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Federal Taxation - Income in Respect of a Decedent - Discount Notes

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Basing accountant's liability on the contemplated use of an audit rather than a consensual relationship will increase the cost of liability insurance. However, this added expense will be passed on to the business community in the form of higher fees. The corporation will in turn either pass on the cost to consumers, or the stockholder will receive a smaller dividend. The end result will be greater protection to the public served by the accounting profession.

Conclusion

Rusch Factors v. Levin established a reasonable basis for accountant's liability; the contemplated use of the audit known by the accountant. This case recognized the independent audit as the primary source of reliable information to the investor. The decision is justified in light of the professional standard of the accountant and the fact that a duty standard based on a consensual relationship is no longer applicable to negligence cases. It is submitted that these factors justify an abrogation of the privity requirement established in *Ultramares Corporation v. Touche,* and an expansion of the accountant's liability to third parties for negligence premised on the contemplated use of the audit known to the accountant when preparing his report.

ARNOLD P. ANDERSON

Federal Taxation—Income in Respect of a Decedent—Discount Notes: In the case of *Levin v. United States,*[1] the First Circuit Court of Appeals considered several questions in the area of federal estate and income taxation. In the *Levin* case, an action was brought by an executrix to recover an alleged overpayment of income tax by the estate. Since the actual facts involved in the controversy were quite complicated, the court adopted a simplified example in order to better illustrate the legal principles involved.

In the hypothetical transaction adopted by the court, the decedent had lent $8,000 in return for a four-year note having a face value of $10,000 and an interest rate of 6%. The $2,000 difference between the amount advanced and the face value of the note was designated "discount income." In reporting his taxable income, the decedent had employed the cash method of accounting. Thus, as he received payments on the face (*i.e.,* excluding the 6% interest) he allocated 80% to principal and 20% to "discount income." For his own records he had used the accrual method of accounting and had recorded the discount in equal installments each year, regardless of whether the entire amount was paid. At the time of the decedent's death (two years after the note had been executed), he had been

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ANALYSIS SERVICE, *Accountant's Professional Liability Policy (§ 273.1),* published by Rough Notes Co. Inc., Indianapolis, Indiana (July 1968).

[1] Levin v. United States, 373 F.2d 434 (1st Cir. 1967).

paid $4,000. Thus, in reporting for tax purposes, $3,200 had been allocated to principal and $800 to "discount income."

Following the death of the decedent, the executrix valued the note at $5,580 for federal estate purposes and paid estate taxes based on that valuation. Thereafter, the note was paid in full to the estate and the executrix then filed a federal income tax return and reported $1,200 as income in respect of a decedent, taxable to the estate under section 691(a)(1)(A) of the Internal Revenue Code.[2] Later, the executrix brought an action for a refund claiming that she should have reported only $200 as income in respect of a decedent.

The district court[3] ruled that the original return filed by the executrix had been correct and that the estate was therefore not entitled to a refund. On appeal, however, the First Circuit vacated the judgment and remanded the case.

In so doing, the court considered several issues of importance, the first of which dealt with the value at which the note should have been reported on the federal estate tax return. According to Section 2031 of the Internal Revenue Code,[4] "the value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property. . . ." The situation in the *Levin* case posed a problem in that there was no quoted market value for the note involved. Therefore, the executrix, in order to arrive at the fair market value of the note, projected the total amount to be received, and discounted it at what she thought to be an acceptable rate of compensation for the postponement of receipt. As a result of the rate at which the ostensible face value ($6,000) of the note was discounted, its fair market value ($5,580) exceeded the amount of unpaid principal (*i.e.*, $4,800). The executrix had, in effect, asserted that the note was of an extremely safe character, had an unusually high present value and that a purchaser of the note would therefore be willing to pay more than the amount of unpaid principal.

The court did not decide whether such a valuation of the note was accurate for federal estate tax purposes because the government never contested the reasonablenss of the figure used in computing that tax. It is apparent that the government had not done so, because by allowing this fair market value estimate rather than the figure representing unpaid principal, a higher estate tax had been received.

Government acceptance of this figure on the estate tax return

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[2] INT. REV. CODE of 1954, § 691(a)(1)(A).
[3] Levin v. United States, 254 F. Supp. 640 (D. Mass. 1966).
[4] INT. REV. CODE of 1954, § 2031(a).

gave rise to the second major issue treated by the court. This issue dealt with whether the above figure then became the basis to be used for federal income tax reporting. The executrix argued that it should, but the government, which had allowed the unusually large figure to be used on the estate tax return, disagreed.

The answer to this question seems to be given in section 1.014-3 of the Treasury Regulations[5] which states that "the value of property as of the date of the decedent's death as appraised for the purpose of federal estate tax . . . shall be deemed to be its fair market value" and according to section 1014 (a) of the Internal Revenue Code[6] is to be used as the basis when filing an inome tax return.

The answer, however, has not always been so definite, for although the generally accepted interpretation of section 1.014-3(a) of the Regulations gives the estate tax valuation prima facie weight, the conclusiveness of the valuation has frequently been rebutted by both taxpayers and the government.[7] When the *Levin* case was originally decided by the district court, it was ruled that ". . . determinations of value for estate tax purposes are not conclusive as to the value for income tax purposes." The court, after stating that this was particularly true where income in respect of a decedent was involved, gave no other reason for not allowing the estate tax valuation to be used. On appeal, however, the court decided that ". . . the value declared and accepted on the estate tax return presumptively establishes the value under section 1014."[8] The court further stated that the presumption had not been overcome since there was no other evidence as to the fair market value of the note.

Because of this presumption by the court, the significance of the valuation on the estate tax return can readily be seen: as the value of the note (as reported on the estate tax return) is increased, the federal income tax which must later be paid on it is decreased. However, it is obvious that as the value at which the note is assessed is increased, the estate tax due thereon will also increase. Thus, it appears that any decision by the executor as to the valuation of such note should include a consideration of the size of the estate and the applicable tax rates to be used on both the estate and income tax returns.

The final and major issue in the *Levin* case concerned income in respect of a decedent, an item which may cause serious income tax consequences. In *Levin*, the district court ruled that the entire $1,200

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[5] Treas. Reg. §1.014-3.
[6] INT. REV. CODE of 1954, § 1014(a).
[7] *See* Recent Decision, *Federal Income Taxation: Relation of Estate Tax Valuation to Income Tax Basis,* 44 MARQ. L. REV. 384 (1960-61) for citations and discussion of this problem.
[8] Levin v. United States, 373 F.2d 434, 438 (1st Cir. 1967).

originally reported as income in respect of a decedent had been reported correctly and hence the estate was not entitled to a refund. The First Circuit, however, ruled that only the discount actually earned prior to decedent's death ($200) and not the unearned discount ($1,000) constituted income in respect of a decedent. This ruling by the circuit court changed the note's basis which was to be used on the federal income tax return and in turn entitled the estate to a refund.

In demonstrating how this ruling affected the note's basis, the general rule as found in 1014(a) of the Internal Revenue Code[9] must first be examined. Under this section the basis of property in the hands of a person (or estate) acquiring it from the decedent is its fair market value at the time of the decedent's death. "This means that any unrealized appreciation in property left by a decedent will escape income taxation on the amount by which the fair market value of the property at the date of the decedent's death exceeds the basis of the property in the hands of the decedent."[10] However, section 1015(c)[11] provides that the above rule does not apply to items which constitute income in respect of a decedent. Thus these items receive no stepped-up basis and are taxed as income even though they are taxed at fair market value on the estate tax return. To reduce the impact of double taxation on such items Section 691(c)[12] provides a deduction on the income tax return for the amount of estate tax attributable to the inclusion of such items in the gross estate.

In reporting income in respect of a decedent on the federal income tax return, proper procedure calls for reducing the basis ($5,-580) of the note by the amount representing income in respect of a decedent ($200). By originally subtracting the entire $1,200 from the fair market value of the note, the executrix had caused the basis to be understated, and thus the overpayment of income tax by the estate had resulted.

Unfortunately, the rules for determining what is income in respect of a decedent are not as clear as the above procedure to be followed once the amount of such item has been determined; for while the Treasury Regulations specifically state how to report income in respect of a decedent, they do not give a particularly revealing definition thereof.

In order to better understand the definition set forth in the Treasury Regulations[13] it is appropriate to review the historical

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[9] INT. REV. CODE of 1954, § 1014(a).
[10] Davison v. United States, 292 F.2d 937, 940 (Ct. Cl. 1961).
[11] INT. REV. CODE of 1954, § 1014(c).
[12] INT. REV. CODE of 1954, § 691(c).
[13] Treas. Reg. § 1.691(a)-1(b).

material leading to its adoption. To do so one must go back to 1934. Prior to that time, money earned by a cash-basis taxpayer and accruable to him on the date of his death escaped taxation if it was still uncollected at the date of his death. The theory was that "... at the time of the taxpayer's death these income items became 'corpus' which passed to his estate and, when later reduced to cash, constituted a mere conversion of capital into a different form."[14] Thus, the cash-basis taxpayer paid tax only on that amount which had actually been collected prior to his death. At the same time an accrual taxpayer paid income tax both on what he had received and on what had accrued to him at the date of his death. This obviously put the taxpayer employing the cash method at a disadvantage and at the same time resulted in loss of tax revenue to the government.

Section 42 of the 1934 Revenue Act,[15] which was aimed at remedying this situation, provided that the last return of the decedent was to include amounts "accrued up to the time of his death." It should be noted that the term "accrued," as interpreted at this time, was used in its strict accounting sense of actually having been earned.

Although the 1934 Revenue Act seemingly effected equality between the cash and accrual methods of accounting, it often resulted in hardship for the cash-basis taxpayer. The reason for this was that Section 42 often resulted in a bunching of large amounts of income in decedent's final return, thus subjecting these amounts to a higher tax rate than had they been spread over a number of years.

The inequities of Section 42 were dealt with in 1942 by the passage of Section 126.[16] The effect of this amendment was to make all payments not received before death taxable when received either by the estate or by the person to whom the right to the amount passed.

Section 691[17] is the successor of Section 126[18] but makes very few changes. It is the legislature's current attempt to resolve "... sharp conflict between the notion that income should not escape taxation merely because of the death of its producer, and the concept that 'property' should receive a basis equal to its fair market value on the date of the owner's death."[19]

In Treasury Regulation 1.691 income in respect of a decedent has been defined as "amounts to which a decedent was entitled

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[14] Ferrari, *Income in Respect of a Decedent: Deductions, Capital Gains, and Double Deductions,* 3 N.Y.U. 23RD INST. ON FED. TAX. 1209, 1210 (1965).
[15] Revenue Act of 1934, § 42.
[16] INT. REV. CODE of 1939, § 126.
[17] INT. REV. CODE of 1954, § 691.
[18] INT. REV. CODE of 1939, § 126.
[19] Ferrari, *supra* note 14 at 1222.

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."[20] (emphasis added).

The difficulty under this definition is twofold. The first difficulty is in determining what the decedent has to have done prior to his death in order to have "entitled" himself to income. It should be noted that "entitled" is definitely not synonymous with the meaning ordinarily attributed to the term "accrued." In fact, the commissioner's choice of the term "entitled" appears to be due to the judicial expansion process which the term "accrued" has undergone since it was originally used in Section 42 of the 1934 act.

In light of this judicial expansion, no short formulae can be given for determining when one is "entitled" to income in respect of a decedent. Instead, the courts have proceeded on a case-by-case basis. All cases, however, have consistently held that in order for an amount to be deemed "income in respect of a decedent" it is necessary that such amount have been the result of activities of the decedent during his lifetime.

The second problem under the definition is in determining when the decedent is entitled to the amount *as gross income* (rather than *as property*) and it is in regard to this problem that the *Levin* case is of significance.

Before examining *Levin's* significance in respect to this problem, it might be valuable to re-examine what difference it makes whether an item passes *as property* rather than *as income*. If an item is deemed to pass as property there can be no "income in respect of a decedent" on which an income tax can be levied. There may, however, be "ordinary income" to the person who took from the decedent when such person disposes of the property. At that time any amount received in excess of the property's value, as of the date of decedent's death, will be subject to taxation.

Due to Section 1014 of the Internal Revenue Code, it will almost always be to the taxpayer's advantage to pay income tax on "ordinary income" rather than on "income in respect of a decedent." Because of the stepped-up basis provision in that section, the amount of "ordinary income" will always be less than the amount of "income in respect of a decedent."

However, in limited circumstances it may be to the taxpayer's advantage to establish that an item passes to him as income (rather than as property) since in so establishing he is entitled to deductions under Section 691.

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[20] Treas. Reg. § 1.691(a)-1(b).

In *Levin* it will be recalled that the First Circuit ruled that only the $200 accruing prior to the decedent's death passed *as income* (*i.e.*, was income in respect of a decedent) and that the amount accruing after his death passed to his estate *as property*. In ruling that only the amount accruing before death constituted income in respect of a decedent, the court stated that income in respect of a decedent ". . . does not include payments in the nature of return after the date of death on property passing to the estate. . . ."[21]

Standing by itself, this statement cannot be disputed (1) because property passing to the estate is not income to the estate and cannot be subjected to an income tax, and (2) because the income realized on the property held by the estate is "ordinary income" to the estate, not "income in respect of a decedent."

However, the statement of the court seems to assume its own conclusions (*i.e.*, that the $1,000 passes as property). The basis for such assumption is unclear in that the court gave no explanation for this statement and cited only two authorities in support thereof: a sentence, which it admitted is dictum, from a Second Circuit case;[22] and a Revenue Ruling[23] which is subject to the same criticism as the *Levin* case.

As previously stated, all courts have consistently held that before an item will be deemed to constitute "income in respect of a decedent" it must be the result of activities of the decedent during his lifetime and not the result of anything done by one taking from the decedent.

In the recent case of *Trust Company of Georgia v. Ross*,[24] the decedent, prior to his death, entered into a contract to sell stock and placed it in escrow. The government contended that the difference between the decedent's cost and the sale pric of the stock was income in respect of a decedent. The executor of the decedent's estate contended that the amount in question was not due to the activities of the decedent, but was rather the result of his own activities (which were performed subsequent to the decedent's death), and that therefore the amount did not constitute income in respect of a decedent.

The Fifth Circuit held that the decedent had entered into a binding agreement before his death and that the amount in question was the result of his activities, despite the fact that some aspects of the transaction which the contract contemplated had to be performed by the executor. The court held that the activities of

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[21] Levin v. United States, 373 F.2d 434, 437 (1st Cir. 1967).
[22] United States v. Ellis, 264 F.2d 325, 327 (2nd Cir. 1959).
[23] Rev. Rul. 60-227, 1960-1 Cum. Bull. 262.
[24] Trust Co. of Georgia v. Ross, 392 F.2d 694 (5th Cir. 1967).

the executor ". . . were not of such scope as would negate the right which [the decedent had] under the contract."[25] Thus, on the theory that the decedent's activities had transformed the stock into a right to income, the amount was ruled "income in respect of a decedent."

The Fifth Circuit, when making its decision, attempted to put the requirement that *income in respect of a decedent must be the result of decedent's activities* in proper perspective when it stated:

> Although it is pertinent to inquire whether the income received after death was attributable to activities and economic efforts of the decedent in his lifetime, these activities and efforts must give rise to a right to that income. And the right is to be distinguished from the activity which creates the rights. Absent such a right, no matter how great the activities or efforts, there would be no taxable income under § 691.[26]

In the *Ross* case it was the sale of the stock which constituted the activity giving rise to the right to income. In the *Levin* case it was the loaning of money which constituted the activity giving rise to the decedent's right to income. Although (unlike the *Ross* case) nothing was required of Levin's executor, the court still refused to hold that the entire discount income was income in respect of a decedent. In so doing, the First Circuit has in effect stated that the activity of the decedent gave him a right to income *i.e.,* income in respect of a decedent) and as of the moment of his death, the same activity ceased ever to have created such a right. It is indeed difficult to understand how an act of the decedent can both "entitle" and "not entitle" him to income. A logical extention of the "entitled to income" concept upon which income in respect of a decedent is based would result in a ruling that *all* the discount income (accruing both before and after decedent's death) was the result of the decedent's activities.

The only justification for what at first glance appears to be rather faulty reasoning might be an attempt to avoid the harshness which a strictly logical extension would yield. For example, assume a situation involving a long term lease in which the lessor dies shortly after entering into the agreement. In the absence of a decision such as that rendered by the First Circuit the entire amount of rental income would constitute income in respect of a decedent.

In conclusion, although cases such as *Levin* result in what would apyear to be equitable outcomes, their lack of a clearly stated reason for their decisions does little to eliminate the confusion surrounding the term "income in respect of a decedent."

ROBERT G. FELKER

[25] *Id.* at 696.
[26] *Id.* at 695.