the sale was not made solely as the result of efforts of the decedent during his lifetime. The government argued that if an estate by changing the time or amount of payment could remove the sales proceeds from § 691 coverage by making the income no longer primarily the product of decedent's agreements, there would be no § 691 income; an estate would simply reduce the contract price by some amount less than the tax due on the income if treated as income in respect of a decedent. Brief for Appellee at 38 & n.17, Trust Co. of Ga. v. Ross, 392 F.2d 694 (5th Cir. 1967).

81 49 T.C. 313 (1968), *rev'd*, 415 F.2d 531, 69-2 USTC ¶ 9626 (6th Cir. 1969).

integral part of the original plan to sell such corporate assets" and was merely "the outgrowth of the . . . contract of sale and other arrangements entered into by decedent prior to his death."[82] Crucial to this finding was the provision in the sale contract providing for its nullification in the event the companies were unable to secure a ruling that a sale and subsequent liquidation would make the sale nontaxable under section 337.[83] On appeal, the Sixth Circuit explicitly adopted the Fifth Circuit's reasoning in *Trust Co. of Georgia v. Ross* that there can be no income in respect of a decedent unless decedent possessed a right to the income. Applying this rule the Sixth Circuit reversed the Tax Court on the ground that "at the date of his death, decedent . . . possessed neither the right nor the power to require the corporations to liquidate and did not, prior to his death, possess the right to receive any proceeds from the contemplated liquidation."[84]

Since the contract to sell the corporations' assets was as binding as the parties could make it,[85] the court must have considered the performance of the routine acts required to liquidate the corporations as prerequisite to applying section 691. This result virtually imposes a requirement that there exist an unqualified right to the income, an interpretation of section 691 inconsistent with *O'Daniel v. Commissioner,* where no right to the income existed; with *Commissioner v. Linde,* where an unqualified right to the income awaited the processing of the grapes and the sale of wine; and with *Trust Co. of*

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82 *Id.* at 320-21. Taxpayer offered evidence of the executor's economic activities as proof that decedent had no right to the liquidation proceeds and to attenuate the causal relationship between decedent's economic activities and receipt of the liquidation proceeds. Six dissenters said that while the corporations had a contingent right to the sales proceeds, the decedent, in the absence of any contract to liquidate the corporations, had no right to the liquidation proceeds. *Id.* at 323-24.

83 *Id.* at 320. Section 337(a) provides that if a corporation adopts a plan of complete liquidation and distributes all of its assets in complete liquidation within the 12-month period beginning on the date of the adoption of the plau, it shall not recognize gain or loss from the sale or exchange of property within the 12-month period. Clearly distinguishable from *Keck* is Boyle v. United States, 355 F.2d 233 (3d Cir. 1965), where the decedent owned all of the stock of a corporation which owned preferred stock of another corporation with accumulated dividend arrearages. After taxpayer's death, his successors liquidated the corporation and received the preferred stock. The accumulated dividend arrearages were not income in respect of a decedent where prior to decedent's death there was no plan to liquidate.

84 Keck v. Commissioner, 415 F.2d 531, 535, 69-2 USTC ¶ 9626, at 85,691 (6th Cir. 1969).

85 At decedent's death the corporations' executory sales contracts were contingent on approval of the sales by the Interstate Commerce Commission. This condition, while recited in the sale contract, was a requirement imposed by federal law. Brief for Respondent at 25 & n.9, Keck v. Commissioner, 415 F.2d 531, 69-2 USTC ¶ 9626 (6th Cir. 1969).

Georgia v. Ross, where an unqualified right to the income awaited the performance by the estate of certain conditions required to consummate the sales contract. In fact, the formal prerequisites to liquidation in *Keck* were substantially equivalent to the acts performable by the estate in *Trust Co. of Georgia v. Ross*, which were held insufficient to vitiate decedent's right to the income. However, since the Sixth Circuit accepted the holding of *Trust Co. of Georgia v. Ross* that income in respect of a decedent is not limited to money owed for property sold before death, its *Keck* decision appears to represent only a factual judgment of the significance of the conditions to the decedent's right to income at the date of death. Nevertheless, *Keck* establishes for purposes of section 691 a questionable distinction between an executory sale of stock and an interdependent executory asset sale and liquidation under section 337.

In the case of personal service income the relationship between the decedent's lifetime activities and the payment is easily established. Even a voluntary posthumous payment for decedent's lifetime services must be regarded as resulting solely from decedent's activities. Accordingly, the Second Circuit in *O'Daniel v. Commissioner*[86] classified a voluntary payment by a former employer to a deceased employee's estate as income in respect of a decedent, holding that the right to the income existing at the decedent's death need not be legally enforceable so long as it derives from services rendered by the decedent. But where gain on a transfer of appreciated property is involved, the income can be primarily the product of either pre-death efforts of the decedent or the post-death efforts of his successors. There must, therefore, be a factual determination of whose efforts are primarily responsible. The difficulty of this determination and the need for a workable minimum standard of when income can be primarily the product of decedent's pre-death activities probably explains the requirement of the *Ross* and *Keck* courts that gain on a posthumous sale cannot be income in respect of a decedent unless decedent's activities gave rise to at least a conditional right to the income. In effect this requirement rejects as insufficient any decedent's activities that fail to produce a conditional right to the income. Because of this requirement, the executory contract holdings will not be extended to cover options to buy or offers to sell that are exercised or accepted after the death of the owner of the property subject to such option or offer.[87] The sales proceeds in such a case may be attributable to

86 173 F.2d 966 (2d Cir. 1949).

87 The government has argued that the sales proceeds in such a case are income in

economic activities and agreements of the decedent and not his successor, but those activities are considered insufficient unless decedent possessed at least a conditional right to the income.[88]

Concerning partnerships, the statutory definition of income in respect of a decedent, as supplemented by the regulations, includes contractual rights "to payment for . . . goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset."[89] Consistent with the cases applying section 691 to rights to

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respect of a decedent because the absence, at decedent's death, of an unconditional right on decedent's part to receive the sales proceeds or of any certainty that they will actually be received is no barrier to inclusion under § 691 if, when they are received, they are clearly the result of the economic agreements of the decedent, and not of the executor. Brief for Appellee at 33-34, Trust Co. of Ga. v. Ross, 392 F.2d 694 (5th Cir. 1967); Brief for Respondent at 16, George C. Keck, 49 T.C. 313 (1968); Brief for Respondent at 21, Keck v. Commissioner, 415 F.2d 531, 69-2 USTC ¶ 9626 (6th Cir. 1969). *Compare* Voegelin, *Use of Options In Tax Planning*, 17 U. So. Cal. 1965 Tax Inst. 729, 769-70, where a § 1014(a) fair market value basis for property subject to an executory option to sell is assumed.

On the other hand, options to produce a play or motion picture do receive a § 1014(a) fair market value basis. Gabriel Pascal, 22 T.C.M. 1766 (1963). Presumably contracts to buy, unlike contracts to sell, obtain a § 1014(a) fair market value basis and not a § 1014(c) decedent's basis upon inclusion in the gross estate. Regulation § 1.1014-3(c) is probably not intended to apply to decedents' contracts to buy; if it were it would amount to an application of § 1014(c) by denying a basis equal to the fair market value of the contract to buy under § 1014(a) plus the purchase price. *Cf.* Rev. Rul. 67-96, 1967-1 Cum. Bull. 195.

88 *See* Cummer v. United States, 62-1 USTC ¶ 9344 (S.D. Cal. 1962), which involved a sale of land to a municipal corporation. Pursuant to escrow instructions contained in the sales contract the land was divided into three parcels and a deed to each parcel was deposited in escrow. The purchase price payments for each parcel were due in 1956, 1957, and 1958, respectively, and the buyer was to receive each deed upon payment therefor. Payments and deed transfers occurred in 1956 and 1957, the seller died on April 15, 1957, and his executor received the final payment and transferred the final deed on January 31, 1958. The court, without discussing § 691, held that the sales contract was void because it violated the California constitution, the transfers constituted three independent sales, and the seller's estate was entitled to a § 1014(a) fair market value basis for the unsold parcel. *Cf.* C. William Meinecke, 47 B.T.A. 634 (1942), *acquiesced in*, 1942-2 Cum. Bull. 13, dealing with a similar situation under the pre-1942 statute, § 42, which required inclusion in a taxpayer's final return of all "amounts accrued up to the date of his death."

89 § 751(c)(1); Treas. Reg. § 1.751-1(c)(1) (1965); § 736(b)(2)(A); § 753. *See, e.g.*, Herman Glazer, 44 T.C. 541 (1965) (alternative holding). Proposed § 776(c)(4)(A) of H.R. 9662 defined "unrealized receivables" as unreported rights

> to payments for . . . goods produced (or delivered, in the case of a partnership predominantly engaged in a distributing trade or business), to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset.

H.R. Rep. No. 1231, 86th Cong., 2d Sess. 158 (1960). The *Report* explained how this definition of income in respect of a decedent limited the existing definition in § 751(c)(1).

In the case of goods, those not yet delivered, where a partnership is predompayments under executory contracts to sell and from completed sales of noncapital assets by individuals, rights to payments under executory contracts to sell and from completed sales of noncapital assets by partnerships are income in respect of a decedent. Inconsistent with the cases applying section 691 to rights to payments under executory contracts to sell and from completed sales of capital assets by individuals, rights to payments under executory contracts to sell and from completed sales of capital assets by partnerships are not income in respect of a decedent. Evidently, to avoid income in respect of a decedent treatment for posthumous payments, sales of capital assets for deferred payments where recognition of gain is deferred should be made by partnerships, not by individuals. And even an individual who sells a capital asset on the installment basis may be able to avoid section 691 by transferring the installment obligation to a partnership.[90]

RIGHTS TO INCOME UNDER EXECUTORY CONTRACTS TO SELL AFTER DEATH

The regulations provide that where the decedent leaves property subject to an executory contract to sell after his death, such property is not a right to receive income in respect of a decedent and section 1014(a) applies to the property. This rule is said to follow from the fact that a sale effective only in the event of death is a sale consummated after death.[91] Why property encumbered by a contract pro-

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> inantly in a distributing trade or business . . . are omitted. For manufacturing and similar types of business, the term includes goods produced, but not yet delivered, where orders have been placed at the time of the withdrawal from the partnership of the deceased . . . partner.

Id. at 35.

90 § 731(b); Treas. Reg. § 1.453-9(c)(2) (1965); *id.* § 1.721-1(a) (1960). The installment obligation is not an unrealized receivable as defined in § 751(c). Concerning gain or loss to the partnership upon a posthumous distribution of the installment obligation, see WILLIS, *supra* note 57, at 289.

91 Treas. Reg. § 1.691(a)-2(b), example (4) (1960), *adopted by* T.D. 6257, 1957-2 CUM. BULL. 342, 345-46. The committee Reports on the Revenue Act of 1942 contained one ambiguous example apropos of the intended application of § 126 to executory contracts to sell property on death.

> An example of the application of this provision . . . is the case of a partner who contracts in the partnership agreement that his interest in certain partnership assets shall pass to the surviving partners in exchange for payments to be made by them to his widow. On his death, the payments by the surviving partners shall be included in the widow's income to the extent they represent the gain on such sale.

H.R. REP. No. 2333, 77th Cong., 2d Sess. 84 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 101 (1942). The same example was carried over into the original regulations which, viding for a sale by taxpayer if he lives and by his executor if he dies is a right to receive income in respect of a decedent, while property encumbered by a contract for a sale by the executor alone is not, is unclear. In each case the income is attributable to decedent's activities and agreements. In each case decedent possessed a conditional right to the income and during his lifetime could have sued upon an anticipatory breach of contract. The government has argued in support of its regulation that a contract for a sale after death is exempt from section 691 because that section is designed to cover situations in which decedent intended to realize income during his lifetime and, but for his death, would have done so.[92] Several decisions, however, have applied section 691 to tax such income items as death benefits which the decedent would not have received had he lived.[93] So long as section 691 taxes such death benefits received by decedent's successors, its failure to reach sales proceeds received by decedent's successors under contracts to sell at death cannot be explained on the basis that the gain on the sale was not intended to be realized during life.[94]

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however, elaborated on the meaning of "gain" by stating that the payments were included in the widow's income "to the extent they exceeded the adjusted basis of such assets in the hands of the decedent immediately prior to his death." Treas. Reg. 103, § 19.126-1, *as added by* T.D. 5233, 1943-1 CUM. BULL. 198, 203-05. Thereafter, two rulings, *Special Ruling of November 10, 1944*, signed by General Counsel Joseph J. O'Connell, Jr. (5 P-H 1945 FED. TAX ¶ 76,080), and *Special Ruling of April 13, 1945*, signed by Acting Commissioner George Schoeneman (5 P-H 1945 FED. TAX ¶ 76,190), held that where decedent's successor sells property pursuant to decedent's executory contract to sell on his death the excess of the sales proceeds over the adjusted basis to the decedent immediately prior to his death is income in respect of a decedent.

In 1945 the regnlations were amended to provide that property subject to an executory contract to sell at death would receive a new basis upon taxpayer's death. T.D. 5459, 1945 CUM. BULL. 193, 194, *amending* Treas. Reg. 111, § 29.126-1 (1943). Subsequently *Special Ruling of August 23, 1945*, signed by Deputy Commissioner Norman D. Cann (5 P-H 1945 FED. TAX ¶ 76,295), elaborated on the change in the regulations and concluded that a fair market value basis attaches to property subject to a contract to sell only in the event of death because such a sale is consummated after death. The example in the *Special Ruling of August 23, 1945*, was carried over into the regulations issued under § 691.

92 Brief for Appellee at 27-28, Trust Co. of Ga. v. Ross, 392 F.2d 694 (5th Cir. 1967); Reply Brief for Respondent at 11-12, George C. Keck, 49 T.C. 313 (1968); Brief for Respondent at 24 n.7, Keck v. Commissioner, 415 F.2d 531, 69-2 USTC ¶ 9626 (6th Cir. 1969).

93 Miller v. United States, 389 F.2d 656 (5th Cir. 1968); Marian Essenfeld, 37 T.C. 117, 124 (1961), *aff'd*, 311 F.2d 208 (2d Cir. 1962); Bausch v. Commissioner, 186 F.2d 313 (2d Cir. 1951); O'Daniel v. Commissioner, 173 F.2d 966 (2d Cir. 1949); Hansberry v. All, 68-1 USTC ¶ 9185 (N.D. Ill. 1967); Bernard v. United States, 215 F. Supp. 256 (S.D.N.Y. 1963). *Contra*, Lacomble v. United States, 177 F. Supp. 373 (N.D. Cal. 1959).

94 *See* Krieg & Buschmann, *Section 126: "Items of Gross Income in Respect of a Decedent . . .",* 32 TAXES 651 (1954), where the authors argue that a right to payment under a completed but unreported sale is as much entitled to an exemption from § 126

Under the present rules, rights to payments under inter vivos redemptions of stock or inter vivos installment redemptions, where each installment is treated as an independent repurchase transaction,[95] are income in respect of a decedent as rights arising under completed or executory sales contracts, while rights to payments under contracts to redeem only after death are not income in respect of a decedent.[96]

Payments from a partnership to a partner in liquidation of his partnership interest are taxed the same, insofar as items of income in respect of a decedent are concerned, whether the liquidation occurs before or after death.[97] Upon the death of a partner the partnership interest obtains a basis equal to its fair market value, reduced however by the value of decedent's interest in items of income in respect of a decedent.[98] These items are unrealized receivables, defined as un-

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as an executory contract to sell at death. They ask, "[c]an an 'item' of income include contingencies for salary purposes and yet exclude a binding, specific buy-and-sell contract?" *Id.* at 653.

95 Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960); Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303, 304-05 (1965).

96 *See* text at notes 72-94 *supra*. Sections 302(a) and 303(a) provide that stock redemptions satisfying certain conditions are treated as exchanges. Stock inherited along with an unexercised option to resell to the corporation presumably obtains a § 1014(a) basis under regulatiou § 1.691(a)-2(b), example (4). Open end investment companies provide their shareholders with options to redeem. Investment Company Act of 1940, § 22(c), 15 U.S.C. § 80a-22 (1964). *See* Note, *Stock Redemption at the Option of the Shareholder in the Close Corporation*, 48 IOWA L. REV. 986 (1963).

97 Section 736(b)(2)(A) provides that liquidating payments for unrealized receivables, as defined in § 751(c), are § 736(a) payments. Sectiou 753 provides that § 736(a) payments to a deceased partner's successor in interest are income in respect of a decedent. Regulation § 1.753-1(a) provides that "[w]hen a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest."

98 Treas. Reg. § 1.742-1 (1960). This regulation, which prevents decedent's successor in interest from realizing a loss equal to the amount of the § 736(a) payments, is apparently without statutory basis. Section 742 refers to the general basis provisions for computation of the basis of a partnership interest acquired by inheritance. The property interest, which receives a new income tax basis under § 1014(a) upon the death of a partner, is the deceased partner's interest in the partnership, not his proportionate interests in the various assets of the partnership. In fact, a § 754 election is required to apply § 743(b) to effect a new basis for the decedent's interest in each asset owned by the partnership. Nevertheless, regulation § 1.742-1 does not consider the partnership interest as a unit but proceeds on an asset-by-asset approach in computing the successor's basis for its interest in the partnership. Similarly, revenue ruling 66-325, 1966-2 CUM. BULL. 249, provides that where an adjustment in the basis of the partnership assets to reflect the change in basis at the partner's level is made under § 743(b), the successor's § 1014(a) fair market value basis for its partnership interest must be reduced to the extent it is attributable to items representing income in respect of a decedent. Legislation has been suggested to accomplish this result. Proposed § 203(c) of H.R. 9662, *amending* § 1014(c), H.R. REP. No. 1231, 86th Cong., 2d Sess. 165 (1960). *See* WILLIS, *supra* note 57, at 389-95; Swihart,

reported rights to payment for services rendered or to be rendered, or for goods delivered or to be delivered where the proceeds on their disposition would produce ordinary income, and certain depreciation subject to recapture. Unlike corporate stock redemptions, rights to liquidating payments for a partnership interest are taxed the same, insofar as items of income in respect of a decedent are concerned, whether the rights to payments arise under an inter vivos liquidation, an executory contract to liquidate during the partner's life but consummated after his death, or an executory contract to liquidate after death.

Rights to Income Under Executory Contracts to Sell in Tax-Free Exchanges

So long as the regulations provide that property subject to a contract to sell after death is not a right to receive income in respect of a decedent, property subject to a contract to sell in a tax-free exchange during life but consummated after death should not be considered a right to receive income in respect of a decedent. In neither case did decedent intend to recognize income during his lifetime. In addition, since property received upon consummation during decedent's life of a tax-free exchange would receive a section 1014(a) fair market value basis at decedent's death, application of section 691 to an executory contract to sell in a tax-free exchange would produce an anomalous result.[99] Under section 1014(c), decedent's basis for the property subject to the executory contract would become the substituted basis for the property received upon consummation of the contract.[100] If section 691 should be held to apply to the contract, its consummation should be tax-free under section 691(a)(3), despite section 691(a)(2), which precludes the tax-free transfer of a right to receive income in respect of a decedent.[101]

Tax Problems Raised by Liquidations of Partnership Interests, 44 Texas L. Rev. 1209, 1223-24 (1966).

99 The various tax-free exchange sections of the Code are intended to result in postponement, not forgiveness, of taxation, and this objective is accomplished through the mechanism of a substituted basis. In theory the unrecognized gain will be taxed when the new property is sold. If the new property is held until death the theory is breached because the postponed gain is obliterated by § 1014(a), under which the heirs take the property with a new basis equal to its value at the date of death. The result should not change because the tax-free exchange is executory rather than consummated.

100 *E.g.*, § 1031(d), § 1033(c), or § 358(a).

101 The tax-free transfer of a right to receive income in respect of a decedent represented by an asset subject to an executory sales contract is precluded by § 691(a)(2). A transfer by consummation of a taxable executory sales contract does not present the same

A similar problem concerning the effect of death on an incomplete nontaxable transaction is presented in revenue ruling 64-161,[102] which holds that the nonrecognition-of-gain benefits of section 1033 do not apply where the taxpayer who receives the proceeds of an involuntary conversion dies and replacement of the converted property is thereafter made by a testamentary trustee. Section 1033 is ruled inapplicable because the section contemplates a continuing investment by the same taxpayer.[103] A supporting argument is advanced that section 1033's substituted basis provisions, cost less unrecognized gain, conflict with section 1014(a)'s requirement that the decedent's property obtain a fair market value basis. The application of section 691 is implicitly rejected because if section 691 applied to the involuntary conversion proceeds the basis conflict would disappear by virtue of section 1014(c), and section 691(a)(3) would presumably preserve the decedent's right to a tax-free replacement of the converted property. As previously noted,[104] the application of section 691 would also produce the anomalous result of a section 1014(a) fair market value basis where decedent dies before the involuntary conversion of his property into money, a section 1014(c) decedent's basis where he dies after the involuntary conversion but before reinvestment, and a section 1014(a) fair market value basis where he dies after completion of the reinvestment. The alternative, nonrecognition of the gain on decedent's final income tax return under section 1033 and a section 1014(a) fair market value basis for the replacement property, is ruled in contravention of the substituted basis provisions of section 1033(c). Because section 691(a)(1) prescribes that decedent's successors shall report income in respect of a decedent when they receive it, the section evidently contemplates unreported and unreceived income. Nevertheless, where before death decedent receives property, which is itself an item of gross income, section 691 is sometimes applied so as to tax decedent's successors in the same manner that decedent would have been taxed if he had lived. This result is achieved by denying a section 1014(a) fair market value basis for that part of the value of the property which represents income received but not reported by the decedent. Since money cannot take a

conflict between §§ 691(a)(2) and (a)(3) as does a transfer by consummation of a tax-free executory sales contract.

102 1964-1 CUM. BULL. 298. *Cf.* Rev. Rul. 67-355, 1967-2 CUM. BULL. 296.

103 *But see* Goodman v. Commissioner, 199 F.2d 895 (3d Cir. 1952), which held that § 1033's predecessor allowed postponement of recognition of gain even though the reinvestment was made by the executor after the taxpayer's death. The court said, "[w]e see no reason why the executor may not do what the taxpayer could have done to perfect a right which came into being in that final taxable period." *Id.* at 898.

104 *See* note 99 *supra* and accompanying text.

basis less than its face value, section 691 is presumably not applicable to income items which the decedent received but did not report before death, such as involuntary conversion proceeds and certain option payments.[105]

PURCHASED RIGHTS TO INCOME

Whether or not a purchased right to recurring receipts is an item of income in respect of a decedent in the hands of decedent's successors is unclear. In 1953 it was said that "it is almost axiomatic that . . . [section 1014(a)] covers the capital assets of an individual which have appreciated in value, such as his stocks, bonds and other investment assets."[106] This result is no longer so clear. In *Francis E. Latendresse*[107] the decedent had purchased a right to receive insurance renewal commissions. Decedent's successors were denied a section 1014(a) fair market value basis on the ground that the right to payments was an item of income in respect of a decedent because the income when received upon collection of the premiums would have been ordinary income. A right to receive insurance renewal commissions acquired in a liquidation of a corporation was also held an item of income in respect of a decedent in *Abraham Goldstein*.[108] Where an author sold his manuscript for a right to royalty payments based on sales, revenue ruling 57-544[109] held the right to be an item of income in respect of a decedent because earned during the deceased author's life. Where

105 For property received as compensation see text at notes 42-71 *supra*; for property received as rent see text at note 119 *infra*. Consideration received for options to purchase, with the amount to be credited against the purchase price if the option is exercised, is generally not taxable until the option lapses or is exercised because the proper tax treatment, ordinary income or sales proceeds, may not be determined until the transaction is closed. Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939). Thus, where the optionor receives such an option payment and dies before the option is exercised or lapses, the tax treatment of such amount is unclear. *See* Voegelin, *supra* note 87, at 769-70. Property subject to an unexercised option to buy would not be treated as property representing a right to receive income in respect of a decedent. *See* text at notes 87-88 *supra*.

An additional complexity with respect to money is that decedent's successors may not receive the amount received but not reported by the decedent. In the partnership area, however, the Internal Revenue Service treats that part of a deceased partner's distributive share withdrawn before death as income in respect of a decedent and taxes it to his successors in interest. Treas. Reg. § 1.753-1(b) (1960).

106 Holland, *supra* note 19, at 368.

107 26 T.C. 318, 326 (1956), *aff'd*, 243 F.2d 577 (7th Cir.), *cert. denied*, 355 U.S. 830 (1957), *acquiesced in*, 1957-1 CUM. BULL. 4.

108 33 T.C. 1032 (1960), *acquiesced in*, 1960-2 CUM. BULL. 5.

109 1957-2 CUM. BULL. 361, *as amplified by* Rev. Rul. 60-227, 1960-1 CUM. BULL. 262. *Compare* Rev. Rul. 60-31, 1960-1 CUM. BULL. 174, 176, 179, example 3, involving deferred compensation.

decedent during his lifetime received in a liquidation of a corporation a right to royalty payments based on net profits from a patented pinsetter device, which the liquidating corporation had sold to another corporation, the right to royalty payments in the hands of decedent's successors was held to be a right to income in respect of a decedent.[110] Classification as income in respect of a decedent resulted from the facts that decedent's executor performed no activities with respect to the right to the royalty payments; that the amounts in question were attributable to the liquidating corporation's economic activity, as passed through to the deceased shareholder upon liquidation; and that the liquidating corporation's activities and efforts gave rise to a right to receive such income.[111] All purchase price payments received under decedent's sales contracts, completed or executory at death, regardless of whether the method of payment is a single payment in a fixed amount, installment payments, royalty payments based on the amount or value of production, or payments tied to net profits from the transferred property, are income in respect of a decedent because decedent possessed a right, contingent or otherwise, to the payments and the payments are the products of decedent's lifetime activities. One may predict that purchased rights to similar payments will also be income in respect of a decedent.

Similarly, claims in litigation at decedent's death for income lost by the decedent during his lifetime because of violations of the antitrust laws or infringement of his patents are items of income in respect of a decedent.[112] The basis for the conclusion is, apparently, that decedent had a contingent right to the income and had he lived such amount would have been taxable to him.[113] On the other hand, one decision held that where decedent's successors in interest receive a payment in settlement of a posthumous breach of decedent's contract to sell a partnership interest at death, such amount is not income in respect of a decedent because decedent never possessed a right to the payment.[114]

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110 Stephen H. Dorsey, 49 T.C. 606 (1968).

111 *Id.* at 632-33.

112 Carter v. Commissioner, 298 F.2d 192 (8th Cir. 1962), *cert. denied,* 370 U.S. 910 (1962); Rev. Rul. 55-463, 1955-2 CUM. BULL. 277. *See also* Edna S. Ullman, 34 T.C. 1107, 1114 (1960), holding an award from the Mixed Claims Commission under the provisions of the Settlement of War Claims Act of 1928 income in respect of a decedent.

113 Carter v. Commissioner, 298 F.2d 192 (8th Cir. 1962), *cert. denied,* 370 U.S. 910 (1962); Edna S. Ullman, 34 T.C. 1107, 1114 (1960). With this standard compare Holland, *supra* note 19, at 368: "Section . . . [691] cannot include every item of income and of appreciation in value of assets, *i.e.,* [it] cannot encompass all of gross income, since there would then be no room left for section . . . [1014(a)]."

114 Mandel v. Sturr, 266 F.2d 321 (2d Cir. 1959). Damage payments under an execu-

Both *Levin v. United States*[115] and *Marshal L. Noel*[116] characterized discount income as interest and held accrued discount income to be income in respect of a decedent.[117] *Levin v. United States* also held that unearned discount income is not income in respect of a decedent. In *Levin* decedent had purchased interest-bearing mortgage notes at a discount and at his death the fair market value of the notes exceeded his basis. A section 1014(a) fair market value basis was acquired for the notes because unearned discount income is unearned interest, which is not income in respect of a decedent unless earned before death, and which, like appreciation on common stock, is includible in the successor's section 1014(a) basis.[118] *Levin v. United States* is irreconcilable with *Francis E. Latendresse,* where purchased insurance renewal commissions were classified as income in respect of a decedent in the hands of decedent's successors and therefore denied a section 1014(a) fair market value basis at decedent's death.

RIGHTS TO INCOME UNDER LEASES AND LICENSES

Crops and livestock share rents of a deceased cash basis landlord are income in respect of a decedent[119] unlike the crops and livestock

tory contract to sell during life but breached after death would appear to be income in respect of a decedent under Trust Co. of Ga. v. Ross, 392 F.2d 694 (5th Cir. 1967).

115 373 F.2d 434 (1st Cir. 1967).

116 50 T.C. 702 (1968).

117 If original issue discount is interest, its treatment as income in respect of a decedent where accrued is clear. But if original issue discount realized on a sale or redemption of corporate obligations is to be treated as gain from the sale of a noncapital asset, as is apparently required by regulation § 1.61-7(c) and § 1232(a)(2), classification as income in respect of a decedent because accrued is improper since there is no basis for accruing gain from a sale until the sale has occurred. Section 1232(a)(2) was not applicable in *Marshal L. Noel. See* De Kosmian, *Original Issue Discount,* 22 ABA TAX SECTION BULL. 339, 345 (1969).

118 373 F.2d at 437, 439. In a representative example used by the court, decedent, a cash basis taxpayer, lends $8,000 for a $10,000 note plus 6% interest payable over four years. As he receives payments on account of the face amount, *i.e.*, excluding the 6% interest, he allocates 80% to discounted principal and 20% to discount income, reporting the latter in the year received. When he dies at the end of the second year he has received $4,000 on the face amount of the note, of which 80% or $3,200 was allocated to discounted principal, and 20% or $800 was allocated to discount income; the total accrued discount income was $1,000. Thus, at death the unpaid discounted principal was $4,800, and unpaid discount income was $1,200, of which $200 is income in respect of a decedent because earned before death. The note is valued at $5,580 for estate tax purposes and this value, less the $200 of income in respect of a decedent, is the § 1014(a) basis.

On the valuation of notes for estate tax purposes, see Rev. Rul. 67-276, 1967-2 CUM. BULL. 321.

119 Davis v. United States, 68-2 USTC ¶ 9483 (S.D. Ill. 1968); Davison v. United

of a farmer, which as property owned at death acquire a section 1014(a) fair market value basis.[120] Accrued rental or royalty income of a deceased cash basis lessor[121] or licensor[122] is income in respect of a decedent. But unlike rights to payments for decedent's services or rights to payments for completed or executory sales, income from leases or licenses is treated as income in respect of a decedent only to the extent accrued to the date of death. Unaccrued rents and royalties under leases and licenses are not income in respect of a decedent because they are not earned during decedent's life but are instead considered as income earned after the date of death by property passing to the estate.[123] Thus, rights transferred under leases and licenses are equated with retained rights and acquire a section 1014(a) fair market value basis in the hands of the deceased lessor's or licensor's successors in interest. If the property leased or licensed by a decedent is depreciable, the successors may recover its value at the decedent's death by deducting an allowance for depreciation from the income that it produces before computation of taxes.[124] On the other hand, rights to unaccrued payments under a partnership's lease or license will probably be con-

States, 292 F.2d 937 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961); Rev. Rul. 64-289, 1964-2 CUM. BULL. 173.

120 Tom L. Burnett, 2 T.C. 897 (1943), *acquiesced in*, 1944 CUM. BULL. 4, *as applied to* § 691 by Rev. Rul. 58-436, 1958-2 CUM. BULL. 366, 367-68, *modified*, Rev. Rul. 64-289, 1964-2 CUM. BULL. 173. Revenue ruling 64-289, 1964-2 CUM. BULL. 173, 175, specifically states that it is not applicable to crops or livestock "received in a sharing arrangement in which the landowner, as well as the tenant, participates materially in the farming operation."

121 Treas. Reg. §§ 1.691(a)-1(b)(1), (2) (1965); National Bank of Commerce v. Mathis, 61-2 USTC ¶ 9744 (E.D. Ark. 1961); Ostella Carruth, 28 T.C. 871, 877 (1957), *acquiesced in*, 1957-2 CUM. BULL. 4.

122 Rev. Rul. 60-227, 1960-1 CUM. BULL. 262.

123 *Id.*; Levin v. United States, 373 F.2d 434 (1st Cir. 1967) (dictum); United States v. Ellis, 264 F.2d 325 (2d Cir. 1959) (dictum); Grill v. United States, 303 F.2d 922 (Ct. Cl. 1962), *discussed in* note 73 *supra*. To the contrary is Davison v. United States, 292 F.2d 937 (Ct. Cl.), *cert. denied*, 368 U.S. 939 (1961), where the decedent died on December 24th with rents owing on two farm leases which ran for the calendar year. The court treated the cash and crop shares received by the estate as income in respect of a decedent because the rents were attributable to pre-death economic activities and were unaccrued at the lessor's death solely because they were not ascertainable in amount. However, revenue ruling 64-289, 1964-2 CUM. BULL. 173, provides that crop and livestock share rents attributable to a rental period after the lessor's death are not income in respect of a decedent.

124 *E.g.*, the devisees of a building subject to a long-term lease may, under § 1014(a) and § 167(g), take the fair market value of the inherited building at the time of death and recover its value by deducting an allowance for depreciation from the income it produces before computation of taxes. While the rent for the entire term is attributable to a contract executed during decedent's lifetime, posthumous rent is considered as income produced by the inherited building and is not income in respect of a decedent.

sidered unrealized receivables and treated as income in respect of a decedent.[125] One court has held that the statutory definition of "unrealized receivables" includes a right to future payments under an exclusive movie distribution contract.[126]

When property subject to a lease is inherited, a separate basis for the leasehold is usually denied on the ground that its value cannot be separated from the value of the reversion.[127] Amortization of the leasehold is therefore denied, and the right to depreciation deductions depends on the nature of the property that produces the income.[128] But if property subject to a favorable lease is inherited, or if a leasehold distinct from the reversion is inherited, there is authority allowing amortization of the leasehold. A devisee who inherits a favorable lease possesses the lease as an asset separate from the underlying property, and may amortize over the remaining term of the lease that part of the value of the inherited property attributable to the difference between the high rentals being obtained under the lease and those which could be obtained at the time of inheritance.[129] Similarly, where the decedent subleased property which he had leased, the devisee of the leasehold was allowed to amortize the value of the leasehold over its remaining term.[130] The premium value of a favorable

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125 Section 753 provides that § 736(a) payments to a successor in interest of a deceased partner are income in respect of a decedent. Section 736(b)(2)(A) provides that payments for unrealized receivables, as defined in § 751(c), are § 736(a) payments. Rights to unaccrued rent or royalty payments for the use of property are neither for goods to be delivered nor for services to be rendered and therefore fall outside the literal scope of § 751(c). Nevertheless, no reason for distinguishing under § 751(c) between rights to payments under these different kinds of executory contracts is evident, and Roth v. Commissioner, 321 F.2d 607 (9th Cir. 1963), refused to do so.

126 Roth v. Commissioner, 321 F.2d 607 (9th Cir. 1963) (alternative holding).

127 Hort v. Commissioner, 313 U.S. 28 (1941) (inherited building subject to lease providing fair market value rentals); *cf.* William R. Farmer, 1 B.T.A. 711 (1925) (taxpayer purchased land, then rented it; depreciation of cost denied because upon termination of the lease taxpayer still owns the land). *See* Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134 (1952).

128 *E.g.*, the value of an inherited building subject to a lease is depreciable whereas the value of inherited land subject to a lease is not.

129 Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954), *on remand*, 14 T.C.M. 869 (1955); Goelet v. United States, 7 CCH 1967 STAND. FED. TAX REP. ¶ 8159 (Commissioner's Report, Ct. Cl. 1967). To the contrary are Schubert v. Commissioner, 286 F.2d 573 (4th Cir.), *cert. denied*, 366 U.S. 960 (1961); Friend v. Commissioner, 119 F.2d 959 (7th Cir.), *cert. denied*, 314 U.S. 673 (1941). *See generally* Rubin, *supra* note 127; Comment, *Depreciation of Property Acquired Subject to a Long Term Lease*, 42 TEXAS L. REV. 72 (1963); Note, 67 HARV. L. REV. 894 (1954).

130 John W. F. Hobbs, 16 T.C. 1259 (1951), *nonacquiesced in*, 1951-2 CUM. BULL. 5. The devisee owned one-fifth of the property subject to the lease and the court allowed amortization of only four-fifths of the value of the leasehold.

lease and a leasehold inherited apart from the reversion are rights to income possessed by decedent at death and attributable to decedent's lifetime economic activities. Nevertheless, in the two cases where the argument was possible, the government has not asserted that such rights are income in respect of a decedent.[131] Instead, it concedes a section 1014(a) basis for the interest transferred, thus treating it as a retained interest, and argues that the owner of a fee cannot separate, for purposes of depreciation, the value of a lease from the value of the reversion.

As previously discussed,[132] all purchase price payments under decedent's sales contracts, completed or executory at death, regardless of the method of payment, are income in respect of a decedent because earned during the decedent's life. Why payments accruing after death under decedent's leases and licenses are unearned and not income in respect of a decedent is unclear. Sales, leases, and licenses are simply alternate methods employed by decedent during his lifetime for realizing economic gain from his property. Characterization of payments as "sales proceeds," "rents," or "royalties" cannot resolve the income-in-respect-of-a-decedent issue because that issue depends on whether decedent possessed a conditional right to the income and whether the payments are attributable to decedent's lifetime activities. Answers to these questions are not supplied by a characterization of the payments. Methods of payment under a lease or license are indistinguishable from methods of payment under sales contracts. Either may be a single payment in a fixed amount, installment payments, royalty payments based on the amount or value of production, or payments tied to net profits from the transferred property. While a lease or license involves a temporal division of the property, a section 1014(a) fair market value basis for the reversion is conceded with the issue being the income tax treatment of the right to payments for the interest transferred.[133] Similarly, where property is divided by use a

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131 Schubert v. Commissioner, 286 F.2d 573 (4th Cir.), *cert. denied,* 366 U.S. 960 (1961); John W. F. Hobbs, 16 T.C. 1259 (1951), *nonacquiesced in,* 1951-2 CUM. BULL. 5. The other cases, Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied,* 347 U.S. 942 (1954), Friend v. Commissioner, 119 F.2d 959 (7th Cir.), *cert. denied,* 314 U.S. 673 (1941), and Goelet v. United States, 7 CCH 1967 STAND. FED. TAX REP. ¶ 8159 (Commissioner's Report, Ct. Cl. 1967), concerned devises which antedated § 126.

132 *See* text at notes 72-118 *supra.*

133 The crucial question is normally whether the transferred rights or the substituted right to payments therefor will receive a § 1014(a) fair market value basis or a § 1014(c) decedent's basis. In Charles G. Barnes, 8 B.T.A. 360 (1927), *nonacquiesced in,* VII-1 CUM. BULL. 36, 40 (1928), a case antedating § 126, the decedent had sold a patent for a right to royalty payments, and the royalty contract acquired a fair market value basis in the hands

section 1014(a) basis is conceded for uses retained, *i.e.*, not sold, leased, or licensed by the decedent. When the contract, whether a sale, lease, or license, was executed, decedent during his lifetime obtained at least a contingent right to the payments. Payments under leases and licenses are as much the product of decedent's lifetime activities as purchase-price payments. The extent and nature of obligations performable by decedent's successors in interest under a sales contract may be more or less than the obligations performable under a lease or license.

Moreover, characterization of payments as sales proceeds, rents, or royalties, for purposes of section 691 classification, introduces needless artificial distinctions and uncertainty. The reference to a sale in revenue ruling 60-227,[134] which interprets section 691 to apply to unaccrued royalties from sales but not licenses, presumably refers to transfers constituting sales for tax purposes and not to state law definitions. Concerning patents and copyrights, the tax definition of "sale" is broad, including exclusive licenses of rights under a patent or copyright.[135] But in transactions involving mineral interests the tax definition of "sale" is narrow. These varying tax definitions of "sale" will produce unequal income tax treatment between estates owning different kinds of rental property. Thus, posthumous royalties resulting from conveyances treated as sales, such as a copyright owner's grant of an exclusive license to exploit the copyrighted work in a medium of publication throughout the life of the copyright, will be income in respect of a decedent because earned during life, while posthumous royalties resulting from conveyances treated as leasing transactions, such as a landowner's sale of the minerals reserving some form of cost-free interest in the nature of a royalty,[136] or a lessee's assignment of his interest reserving a fractional cost-free share in pro-

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of decedent's successors. In John L. Whitehurst, 12 B.T.A. 1416 (1928), *nonacquiesced in*, VIII-1 Cum. Bull. 62 (1929), another case antedating § 126, the decedent had granted an exclusive license to use certain patents in exchange for a right to royalty payments, and the patents subject to the license received a fair market value basis in the hands of decedent's successors.

With some assets the § 691 classification issue also affects the character of the income. For example, copyright rights in the estate's hands, unlike in the author's hands are capital assets under § 1221(3), unless § 691(a)(3) applies.

134 1960-1 Cum. Bull. 262. This ruling described an author's transfer of publication rights as a sale. For discussion see Earl & Middleditch, *Copyrights and the Author's Estate*, 53 A.B.A.J. 366, 369-70 (1967).

135 § 1235 and Rev. Rul. 58-353, 1958-2 Cum. Bull. 408, dealing with patents; Rev. Rul. 60-226, 1960-1 Cum. Bull. 26, dealing with copyrights.

136 United States v. White, 401 F.2d 610 (10th Cir. 1968); GCM 27322, 1952-2 Cum. Bull. 62. *See also* Galvin, *The "Ought" and "Is" of Oil-and-Gas Taxation*, 73 Harv. L. Rev. 1441, 1484 & n.133 (1960).

duction,[137] are not income in respect of a decedent because they have not been earned during life.[138] Similarly, payments received in discharge of retained production payments would not be income in respect of a decedent because a production payment as a retained economic interest in the minerals is the antithesis of a sale.[139] In addition, whether a transfer is a lease or sale can be unclear, and genuinely contingent contracts, such as leases with options to purchase, will require special treatment.[140]

SUMMARY AND CONCLUSION

Any rights to income attributable to decedent's services rendered while living are income in respect of a decedent because both the right to the income and its receipt are attributable solely to decedent's services. Concerning partnerships, consideration received for the value of decedent's right to render services in the future under contracts in existence at death is also income in respect of a decedent. Property received during life as compensation for services, but not taxed before death because of restrictions precluding valuation or because of a statutory exclusion from income conditioned on a reduction in basis, should be treated in the hands of decedent's successors as income in respect of a decedent. This appears to be the treatment accorded in most cases.

Rights to payments under completed sales, and under executory contracts to sell, except where by the terms of the contract the sale is to occur only after death, are income in respect of a decedent. The government distinguishes executory contracts to sell after death from other executory sales contracts because, in its view, section 691 is only applicable where the decedent intended to realize income during his

137 GCM 22730, 1941-1 CUM. BULL. 214, 216.

138 *Cf.* Rev. Rul. 66-348, 1966-2 CUM. BULL. 433, holding that proceeds received by an estate from the extraction and sale of minerals during the alternate valuation period do not constitute amounts to which a decedent was entitled as gross income and therefore cannot constitute income in respect of a decedent.

139 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 422 (1968); Rev. Rul. 60-19, 1960-1 CUM. BULL. 251.

140 J. Strickland & Co. v. United States, 352 F.2d 1016 (6th Cir. 1965), *cert. denied,* 384 U.S. 950 (1966) (contract in the form of a license of trademarks with option to purchase held a contract of sale); Kitchin v. Commissioner, 353 F.2d 13 (4th Cir. 1965) (genuinely contingent lease-or-purchase agreement treated as lease until option to purchase is exercised); Note, *Federal Income Tax Treatment of Equipment Lease-Or-Purchase Agreements,* 52 VA. L. REV. 1336, 1350-59 (1966). Revenue ruling 55-540, 1955-2 CUM. BULL. 39, provides economic tests to be applied when the issue is whether the taxpayer should be treated as the owner or lessee of equipment which he in form rents as lessee.

lifetime and, but for his death, would have done so. The basis for the distinction is questionable. Concerning partnerships, the same rules apply with three variations: rights to payments under sales of capital assets are not income in respect of a decedent, rights to payments otherwise income in respect of a decedent remain so where a partnership interest is to be liquidated only after the partner's death, and rights to payments for potential section 617, 1245, and 1250 gain are also income in respect of a decedent. Evidently, all sales proceeds received under decedent's contracts, completed or executory at death, regardless of the method of payment, are considered income in respect of a decedent because decedent possessed at least a contingent right to the payments and the payments are considered attributable to decedent's lifetime activities.

Purchased rights to income will probably be considered analogous to gain on a sale and treated as income in respect of a decedent. Several cases have classified purchased rights to income as income in respect of a decedent, but the reasons for such classification are unclear. *Levin v. United States*[141] held that unearned discount income was not income in respect of a decedent, but the court characterized the discount income as interest.

Interest payments and payments under leases and licenses are not income in respect of a decedent unless accrued before death. Accrual accounting is adopted as an exclusive test, with income accrued after death considered as income produced by the property passing to the estate. The criteria used to classify other kinds of income as income in respect of a decedent—whether or not decedent possessed a conditional right to the proceeds and the relationship between decedent's activities and receipt of the proceeds—are abandoned without explanation. The basis for distinguishing rights to payments under leases and licenses from rights to payments under sales contracts or employment contracts is unclear. Characterization of income as sales proceeds, rent, or royalty income is difficult, and different property interests receive different income tax treatment because of the multiple tax definitions of sale and lease. The partnership definition of income in respect of a decedent probably includes rights to payments under leases and licenses.

A few tax planning points concerning the acquisition of a section 1014(a) fair market value basis are evident. Leasing, licensing, or borrowing against appreciated assets is preferable to a pre-death sale or contract to sell. When a sale is desired, division of the property either

141 373 F.2d 434 (1st Cir. 1967).

temporally or by use will preserve the possibility of a section 1014(a) basis for the unsold rights in the event of death. A provision nullifying a contract to sell upon the seller's death should be considered, especially where a substantial period will elapse between execution of the contract and its consummation. Sales of capital assets on a deferred payment basis should be made through partnerships. Installment obligations arising from an individual's sale of capital assets which are contributed to a partnership may elude section 691. Property subject to the depreciation recapture rules should be owned individually and not by a partnership.

Section 126, adopted in 1942, established for the first time that unrealized appreciation on certain property, referred to as items of gross income in respect of a decedent, would no longer escape income taxes because of the death of the owner. The rule was carried over into section 691 of the 1954 Code and today occupies a substantial area formerly held by section 1014(a). Under the current concept of income in respect of a decedent, acquisition of a section 1014(a) fair market value basis or retention of a section 1014(c) decedent's basis does not depend solely on a distinction between property and rights to income but also depends on distinctions between rights to different kinds of income. Thus, the successor's income tax bill, like the estate tax bill, depends to a considerable degree not on the value of what decedent leaves, but on how he leaves it.