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Lost Income - Taxation

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NOTES AND COMMENT

LOST INCOME—TAXATION. In *Herzberg* v. *Wisconsin Tax Commission*,[1] the Supreme Court of Wisconsin was presented with the following situation. The deceased, Joseph Herzberg, had been an agent for a life insurance company. By virtue of such agency he had become entitled to certain commissions on the renewal premiums to be paid in the future on the life policies which he, Herzberg, had written. At the time of his death the present value of these future commissions was fixed at $66,071, and an inheritance tax assessed on account thereof. Later these commissions were paid by the insurance company to his executor, and the question was whether such items constituted income assessable to the estate. The then statute provided: "Every executor or administrator shall be assessed on the taxable income received by him from the estate of the deceased during the year, together with the income received by the decedent during that portion of the year covered by the return preceding the demise of the deceased * * *"[2] The court held that these items did not constitute income within the statute, saying,

> "The two sums so paid were but part payments of the obligations to make future payments, the present worth of which obligation as of the time of the death of the testator here having been appraised at $66,071. They were in no sense interest upon the said fund of $66,071 or in any sense an increment to it, or in the nature of a return upon the use of such fund * * * The oft repeated and now firmly established doctrine that the term 'income' in such taxation statutes requires that there must be the element of gain or profit as distinguished from corpus or principal * * * is ample warrant and authority for the ruling we now make."

The Court was probably right in not assessing these receipts. The renewal commissions were not income to the decedent, who apparently kept his books on a cash basis, because never received by him. They were not income to the estate, because an integral part of the corpus thereof, and not a gain or profit.[3]

As if to make certain the proper solution of the problem raised in the Herzberg case, the income tax statute, while that case was still pending, was amended so as to read:

> "Every executor or administrator shall file an income tax return * * * in all cases where the decedent if living would have been required

[1] 194 Wis. 126, 215 N.W. 936 (1927).

[2] Wis. St. (1925) 71.09(5).

[3] See discussion of this case, 4 Wis. L.R. 465 (1928).

to file such return. * * * Such executor or administrator shall include in such return:

"1. All income received by the decedent during that portion of the year covered by the return preceding the demise of the decedent.

"2. All receipts by him from the estate of the deceased during the year covered by the return, *if such receipts would have been taxable as income to the decedent had he survived.*

"3. All receipts by him during the year from the estate of the deceased accrued at the date of the death of the decedent but not reported by the decedent on the accrual basis, if such receipts would have been taxable as income to the decedent had he survived and made the return."[4]

This attempt to deal with the problem of the Herzberg case has recently however been declared by the Supreme Court of the state, an unconstitutional exercise of legislative power. In Norris v. Cary[5] the decedent had sold certain stock at a profit, payments to be made in installments over a period of years. He died before the payments were completed. In Smart v. Wisconsin Tax Commission[6] a lawyer died leaving owing to his estate certain fees for services rendered. In both cases the assessor of incomes for Milwaukee County assessed the respective executors of the estates of the decedents for the receipt by them of the above mentioned items. Reliance was had on the income tax statute as above amended. The order of the Tax Commission affirming the assessment was reversed by the Circuit Court and the Circuit Court's judgment affirmed in the Supreme Court. Although in both cases the decedent had died prior to the amendment of the statute, the court in holding the statute unconstitutional seems not to have relied on this feature alone, but upon the ground that the legislation was inherently invalid as an attempt to tax as income a receipt of money, which was not income but corpus. The Court said:

"Items of the character considered in this case uncollected at the time of death fix themselves into the estate, become part of the corpus, are subject to inheritance tax, but can not be treated as income * * * Therefore an act which attempts to impose an income tax on what is, and is commonly understood to be principal, capital, or corpus of an estate, is void."[7]

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[4] Wis. St. (1931) 71.095(1) (a). Italics are author's.

[5] 237 N.W. 113, 238 N.W. 415 (Wis. 1931).

[6] 237 N.W. 114 (Wis. 1931).

[7] Norris v. Cary, supra. 238 N.W. 415. See also In re West, 242 N.W. 165 (1932) at page 169.

Now in all these three cases it is obvious that the items considered by themselves are intrinsically income. They are either payments for personal services rendered, or else the profit made on the conversion of capital assets. Had the creditors in the three cases not died but survivd to collect these items they would clearly have constituted income and have been taxable as such. How can the death of the prospective recipient and the subsequent collection by his personal representative of the items change their character as income? It is believed that the correct answer is that they can not. It is admitted that at first impression there seems to be gross inconsistency in treating at one time the right to receive these sums as an inheritance and taxing it as such, and at a later time treating the actual receipt of the same money as income and so taxing it. Yet closer consideration of the problem will show that this is not so. The two taxes, the inheritance and the income, are both excise taxes, or in the nature thereof. The inheritance tax is laid on the exercise of the right to pass property from the dead to the living, and is measured by the value of the right transferred. The income tax is levied on the right to receive income, and is measured by the amount received. Now if the right which the decedent, either by will or the laws or intestate succession, passes to the living is the right to receive income, there will in the nature of thinge be two taxes leviable; the inheritance tax on the passage of the right, and the income tax on the receipt of the income. The circumstance that the value of the inheritance, allowance being made for the future receipt of the sums devised, will be the same as the amount of the income received does not alter the fact that the two taxes are levied on two distinct rights. This has been decided both by the Supreme Court of the United States and by the Supreme Court of Wisconsin in cases involving the bequest of the income from a capital sum, and holding that the subsequent receipt of such income was taxable under the income tax laws.[8]

In the present type of cases, however, it may be argued that the subsequent receipt of the items involved is not income to the estate, but a part of the corpus. Against this stands the query previously made, can the receipt of the sums in question by the decedent's personal representative be corpus, if the receipt of those sums by the decedent himself would have been income? The explanation is believed to be in the fact that a shift is made in the methods of accounting by which the inheritance and the income tax in these particular cases has been determined. Had the original tax payer, the decedent, kept his books on an accrual basis, it is clear that an income tax would have been prop-

[8] Irwin v. Gavit, 268 U.S. 161, 45 Sup. Ct. 475, (1925);
State ex rel Hickox v. Widule, 166 Wis. 113, 163 N.W. 648 (1917);
For a discussion of the latter case see 4 Wis. L.R. 368 (1928).

erly assessable against him personally and certainly his personal representative could have been compelled to return for taxation items of income properly chargeable to the decedent prior to his death. He, however, kept his books on a cash basis and so no income tax was chargeable against him. But when the inheritance tax was figured this right to receive income was quite properly, treated as an existing valuable right of the estate, and taken into consideration in valuing it. This is a shift to the accrual basis. Just as in income taxation on that basis, the right to receive income in the future, is treated as the equivalent of income already in hand, so here for inheritance tax purposes the right to receive these sums is treated as if they were already received and were a part of the estate. The subsequent actual receipt of the income does not, therefore, enhance the estate, but this does not deprive the receipt of the money of its intrinsic character of income. What the decedent, whether by will or intestate law has done is to pass on to his personal representative the right to receive income. That such right should be burdened with the duty of paying the income tax due thereon seems indubitable. The laws of both the United States and Wisconsin provide that when a donee of property sells the same that the basis on which the profit from the sale of such property shall be determined shall be, not the value at the time he acquired it, but the cost of the property to his donor. This apparent assessment to one person of a profit which had accrued to another is justified on the theory that the original owner of the property holds it "subject to the right of the sovereign to take part of any increase in its value when separated through sale or conversion and reduced to his possession, and that his donee takes it subject to that burden." This line of reasoning is certainly doubly applicable to the personal representative of a decedent who has acquired from the latter the right to collect items of income. It is believed that the decision of the Wisconsin Supreme Court in the Norris and Smart cases deprives the state of income taxes to which it is on every count justly entitled.

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CARRIERS—AGENCY—TORTS OF AGENCY. *Ripon Knitting Works* vs. *Railway Express Agency* ... Wis. ..., 240 N.W. 840. Here the defendant common carrier delivered to and received from the plaintiff company considerable amounts of goods, some of the goods being delivered C.O.D. For three years the driver for the defendant company delivered the goods to the plaintiff and collected the charges

[9] Taft v. Bowers, 278 U.S. 470, 49 Sup. Ct. 199 (1929).

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