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FEDERAL ESTATE TAX ON INCOME ACCRUING AFTER DEATH

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PRIOR to the enactment of Section 302(j) of the Revenue act of 1926, as added by Section 202(a) of the Revenue Act of 1935,[1] neither the statutory law nor Treasury regulations interpretative thereof required the inclusion in the gross estate owned by a decedent on the date of death of income accruing to the estate after the decedent's death for the purpose of determining the federal estate tax. Nor does Section 302(j) appear to require the inclusion of such income in the gross estate.[2]

Since Section 302(j) deals only with the *date* of the valuation of the gross estate, one may question how "all the property included therein on the date of the decedent's death" can include, by virtue of Section 302(j), after-accrued income which was never owned by the decedent. Yet Article 11 oi U. S. Treasury Regulations 80,[3] purporting to interpret the section, requires the inclusion of such income; and the interpretation has been upheld by the United States District Court for the Southern District of New York in *Saks* v. *Higgins*,[4] a case of first impression, in an opinion rendered October 27, 1939.

Article 11 begins by stating:

> In general, the object of subdivision (j) of section 302 is to make provision whereby the amount of tax otherwise payable may be lessened

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1 Section 811(j), I.R.C.

2 "(j) Optional Valuation—If the executor so elects upon his return (if filed within the time prescribed by law or prescribed by the Commissioner in pursuance of law), the value of the gross estate shall be determined by valuing all the property included therein on the date of the decedent's death as of the date one year after the decedent's death, except that (1) property included in the gross estate on the date of death and, within one year after the decedent's death, distributed . . . shall be included at its value as of the time of such distribution . . . instead of its value as of the date one year after the decedent's death, and (2) any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death . . . with adjustment for any difference in its value as of the later date not due to mere lapse of time. . . . In case of an election . . . any bequest, legacy, devise, or transfer . . . enumerated therein shall be valued as of the date of decedent's death with adjustment. . . ."

3 1937 ed. 4 29 F. Supp. 996 (1939).

when, within the year following the decedent's death, the gross estate has suffered a shrinkage in its aggregate value.

If the decedent died after August 30, 1935, the executor may by an election upon his return, . . . have the property which was included in the gross estate on the date of the decedent's death valued as of the applicable dates, as follows:

(1) . . . .

(2) Any property not distributed, sold, exchanged, or otherwise disposed of within such 1-year period, valued as of the date one year after the date of the decedent's death . . . .

Before examining following portions of the article in order to determine why, in view of the language, "property . . . on the date of death," income accrued to the estate after the decedent's death is subject to estate tax, several points should be noted.

First, the federal estate tax law does not define *value,* nor prescribe how it shall be determined, except as it refers to "fair market value," where transfers for insufficient consideration are involved.[5] The determination was left to be prescribed by regulations of the Treasury Department.[6]

Secondly, the prescribed method for determining the value of the gross estate for estate tax purposes is found in Article 10 of U. S. Treasury Regulations 80, where it is stated in part:

Valuation of Property.—(a) General.—The value of every item of property includible in the gross estate is the fair market value thereof at the time of the decedent's death; or, if the executor elects in accordance with the provisions of article 11,[7] it is the fair market value thereof at the date therein prescribed or such value adjusted as therein set forth. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell.

Thirdly, Section 302(j) refers to only three valuation dates. They are: *the date one year after the decedent's death,* as to property not distributed, sold, exchanged, or otherwise disposed of within one year after death; *the date of distribution,* as to property distributed, sold, exchanged, or otherwise disposed of (whichever first occurs) within one

5 Section 302(i), Rev. Act of 1926.

6 Brooks v. Willcuts, 78 F. (2d) 270 (1935).

7 The election would seem to be made pursuant to Section 302(j) rather than to Article 11 of Regulations 80.

year after death; and *the date of death,* (a) as to an interest or estate which is affected by the mere lapse of time, and (b) as to transfers for public, charitable, or religious uses, the value of both being subject to adjustment; and they relate to the *property included in the gross estate on the date of the decedent's death.*

It is, therefore, clear that under Section 302(j) property included in the gross estate on the date of the decedent's death which is not of a kind affected by the mere lapse of time, nor is deductible as a transfer for public, charitable, or religious uses, should be valued as of the date one year after the decedent's death, or as of date of distribution, if disposed of within the year following death, if the optional valuation date is selected, and, under Article 10, the value should be determined, in general, by the application of the fair-market-value test.

How, then, can property included in the gross estate on the date of the decedent's death (as, for example, real estate, bonds, and corporate stock) include therein rents, interest, and dividends which have accrued to the estate after the decedent's death? The language of Article 11 is not specific enough to state with certainty the answer to this question. However, certain deductions may be drawn from the following pertinent parts of the article:

> The property to be valued as of one year after the date of decedent's death, or as of date of decedent's death, or as of some intermediate date, is the property included in the gross estate on the date of the decedent's death. As property and its value are separate and distinct, . . . it will be necessary in every case first to determine what property constituted the gross estate at decedent's death. . . .
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> Interest-bearing obligations, such as bonds and notes, embody two promises, one to pay principal and the other to pay interest, and both promises are a part of the gross estate at the death of the decedent, if the obligation was then owned by him. . . . If the valuation date is subsequent to death, the principal and interest then accrued and unpaid are to be valued as of that date. The valuation date of any part payment of principal or of any installment of interest, made between decedent's death and the date as at which the obligation is to be valued, will be the date of such payment. Like rules will govern, so far as applicable, when any other obligation is involved, as, for example, one calling for the payment of rent or a royalty. Thus, in the case of rent, if the realty and the obligation to pay the rent reserved were

parts of the gross estate at the time of decedent's death, the value of the former must be determined as of the applicable valuation date, and also the value of the rent then accrued and unpaid reserved by the latter. The valuation date of any rent paid in the interim pursuant to the rental obligation will be the date of its payment. . . .

When corporate stock is a part of the gross estate at decedent's death, and a dividend in partial liquidation is thereafter paid on or before the date as of which the stock is to be valued, the valuation date of such dividend will be the date of its payment. Similarly, a dividend paid within the same period out of earnings, whether the earnings are made or accumulated prior or subsequent to decedent's death, will be valued as of the date of its payment. . . .

. . . . .

In every case where the election is exercised, the return . . . must set forth . . . (3) the value of each item of property determined in accordance with the provisions of subdivision (j). The amount of any income accrued and unpaid at the date of the decedent's death on each item of principal, the amount of any income collected or otherwise realized thereon after the decedent's death and prior to the date as of which the item of principal is to be valued, and the amount of any income accrued and unpaid thereon at such subsequent valuation date, shall be separately shown.

It should be noted that Article 10, covering valuation of property, states that, in the case of stocks and bonds, fair market value is the mean between the highest and lowest quoted selling price on the valuation date, if the stocks and bonds are listed upon a stock exchange, or the mean between the highest and lowest selling price on the valuation date if the securities are not listed upon an exchange. If the value of a security cannot be determined by representative sales, or from bid and asked price, then the fair market value is to be arrived at by giving consideration to the soundness of the security, interest yield, date of maturity, and other relevant factors in the case of bonds, and to the company's net worth, earning power, dividend-paying capacity, and other relevant factors in the case of shares of stock. The valuation of an interest in a business in which the decedent was interested is stated to be equal to the amount which a willing purchaser would pay therefor to a willing seller in view of the net assets, including good will, and demonstrated earning capacity of the business. Any property not specifically treated by a subdivision is to be valued in accordance with the fair-market principle of subdivision (a). Rules for determining the value of annuities, life, remainder, and reversionary interests make use of tables of applicable factors to be used in reckoning the value of future payments. One example given is that of an annuity which entitled the decedent to $1000 annually in installments of $500 for a term certain. At the death of the annuitant there remained twenty payments to be made over a period of ten years. By reference to the table of factors the value of this annuity was determined to be $8,258.51. In other words, future payments for a term certain are to be discounted upon the basis of compound interest at the rate of 4 per cent a year.

There is in Article 10 no reference to the method by which a promise to pay interest, or a right to future profits or rent, shall be valued, for there is no reference to the divisibility of property for valuation purposes into rights to principal and rights to income. On the contrary, the implication is clear that stock exchange quotations or selling prices, where available, of a bond or a share of stock, reflect the value of the promise to pay interest embodied in a bond and the right to future dividends which may be declared on the stock.

Article 11, as we have seen, does not discuss either what property constituted a gross estate of a decedent on the date of his death[8] or rules for determining the value of such property. Article 11 is concerned with the *date* as of which such property shall be valued, if the executor elects to value the estate in accordance with the provisions of Section 302(j). Although the section grants but one valuation date, namely, the date one year after death, for property not disposed of within the year following death, and but one date, namely, date of distribution, for property which is disposed of within the year following death, Article 11 adds date of payment, and date of accrual, as the proper valuation dates for interest, rents and dividends accrued after the decedent's death and prior to the date as of which the obligation or principal is to be valued. Here is the crux of the whole matter, for by this extension of the clear language of Section 302(j), Article 11 effectively requires interest, rents and dividends accrued to

[8] It refers to subdivisions of Section 302, as amended, other than subdivision (j), as supplying the information necessary to that determination.

the estate after death of the decedent to be valued, and, thus, necessarily considers them part of the gross estate owned by the decedent on the date of his death. Yet, there can be no such devious enlargement of the gross estate where the executor elects to value it as of the date of the decedent's death, since, in such case, date of death and date as of which the item of principal is to be valued are identical, and no interim wherein income may be earned exists.

The inclusion in the gross estate of income accruing to the estate of a decedent after the death of the decedent is accomplished, we may conclude, by (1) conceiving property as capable of divisibility for valuation purposes into principal rights and income rights, and applying the theory to the property of a gross estate owned by a decedent at death where the executor elects to value it under the optional valuation date granted by section 302(j); (2) requiring a valuation date for the *income right,* which is, in fact, date of payment or accrual of *income* accrued to the estate after death and prior to the valuation date of the item of principal, (the latter being valued either as of date of distribution, if distributed within one year following death, or date one year after death), although there is no ground for this requirement in Section 302(j) nor from the intent of Congress as drawn from the Conference Report[9] on the bill; (3) requiring the value of the principal right to be, apparently, the fair market value of the property on the valuation date, and the value of the income right to be equivalent to the amount of income realized from the property after death and prior to the valuation date of the item of principal.

The reason for our first conclusion is that the reference to the divisibility of income-producing property into a promise to pay principal and a promise to pay interest, and the extension of the theory to real estate and rents, and stock and dividends, appears only in Article 11. A study of opinions of the Commissioner of Internal Revenue, the Board of Tax Appeals, and judicial decisions has revealed no prior instances where, when the entire interest was owned by one person, it has been deemed necessary to so divide property

9 H.R. Rep. No. 1885, 74th Cong., 1st Sess. (1935), 9.

for the purpose of determining its value for income tax, gift tax, or estate tax.

Our second conclusion follows from the express language of Article 11. As stated above, neither date of payment nor date of accrual is mentioned in Section 302(j). Furthermore, the example given in the conference report, *supra,* indicates, it is believed, that income is not a factor to be considered in valuing a gross estate pursuant to the election granted by Section 302(j). The hypothetical gross estate set up in the conference report consisted of cash, real estate, foreign bonds, domestic bonds, and corporate stock and was valued as of date of death and also pursuant to the provisions of the section. It completely ignored any valuation or date of valuation for income earned after death, even though the foreign bonds were stated to have matured and been paid in full within the year after death. And there is, of course, no justification, even if it be conceded that the value of a principal right can be separated from the value of an income right, for valuing the two rights as of different dates.

A startling provision of Article 11 is the method, as stated in our third conclusion, required for valuing the income right. We may ask why the fair market value of the item of principal does not reflect the value of the income right, unless by "the item of principal" is meant the property minus its income-producing factor. It can scarcely be contended that defaulted bonds, stocks which have passed dividends, and undesirable realty, do not have these facts reflected in their fair market value or in the price they fetched in representative sales. If such factors which affect value are removed by actual payment of income during the year following death, the fair market value on the date one year after death will ordinarily show an increase over the fair market value on the date of death. From a theoretical point of view it is possible to conceive of the valuation of the principal right of certain types of property apart from the valuation of the income right of the same property, but both valuations should be as of the same time, and the two values together, that is, what a willing buyer would pay a willing seller for the principal right alone, and what a willing buyer would pay a willing seller for the income right alone, should not exceed what we are accustomed to understand is meant by fair market value. By way of illustrating the operation of Section 302(j), Article 11 gives an example valuing a gross estate both as of the date of death and as pursuant to the election. Therein we find an item of corporate stock valued at $200,000 on the date of death. It was distributed to the legatee eleven months after death and its value at that time was $100,000. A cash dividend of $100,000 was paid on this stock seven months after death and that amount was included in the value of the gross estate pursuant to the election, making the value of the stock $200,000 when valued as of date of death, and $200,000, if the dividend is included, when valued as of the date of distribution.

How is the value of $100,000, as of date of distribution, determined? The example gives no explanation. Is it the price a willing buyer would have paid a willing seller therefor on such date? If so, does it include or exclude the value of the right to future dividends declared subsequent to the date of distribution? If it is fair market value of the stock, including the value of the so-called income right, it is curious that the stock decreased in value 50 per cent in the eleven months since death, since a dividend (which was not described as a liquidating dividend), equal to 50 per cent of the value of the stock on date of death was paid seven months thereafter. If the value of $100,000 on date of distribution is the fair market value excluding the right to future dividends, are we to assume that the proper way to value stock under the requirements of Article 11 is to determine first what a willing buyer would pay a willing seller for the right to share proportionately with other owners in the assets of the corporation if and when the corporation is dissolved, and then to determine the amount a willing buyer would pay a willing seller for the right to share in future dividends? If so, the problems of executors in valuing corporate stock when the optional valuation date is selected will hardly warrant the election of the privilege granted by Section 302(j). And, finally, if the $100,000 valuation of the stock on the date of distribution is not fair market value, how was it determined? Possibly it was fair market value less the amount of the dividend paid since date of death. In such case fair market value on the date of distribution must have been $200,000, since the amount of the dividend was $100,000. This is curious too, since, in ordinary cases, fair market value is usually more than twice the amount of the last dividend; and the example given was not stated to be extraordinary nor involving a liquidating dividend. At least, it is unlikely that had the decedent died eleven months later than the date of death stated in the hypothetical example, and his executor had valued his gross estate as of date of death, the commissioner would readily have accepted a valuation of $200,000 on stock which four months before had paid a dividend of $100,000. In any event, there seems to be no reason why the stock should not have been valued at $200,000 on the date of distribution, if that was its fair market value on that date, rather than at $100,000 and the amount of the dividend listed separately.

The purpose of dealing at such length with the example given in Article 11 of the valuation of corporate stock under the provisions of Section 302(j) is not to indicate that the hypothetical figures used were selected with the view of justifying the inclusion in the gross estate of income earned after death, but to show that the example does not make clear how corporate stock should be valued. Since the figures used in the commissioner's example appear in columns headed "Value at valuation date," and "Value at date of death," in lieu of any special definition of the word value, we conclude that value means fair market value in both instances; and since fair market value as of date of death would assuredly mean the value of both the income right and the principal right, so it must mean the same as of valuation date. The only alternative is to assume that value at valuation date means the value of the principal right only, which, as we have indicated, is an unreasonable assumption since what a buyer of stock is generally buying is future earnings.

In the case of bonds, although the principal sum, the rate of interest, and the period to maturity, be certain, apparently the value of the promise to pay the principal sum is not discounted at prevailing interest rates, and the value of the promise to pay the interest on the principal sum determined by discount factors comparable to those in effect in valuing an annuity for a term certain; on the contrary the value of the principal sum of a bond or note is, presumably, what a willing buyer would pay a willing seller for the bond or the note, and the value of the promise to pay interest is whatever amount of interest accrued or was paid during a relatively short period prior to the date as of which the promise to pay the principal sum is to be valued. Thus, if two interest payments accrue or are paid within a year after death, the promise to pay interest would have two valuation dates; if an interest payment accrues but is not paid during the same period, the value of the promise to pay interest under the regulations would be equivalent to the amount of interest in default. Can it be said with any reasonableness that the price which a willing buyer would pay a willing seller for a promise to pay $10 a year for ten years is $10? And that the price which a willing buyer would pay a willing seller for a promise to pay $200 ten years hence is $200?

Since the income right of an interest in property has not heretofore been valued for tax purposes apart from the principal right of the same property, no case has been found ruling on the propriety of so evaluating the property of a gross estate, prior to the promulgations of Article 11, and the Saks case, *supra*. At the time of the enactment of the first estate tax law the question of the government's right to include in the gross estate income earned during administration and appreciation during that period, was presented by the Secretary of the Treasury to the Attorney General who replied, that, since the tax was not upon the property but upon the transfer of the estate, the answer was that there was no authority under the act to include in the gross estate income earned after death.[10] Apparently the question has not arisen during the intervening years until the present instance.

An attempt was made in *Bull* v. *United States*,[11] a leading case, to subject to both estate tax and income tax profits received by the estate of a decedent resulting from a partnership agreement whereby the estate of a partner was to share in partnership profits and losses during the year following the death of the partner in the same proportion that he would have shared in if alive. The government contended that as the agreement gave Bull a valuable right which passed to his estate at his death, the commissioner correctly included its

10 31 Opin. A. G. 64 (1916).

11 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421 (1935).

value for estate tax purposes (as well, of course, as taxing profits received after death as income to the estate for estate income tax) and that, since the right to profits is distinct from the profits actually collected, the court could not say more than that perhaps the commissioner had put too high a value on the contract right when he valued it as equal to the amount of profits received during the year following the partner's death.

The court, however, did say more. It said that there was no justification for the commissioner's rulings; that the identical money was the basis of two assessments; that there was no justification for characterizing the right of a living partner to his share of earnings as part of his capital, and if the right was not capital to him, it could not be capital to his estate; and that there was no estate tax due in respect of the sum paid to the executor as profits for the period subsequent to death. The Bull case has been followed in a similar situation where the profits were received from a personal-service partnership,[12] and also where they were received, presumably as a result of a capital investment, from a cotton brokerage partnership.[13]

That the court in the Bull case was dealing with a theory similar to that which furnishes the basis for the requirements of Article 11 is made clear by a statement of the court therein. It said that it thought that, had Bull during his lifetime, with his partners' consent, assigned his interest in the firm to a third person, the commissioner would have objected to Bull capitalizing the right to profits thus assigned, deducting its value from the consideration received, and returning the difference only as gain. The court stated it thought in such a case the commissioner would rightly have insisted that Bull return the entire amount received as income.

Of course, income received by the estate during the year following death, which, under Article 11, is part of the gross estate upon which the estate tax is based, is also subject to estate income tax and it was suggested by the court in the Saks case, *supra,* that the objection on the grounds of double taxation should not be made to the requirement of Article 11,

12 Darcy v. Commissioner of Internal Revenue, 66 F. (2d) 581 (1933).
13 Degener v. Anderson, 77 F. (2d) 859 (1935).

since income accrued but unpaid at date of death is subject to both income tax and estate tax.

Apparently the court, by this observation, failed to consider the principle underlying the imposition of the estate tax. Conceivably the greater part of a gross estate of a decedent might consist of income which he had accumulated before his death and upon which he had paid income tax. But this fact would hardly serve to justify the exclusion of this income from the property which, by virtue of statute, may be transferred by reason of the death of the owner. It is the privilege of transfer which is the subject of the estate tax, the amount of the tax being measured by the value of the property which is transferred. Certainly no one would want his right to have his property transferred after his death limited to such property as upon which he had not been required to pay an income tax. It is proper to schedule income accrued but unpaid at the death of the owner upon the decedent's final income return, since the decedent in his lifetime had a power of disposal over it; and it is equally proper to permit such income to be transferred after death and thus be a part of the gross estate which, because it is transferred, furnishes the basis for the estate tax. But it is quite a different thing to place income accrued to the decedent's estate in the same class as income accrued to the decedent while he was alive, and to reason that the former should be part of the gross estate subject to estate tax just as is the latter. Death is the generating source from which the authority to impose an estate tax takes its being, and necessarily death is the factor which ends the accumulation of property upon the value of which the estate tax is based. It is well settled that income is taxable to the person to whom it belongs. Income accrued to the estate after death is not taxable to the decedent, for a dead man owns nothing. It should be equally well settled that income accrued to the estate after death is not property owned at death though it is realized from property owned at death. Article 11 in a sense recognizes this fact, for if property owned at death is sold by the executor and reinvested in property which produces an income during the year following death, such income is not considered part of the gross estate of the decedent on the date of his death.

The promulgators of Article 11, and the court in the Saks case, seem to have reasoned that if property transferred at death is capable of producing income, then there is a right to future income which is transferred at death. If this point be conceded, it follows that it must be valued for estate tax purposes, not only where the gross estate is valued under the optional valuation date, but also where it is valued as of the date of death. Such a right to future income should also be valued when it is transferred as a gift, when it was part of the property of the gross estate of a prior decedent upon which estate tax had been paid, when it was sold with a capital gain or loss. Such, however, is not the case. And it is believed that the reason why it is not is that a right to *future* income can be valued only by permitting "mere speculation and conjecture to become a guide for the ascertainment of value—a thing to be condemned in business transactions as well as in judicial ascertainment of truth."[14]

Article 11, in requiring the return of income realized or collected between date of death and valuation date, in effect states that the value of the promise which it requires to be valued is the amount of income realized. It is this method of determining the value of the right or promise to future income which is the gist of the matter, for past, actual, gain for a definite period determines the value of a future, possible, gain for an indefinite period.

The real question is whether income actually realized during the year following death should be included in the gross estate of a decedent, either as property existing on the date of death, or as the value of property existing on the date of death. Article 11 answers the question affirmatively—income accruing to the estate after death should be included in the gross estate as the value of property existing on the date of death. Inasmuch as, under the requirements of Article 11, the right to future income is property existing on the date of death but it has no separate value if no income is realized therefrom during the brief stated period, one is led to believe that the result of the requirements of Article 11 is the taxation of income accruing to the estate after death, rather than the

14 Olson v. United States, 292 U.S. 246 at 257, 54 S. Ct. 704, 78 L. Ed. 1236 at 1245 (1934).

valuation of the income-producing factor of property existing on the date of death.

In view of the fact that the estate tax is a transfer tax on the right of having property transferred upon the owner's death, and that since the enactment of the first estate tax law no attempt has heretofore been made to include in the property transferred at death income accruing to the estate after death; and in view of the fact that Section 302(j) furnishes no basis for including such income in the gross estate owned at death; and in view of the fact that it is alone Article 11 which requires the inclusion of such income in the gross estate, and this because it requires, where the executor elects the optional valuation date granted by the section, that the income right of property owned at death shall be separately valued but does not indicate whether the principal right of such property is also to be separately valued; therefore, it is submitted that Article 11 insofar as it requires the inclusion in the gross estate of a decedent for estate tax purposes of income accruing to the estate after the decedent's death, is an arbitrary and capricious construction of a clear and unambiguous statute, and should be held by the courts to be invalid.