

ACCRUALS TO DATE OF DEATH FOR INCOME TAX PURPOSES

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In the January, 1939, issue of this REVIEW,¹ Charles Parlin discussed the meaning of the term "accrual" in Section 42 of the Revenue Act of 1934,² and considered whether certain types of income, such as fees of a law partnership and commissions due a deceased executor or trustee, had accrued so as to be included in the decedent's last income tax return. Since that time the Supreme Court in *Helvering v. Estate of Enright*³ has held that "accrual" as used in Section 42 is to be interpreted, not in light of past cases dealing with accrual of income, but in the light of the purpose of Congress in enacting Section 42, namely, to cover into income items subject to the estate tax but which might escape income taxation altogether. Mr. Parlin pointed out that the Bureau of Internal Revenue was contending that there was an accrual of income under Section 42 if it was "reasonably probable that a determinable amount of money would be paid in the future". Following the *Enright* decision, the Bureau of Internal Revenue is pressing that contention with renewed vigor, claiming that there is an accrual under Section 42 if the decedent had any connection with the transaction,⁴ or if there is any possibility of valuing the decedent's right.⁵ Such claims make necessary a review of the decision in the *Enright* case and of the cases following it.

The Enright Case

In the *Enright* case⁶ the decedent was a partner in a law partnership and after his death his interest under the partnership agreement was computed by his partner Carpenter as follows:

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1. *Accruals to Date of Death for Income Tax Purposes* (1939) 87 U. OF PA. L. REV. 295. See also Farrand & Farrand, *Treatment of Accrued Items in the Event of the Death of a Taxpayer* (1940) 13 SO. CALIF. L. REV. 431.

2. This section provides: "In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of death, amounts accrued up to the date of his death. . . ." 48 STAT. 694, 26 U. S. C. A. § 42 (1934). This section was continued in the Revenue Acts of 1936 and 1938, and in the Internal Revenue Code. 49 STAT. 1666 (1936), 26 U. S. C. A. § 42 (Supp. 1937); 52 STAT. 447, 26 U. S. C. A. § 42 (Supp. 1938); INT. REV. CODE § 42.

3. 312 U. S. 636 (1941).

4. Estate of Taggart, C. C. H. B. T. A. Serv., Dec. 12,167-C, Nov. 3, 1941 (memo. opinion).

5. Estate of Francis Smyth, C. C. H. B. T. A. Serv., Dec. 11,842-E, May 31, 1941 (memo. opinion).

6. 312 U. S. 636 (1941). The Court did not discuss the constitutionality of Section 42. However, in view of the Court's decision against the taxpayer, the question of constitutionality can no longer be considered open.

1. Interest in fees collected	\$4,143.81
2. Interest in accounts receivable	2,055.55
3. Interest in estimated work	40,855.77

Of the cases in the second and third group nine were being handled on a fixed fee basis and in the remainder a reasonable fee was to be paid for work done. As to fees contingent on the outcome of the case, the evidence, as stated by the Board of Tax Appeals, was that "only a few cases were being handled upon a contingent fee basis and such cases Carpenter valued in his estimate at one dollar."⁷ The Board decided against the executors on the ground that the evidence did not show which fees had accrued, and used Carpenter's estimates in computing the tax due. The Circuit Court of Appeals for the Third Circuit reversed on the ground that Section 42 did not require the accounts of the partnership to be put on an accrual basis.⁸

The Petition for Certiorari filed by the Department of Justice stated that the question was whether "income earned, but not yet received" should be included in gross income. The Supreme Court reversed the decision of the Third Circuit Court, holding that the decedent's death dissolved the partnership and the decedent's estate was entitled to an accounting to date of death, and further, that the estimated amount of fees had accrued. In defining "amount accrued" the Court said:

"The meaning of 'amounts accrued up to the date of his death' is clear as to fixed rent, interest, salary or wages for personal services and other similar income which may readily be attributed to a particular period. There are like deductions such as interest and taxes. The uncertainty as to the meaning arises in the field of personal service from items which cannot be accounted for on a basis of successive equal units of time. Examples of the difficulty are the value, prior to a successful result, of services rendered on a contingent basis, done on a quantum meruit whether that would or would not vary with the outcome, or exploratory or preliminary steps looking towards final accomplishment."⁹

7. C. C. H. B. T. A. Serv., Dec. 10,808-B, Aug. 28, 1939 (memo. opinion). The question of the amount of the accrual remains. This amount should be the value of the decedent's right on date of death and not the amount actually collected as the Commissioner has contended. Estate of Ledyard, 44 B. T. A. 1062 (1941). The Board recognized this Rule in Estate of McGlue, C. C. H. B. T. A. Serv., Dec. 12,234-D, Dec. 31, 1941 (memo. opinion), but held the accrual of executors' fees equalled the amount actually collected and rejected testimony that no one would purchase the right to such fees.

8. 112 F. (2d) 919 (C. C. A. 3d, 1940).

9. 312 U. S. 636, 643 (1941).

After pointing out that the word "accrual" had no fixed meaning in the law, the Court stated:

"Accruals here are to be construed in furtherance of the intent of Congress 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. Congress sought a fair reflection of income."¹⁰

As to the items in question:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income.' *The completion of the work in progress was necessary to fix the amount due but the right to payment for work ordinarily arises on partial performance.* Accrued income under § 42 for uncompleted operations includes the value of the services rendered by the decedent, capable of approximate valuation whether based on the agreed compensation or on quantum meruit."¹¹

Pfaff v. Commissioner,¹² decided the same day as, and on the basis of, the *Enright* case, held that the decedent's return should have included the estimated value of fees of a medical partnership.

Particular note should be made of the fact that the *Enright* case involved only collected but undistributed fees and fees for work done on a fixed fee or quantum meruit basis, and that it did not involve fees for work done on a purely contingent basis. The Court in the sentence italicized above, points out that "accrual" here means the right to income and that although completion of the work was necessary to fix the amount of the compensation, the right to payment arose as the work was done. Such is the nature of quantum meruit; a right to compensation arises as the work progresses.¹³ Here then is the decision of the *Enright* case—if the decedent was entitled, at the time of his death; to payment for work done though the amount was not then fixed, there is an accrual under Section 42. A distinction is to be observed between income to which the decedent is entitled in some amount, the amount to be fixed after his death, and cases in which it is uncertain at the time of death whether the decedent will ever receive any amount. Such being the rule of the *Enright* case, do the cases following it apply that rule?

10. *Id.* at 644.

11. *Id.* at 645. (Italics supplied.)

12. 312 U. S. 646 (1941).

13. *Sargent v. McLeod*, 209 N. Y. 360, 103 N. E. 164 (1913).

Fees of a Law Partnership

Fees of a law partnership are, at the time of death, generally of the following types:

1. Collected but not distributed.
2. Billed but not collected.
3. Fixed on a monthly or yearly basis.
4. Based on value of work done.
5. Contingent on the outcome of the case.

That there is an accrual of the first four types of fees has been settled by the *Enright* case. Patent attorneys often bill clients each month on the basis of time spent on the client's matters. In this type of case there would clearly be an accrual of the amount billed in the year of death and the amount unbilled in the month of death to the date of death. As to contingent fees, no right exists to payment of any amount until completion of the case, and no right existing, there is no accrual. The *Enright* case did not consider this type of fee and in no case decided since the *Enright* case has it been held that there would be an accrual under Section 42 of a contingent fee.¹⁴ In such case there is no fixed right to payment of any amount at date of death. Although such an expectancy might have value depending upon one's appraisal of the case at hand, there is no accrual of income. If there is not even an expectancy, of course there is no accrual. Such a case was *Peyton v. Commissioner*.¹⁵ In that case the decedent was a member of a law partnership which had entered into a fee agreement with a client before the decedent's death, providing that payment of the fee stated in the agreement was to be made one-half upon the release of certain funds by the Court and one-half at the end of the litigation. Practically all of the work was done after decedent's death and the events upon which payment depended happened after the decedent's

14. In Estate of Wickersham, 44 B. T. A. 623 (1941), the Board considered the accrual of a decedent's interest in a law partnership, stating that the fees of the partnership which had accrued to a deceased partner under Section 42 consisted of periodic retainers, of fees fixed by agreement and of fees for uncompleted work being done on a quantum meruit basis. In Estate of Smyth, C. C. H. B. T. A. Serv., Dec. 11,842-E, May 31, 1941 (memo. opinion), the Board held that there had been an accrual of fees of a partnership which had been collected but not distributed, and of fees for work being completed but on which no fee had been fixed. In Estate of Smith, C. C. H. B. T. A. Serv., Dec. 11,848-B (memo. opinion), the Board held that there had been an accrual of fees of a law partnership and stated "in none of the cases in question was the firm retained on a contingent basis". In Estate of Ledyard, 44 B. T. A. 1062 (1941), no amount was included under Section 42 for any work being done by the decedent's law firm on a contingent basis. In all of these cases a right to some compensation existed at the time of decedent's death; no uncertainty existed about the fact that there would be some payment.

15. 44 B. T. A. 1248 (1941).

death. The firm did not consider that the decedent had any legal right to share in the fee but paid an amount to his estate for moral reasons. The Board distinguished the *Enright* case and held there had been no accrual to the decedent under Section 42 of the Revenue Act of 1934.

Would the result have been different in the *Enright* case if the partnership had been on the accrual basis? Prior to completion of legal work, there is no ordinary accrual of income.¹⁶ Mr. Parlin has pointed out that there can be an accrual when the fee is fixed and a bill rendered, but work in the process of completion cannot be accrued.¹⁷ Hence, the result would be the same except as to items that might have been included in a prior year's return by reason of this method of accounting, and the Supreme Court so stated:

"This will cause the accrued items of partnership returns to be included in the income tax return of a deceased partner, whether the partnership method is accrual or cash."¹⁸

Similarly, it would not matter that the partnership did not end with decedent's death. The problem is to determine the decedent's distributive share and that problem remains whether the partnership terminates or not. An analogous situation was considered by the Board in *Estate of MacFarlane*,¹⁹ in which the partnership agreement provided that upon death of one of two partners, the survivor should own all the accounts receivable. While the facts as stated by the Board do not show the precise interest the decedent had in the firm, this interest was valued and treated as accrued income.

What then of a provision in the partnership agreement that a deceased partner shall have no interest in the firm business, but his estate shall continue as a partner for a specified period, or that life insurance proceeds from policies on which the premiums were paid by the firm be accepted in lieu of an interest in the firm. Or again, the partnership agreement might provide that income during a specified period be accepted in payment for the deceased partner's interest. In none of these three cases could there be an accrual under Section 42 as all right in the firm business ends on death. *Bull v. United States*²⁰ controls the first case—the estate is a partner and income received by it is estate income. Note that although the right to continue as a partner has value, that fact should not result in an accrual under Section 42. In the second case all right in the firm ceases and there is

16. Parlin, *Accruals to Date of Death for Income Tax Purposes* (1939) 87 U. of PA. L. REV. 295, 307.

17. *Ibid.*

18. 312 U. S. 636, 642-643 (1941).

19. C. C. H. B. T. A. Serv., Dec. 12, 139-F, Oct. 21, 1941 (memo. opinion).

20. 303 U. S. 645 (1938).

nothing to accrue. Nor could there be a purchase of the decedent's interest in the firm as the premiums which were paid by the firm would have been paid by the decedent and the proceeds of the life insurance treated the same as any other proceeds from policies on which the decedent paid premiums.²¹ In the third case, there is a sale of the partnership interest to the surviving partners and the amount paid to the estate is paid as capital.²²

Corporate Dividends

In this type of case it has been recognized that no accrual results unless the relationship of debtor and creditor existed between the corporation and the decedent at the time of death. If, under the local law, the declaration of a dividend creates this relationship and the decedent dies after that date but before the record date of the dividend, there has been an accrual of income.²³ On the other hand, if the declaration of the dividend does not create a debtor-creditor relationship, but that relationship arises only on the record date of the dividend and the decedent dies between the date of declaration and the record date, there is no accrual under Section 42.²⁴

Trust Income

A trust instrument may provide that upon the death of the life beneficiary, income is to be treated in one of three ways:

1. Income collected and unpaid, or income accrued, is to go to the holder of the next estate.
2. Income collected but unpaid at date of death is to be paid to estate of deceased beneficiary.
3. Income is to be accrued to date of death and is to be paid to the estate of the deceased beneficiary only when collected.

In the first case clearly no accrual results under Section 42. On the other hand, in the second case, the income collected but unpaid could constitute an accrual. In the third case, the Circuit Court of Appeals for the Third Circuit in *Bach v. Rothensies*,²⁵ decided on

21. See Paul Legallet, 41 B. T. A. 294 (1940); Estate of Mitchell, 37 B. T. A. 1 (1938); M. W. Dobrzensky, 34 B. T. A. 305 (1936); PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) § 10.18.

22. Bull v. United States, 303 U. S. 645 (1938); Estate of Nutter, 46 B. T. A. No. 4, Jan. 7, 1942.

23. Helvering v. McGlue's Estate, 119 F. (2d) 167 (C. C. A. 4th, 1941); Commissioner v. Cohen, 121 F. (2d) 348 (C. C. A. 5th, 1941).

24. Estate of Putnam, 45 B. T. A. No. 84, Oct. 28, 1941.

25. 124 F. (2d) 306 (C. C. A. 3d, 1941), *certiorari applied for*, March 6, 1942.

December 8, 1941, held that there had been an accrual under Section 42 to the beneficiary of a trust which provided that the beneficiaries were to receive income only when collected. In that case the accrual was of the amount of income accrued on the trust assets and not collected to the date of decedent's death. The Court held that there was no legal contingency as to the decedent's right to the income and it was in fact received by the decedent's estate.

Trustees Commission

As Mr. Parlin pointed out, before a deceased executor or trustee is entitled to commission based on principal, his personal representative must "(a) render on behalf of the deceased executor an account, (b) satisfy the beneficiaries and the court that the deceased properly discharged his fiduciary duties, and (c) satisfy the beneficiaries and the court that the services actually rendered by the deceased warrant the allowance as requested."²⁶

Although the amount of trustees' commissions must be fixed or approved by the Court having jurisdiction of the trust, the work has been done by the decedent in his lifetime and the decedent is entitled to some compensation unless it appears that the decedent's conduct as trustee would prevent the Court from allowing any commissions. Merely the amount remains uncertain. In *Helvering v. McGlue's Estate*,²⁷ the Court of Appeals for the Fourth Circuit held that such fees had accrued under Section 42 of the Revenue Act of 1934. At page 170 the Court stated:

"Certainly there is no contingency or uncertainty qualifying respondent's right to at least a quantum meruit recovery. Cf. *Seattle First Nat. Bank v. Henrickson*, D. C. W. D. Wash. 1938, 24 F. Supp. 256, appeal dismissed 9 Cir., 1939, 100 F. 2d 1015. Under Section 42, respondent's claim was 'fixed', rather than 'inchoate' or 'in the process of becoming'."

In the foregoing quotation the Court recognizes that it is considering a case in which the right to some compensation has become fixed during the decedent's lifetime and only the computation of the amount remains to be done after his death.

The Board of Tax Appeals has recognized the same rule in *Estate of Wickersham*²⁸ and *Estate of Ledyard*.²⁹ The Board's deci-

26. Parlin, *Accruals to Date of Death for Income Tax Purposes* (1939) 87 U. OF PA. L. REV. 295, 313.

27. 119 F. (2d) 167 (C. C. A. 4th, 1941).

28. 44 B. T. A. 623 (1941).

29. 44 B. T. A. 1062 (1941).

sion in *Estate of Robinson*³⁰ might appear to be contrary to that rule. In that case the Board held there was an accrual of trustee's commissions even though the decedent had agreed not to take any commissions until the termination of the trust which, in fact, had not terminated prior to his death. However, the facts show that no provision was made regarding commissions if the decedent died before the termination of the trust. Under those circumstances the decedent was entitled at the time of his death to some commission for the work done to date of death and an amount was finally allowed by the Court. Thus the right to some payment existed at the time of the decedent's death.

Other Commissions

Commissions may be payable when an order is accepted or when goods are shipped. If the order received by a decedent is accepted before death and he is then entitled to a commission, income is then accrued. If the commission is payable only when the goods are shipped and the decedent dies before shipment, there should be no accrual. The decedent's right is still subject to contingency, namely, completion and shipment of the goods. The Board considered this type of case in *Estate of Taggart*,³¹ and held that there was an accrual. The decedent had an oral arrangement with a pump company under which he was entitled to commission on business received when pumps were shipped and invoiced. Certain pumps were ordered through decedent before his death. After his death the specifications for the pumps were changed materially and the Board found that if the changes had not been mutually satisfactory, neither party would have been liable. The president of the seller company and the decedent's attorney testified that decedent had no right to any commission at the time of his death and no right at any time to any commission by reason of the transaction. The amount paid decedent's executors was returned by them as income. The Board admitted that if the changes made had not been satisfactory, no payment would have been made but said the decisive fact was that "the transaction was consummated and payment was received", and then:

"Since we are of the opinion that enough was done toward the placing of these orders before decedent's death to demonstrate that his services were responsible for the payment ultimately made to his estate, we cannot escape the conclusion that the proceeds are taxable as his income earned by him through the connection he had with the transaction while he was alive."³²

30. C. C. H. B. T. A. Serv., Dec. 12,253-A, Jan. 16, 1942 (memo. opinion).

31. C. C. H. B. T. A. Serv., Dec. 12,167-C, Nov. 3, 1941 (memo. opinion).

32. *Ibid.*

That case on its facts is *contra Estate of Peyton*³³ as the uncontradicted evidence was that the decedent had no right to any commission. Moreover, as the facts fixing right to payment occurred after the decedent's death, the case is *contra* the theory of *Bull v. United States*.³⁴ The *Taggart* case is the only case in which an accrual has been found where no right to compensation existed at the time of decedent's death.

Income Earned but Unreported

In *Estate of Letz*,³⁵ the decedent had received notes for salary for several years and had not reported the value of the notes as income. Upon his death the Commissioner contended that all notes so received were "accruals" under Section 42. The Board found that the notes should have been reported by the decedent as income in the years when they were received and hence were not items to be accrued in the decedent's last return.

Pension Trust and Salary Agreement

As Mr. Parlin pointed out, any salary or profit-sharing agreement that permitted computation of the amount to date of death, such as an agreement calling for monthly compensation, results in an accrual under Section 42. Similarly, a fixed salary to be paid for a fixed period of years after date of death to decedent's estate or persons named by the decedent would result in an accrual. Hence, it becomes necessary to review all salary arrangements and pension trusts in the light of the *Enright* case. What of a profit-sharing arrangement that calls for a share of profit based on a year's operations? *Fehrman v. Commissioner*,³⁶ decided before the *Enright* case, held Section 42 did not apply to such a case. At the time of the decedent's death, all of the facts fixing his right to compensation have not occurred. Operating losses between the date of death and end of the year may well prevent any payment. Such a contingency goes not alone to valuation of the right; it goes also to the very existence of the right.³⁷

Insurance Agents

An insurance agent is, under his contract, entitled to a portion of the first premium paid by the insured and to a percentage of subsequent

33. 44 B. T. A. 1248 (1941).

34. 303 U. S. 645 (1938).

35. 45 B. T. A. No. 157, Dec. 16, 1941.

36. 38 B. T. A. 37 (1938).

37. Cf. *Estate of Kirchner*, 46 B. T. A. No. 71, March 11, 1942.

premiums paid for a certain period. If the insured dies or cancels his policy so that no premiums are paid, the agent receives no commission. Considering such commissions which might be paid after deceased agent's death, the Court held (before the *Enright* decision) in *Seattle First National Bank v. Hewricksen*,³⁸ that Section 42 did not apply. In this type of case, although the decedent has done all the work required, all of the facts necessary to fix decedent's right have not occurred, and there would seem to be no accrual under Section 42. The Court of Appeals for the Fourth Circuit, in the quotation set forth above, referred to the *Seattle First National Bank* case as one to be contrasted with cases involving trustee's commissions.

Moreover, in this type of case, it may be argued that there is no income which escapes taxation, as income is not realized until each premium is paid. At the time of the decedent's death he had an expectancy of future income under his contract with the insurance company. The income was inchoate, in the process of becoming; nothing had accrued at the time of his death. As in the case of dividends which, under local law, become debts of the corporation only on the record date, upon declaration of the dividend there is an expectancy but unless the stock is held on the record date, there is no accrual.³⁹ Other illustrations are rent and interest. Upon the decedent's death, there is a right to rent or interest under the lease or bond and the rent or interest collected thereafter is income to the decedent's estate.⁴⁰ The Commissioner has never contended that such rent or interest payable over the whole term of the lease or bond constitutes an accrual at the date of death.⁴¹ The dividends, rent or interest are severed from the right to them and are income. So here, the decedent's rights under the contract have value as do stock, leases or bonds, but the income severed from that right does not exist at the date of death but comes into being, or accrues, only when the premiums are paid by the insured.

Helvering v. Eubank,⁴² holding that an assignor of insurance renewal premiums remains liable for taxation upon the commissions when paid supports this view. In that case the assignor was not taxed on the present right to receive income in the future at the time of the assignment; the assignor was taxed in the year the commission was paid to the assignee. Here the Supreme Court recognizes that income arises only when the commission is paid.

38. 24 F. Supp. 256 (W. D. Wash. 1938), *appeal dismissed on motion of defendant*, 100 F. (2d) 1015 (C. C. A. 9th, 1939).

39. Estate of Putnam, 45 B. T. A. No. 84, Oct. 28, 1941.

40. Cf. *Maass v. Higgins*, 312 U. S. 443 (1941).

41. I. T. 3343, 1940—1 CUM. BULL. 21.

42. 311 U. S. 122 (1940).

Conclusion

As yet no decision (with the possible exception of *Estate of Tagger*) has adopted the Commissioner's test of items being accruable if it is reasonably probable an amount will be paid. Nevertheless, Section 42 as requiring a piling up of income in the decedent's last return is a harsh provision and unduly discriminates against a person who earns income. Earned income for future years is taxed in one year, while investment income from bonds or leases is taxed as it is received. The Internal Revenue Code should be amended so as to tax the payments made after decedent's death as income when they are received. To amend the Code would carry out the purpose of Congress in enacting Section 42 to prevent such income from escaping taxation. In order to avoid any constitutional question regarding such an amendment it should give the taxpayer the option of reporting the income under Section 42 or, upon filing a bond satisfactory to the Commissioner of Internal Revenue, of reporting as income when received the amount which would have constituted income to the decedent if he had lived and received such amount.⁴³ Section 43 of the Internal Revenue Code should also be amended to disallow the accrual of deductions connected with income reported under the proposed amendment to Section 42. The Treasury Department has now recommended to Congress that the Internal Revenue Code be so amended⁴⁴ and the Revenue Act of 1942 should contain such amendments.

43. The income would be reported under the proposed amendment on the taxpayer's usual accounting method, either the cash or accrual method.

The American Bar Association favors eliminating personal service income from Section 42. At its 1941 meeting the House of Delegates approved a resolution of the Section on Taxation that Section 42 be amended to read as follows:

"SECTION 42. *Period in Which Items of Gross Income Included.*

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts (*other than undetermined amounts for personal services*) accrued up to the date of his death if not otherwise properly includable in respect of such period or a prior period."

American Bar Association, Section on Taxation, *Summary of Action Taken at Annual Meeting in Indianapolis, Indiana*, p. 14.

See also Paul, *Suggested Income Tax Revisions*, NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THIRTY-FOURTH NATIONAL CONFERENCE, 1941, pp. 381, 388.

44. Statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury, before the Ways and Means Committee of the House of Representatives, March 3, 1942.