THE GHOST OF THE ACCORDION EFFECT IN THE PHILIPPINE TAX CODE

JESUS M. MANALASTAS *

Whoever it was who said that the only certain things in this world are death and taxes was not merely trying to be humorous. For indeed the law has a long memory - and a still longer taxing arm. Not even death can prevent it from reaching out and exacting its pound of flesh.

Our National Internal Revenue Code taxes "gains, profits, and income derived from any source whatever." [1] The generality of the language used affords the Bureau of Internal Revenue a convenient net with which to catch and tax any and all income flowing from whatever activity in one's lifetime. But death stops all activity and halts all flow. The Tax Code, therefore, excludes from gross income "the value of property acquired by gift, *bequests, devise*, or *descent.*" [2] At death everything is at a standstill. The deceased ceases to earn income, but "the value at the time of his death of *all property*, real or personal, tangible or intangible, wherever situated" [3] forms part of his estate and is still subject to a death duty, the estate tax.[4] Nothing can be more definite and fixed than death as a demarcation line and yet the distinction between the income and the estate taxes is not well established. This is because the successors of the deceased taxpayer complete many transactions which in part had their origin in the lifetime activities of the deceased. Sums of money are collected, other claims are enforced, tangible property which descended is sold. Had the decedent lived to carry out these transactions certain tax consequences would have followed. In the United States, too, the problem is a complex and difficult one and Congress, through the years, has attempted a motley of solutions to the problem. It is not surprising, therefore, that in copying almost to the letter the Tax Code of the United States, we inherited its complexities, difficulties and inadequacies.

WHAT HAPPENS AT DEATH?

When an individual dies an income tax return is filed for him, by the executor or administrator, covering the period from the beginning of the

---

* *Vice-Chairman*, Student Editorial Board, Philippine Law Journal.

[1] TAX CODE, sec. 29.

[2] *Ibid.*

[3] *Id.*, sec. 88.

[4] *Id.*, sec. 85.

taxable year to the date of his death. Thereafter, the executor or administrator files income tax returns for the estate [5] during the period of administration until the estate is finally wound up. If, for example, a taxpayer who filed on a calendar year basis died on April 30, 1955, his executor would file a return for him covering the period January 1, 1955 to April 30, 1955; this return is spoken of as the last or final return of the decedent.[6] If the estate of the decedent also reported on a calendar year basis, the executor would file an income tax return for the estate for the period May 1, 1955 to December 31, 1955; and would thereafter file a return for each subsequent year until the estate was wound up. For the year of death, two different returns are filed.

The problem with respect to a cash basis decedent's income arises from the fact that at the time of his death the taxpayer ordinarily owned certain amounts of income which have not been received, as for example, unpaid salary. Since there has been no receipt of such items prior to death, they are not included in the decedent's last return. The right to receive the items is, of course, an asset of the decedent's estate, and, if the estate is sufficiently large to require the filing of an estate tax return, the right is included in the estate tax return and estate tax paid on it. The same problem arises with respect to decedents who had reported on the accrual basis. Income items would not have been reported in returns for earlier years or in the last return of the decedent if all the events which would require a proper accrual of the income had not occurred prior to death.[7]

TAX CONSEQUENCES OF DEATH: THE U.S. RULE THRU THE YEARS

Section 691 of the present United States Tax Code is concerned with the tax treatment of income received by the estate or legatee of a deceased taxpayer where the income item is traceable in some manner to activities of the decedent prior to his death. The taxpayer's death may have occured, for instance, prior to the receipt of wages due him from his employer for services performed during his life, or prior to the receipt interest or rent attributable to a particular period before his death, or following a sale of property but prior to receipt of the proceeds. In these and like situations, the decedent's estate or legatee will collect the amounts that are owning and may even be required to complete the transaction by enforcing claims, making delivery of property, and so on. If the decedent had lived to complete the transaction himself, the tax consequences would be those normally arising

---

[5] The estate is considered a distinct taxable entity. Frank v. Commissioner, 6 B.T.A. 1071 (1927).

[6] STANELY & KILCULLEN, THE FEDERAL INCOME TAX 246 (1955).

[7] *Ibid.* at 246.

from the transaction. The question dealt with section 691 is whether these consequences are in any way altered by decedent's death.[8]

Prior to the enactment of said section and other special statutory provisions, where an asset realized upon by the successor consisted of the right to receive sums which the decedent had not collected, there were many possible ways in which those amounts were or could be treated.[9] Almost always the income eluded income tax entirely since when payment was received by the estate it was treated as the receipt of corpus rather than as income.[10] The tax results turned largely on the decedent's method of accounting. If the decedent had been an accrual method taxpayer, the items in question, if properly accruable at the time of his death, were included and taxed in the decedent's final return. But if the decedent had been a cash method taxpayer, so that income was regarded as realized only when received, nothing could be included in his final return with respect to items unpaid at death. Unpaid items owing to a cash method decedent, as well as items not properly accruable by an accrual method taxpayer, were likely to escape tax entirely. This followed either because the item was treated as part of the corpus of the decedent's estate and, for that reason, was excluded from the income of the recipient as property received by bequest or devise, or because the item received an offsetting basis equal to its value at the decedent's death,[11] and when subsequenfly received by the executor, it was received not as income but as return of capital free from income tax.[12]

The first specific statutory treatment of decedent's income appeared in the Revenue Act of 1934. In an effort to prevent the complete escape from taxation of income earned by cash method decedents, the U.S. Congress enacted a new section (than sec. 42) in the Tax Code which provided that: "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 accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period." [13] The 1936 and 1938 Acts reproduced this section. But the question of when an item is "accrued" is a mixed question of fact, law and accounting practice. The point is attended with much difficulty and any conclusion is open to attack.[14]

---

[8] HARVARD LAW SCHOOL, TAXATION IN THE UNITED STATES (World Tax Series) 944 (1963). Under this section, the full reach of which is still unknown inasmuch as the term is not defined in the statute, the estate must report income if it collects the claim.

[9] Comment, *Income in Respect of Decedents: The Scope of Section 126,* 65 HARV. L. REV. 1024 (1952).

[10] STANELY & KILCULLEN, *supra, note* 6 at 247.

[11] TAXATION IN THE U.S., *supra,* note 8.

[12] *Parlin, Accruals to Date of Death for Income Tax Purposes.*

[13] 2 MERTENS, THE LAW OF FEDERAL INCOME TAXATION, sec. 12.100 (9162).

[14] Parlin, *supra,* note 12 at 302.

While this provision on accrual of income solely by reason of death succeeded in producing equality between cash and accrual method decedents, its effect in many cases was to "bunch" in the decedent's last return income which, had the decedent lived to receive it, would have been spread over a number of years and hence taxed at lower marginal rates.[15] Thus, when a taxpayer died, although he had been operating upon the cash basis for income tax purposes in his lifetime the fact of his death was considered as "accruing" to him all outstanding income items. That is to say, if he was a contractor halfway through a bridge project when arteriosclerosis laid him low, his profits prospects from the job were accelerated into his last income tax period; and if he was a lawyer, with a number of contingent fee cases pending when he died, the outcome of the cases was "related back to him as if his ghost were to continue the prosecution." [16]

This problem of bunching - otherwise known as the "accordion" effect - became especially acute when, in 1941, the U.S. Supreme Court, in *Helvering v. Enright*,[17] extended the meaning of "accrued" beyond its customary accounting definition and, in effect, required inclusion in a decedent's final return of anticipated earnings and other conjectural income items which might be collected, if at all, only after long delay.[18] The Court, relying on the assumption that it was the intent of Congress "to cover into income the assets of decedents earned during their life and unreported as income," and suggesting that the term "accrued" was not a word of art with a fixed connotation, but was a word the meaning of which must be gathered from its surroundings, held that there should be included in the decedent's gross income for the period ending with his death his share of the profits of a law partnership earned but not received, or a certain percentage of anticipated earnings attributable to work already done on unfinished partnership business. The Court gave the term a much broader meaning than as used in accounting practice, which does not ordinarily recognize accruals until there has been a determination of the right to receive and of the amount payable.[19]

Note that the *Enright* case involved only collected but undistributed fees and fees for work done on a fixed fee or *quantum meruit* basis, and it did not involve fees for work done on a purely contingent basis. The Court pointed out that "accrued" meant 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. This then was the deci-

---

[15] TAXATION IN THE U.S., *supra*, note 8.

[16] HENDERSON, INTRODUCTION TO INCOME TAXATION 233 (1949).

[17] 312 U.S. 636, 85 L. Ed. 1093, 61 S. Ct. 777 (1941). This was a controversial case which provoked discussion and comment in various law journals and which eventually led to the amendment of the U.S. Tax Code.

[18] TAXATION IN THE U.S., *supra*, note 8.

[19] 2 MERTENS, *supra*, note 13 at sec. 12:101.

sion 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 was 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.[20]

The *Enright* rule seems to have been that all unreported income which would be included as an asset of the decedent in the estate tax return should be included in the decedent's final income tax return. There would be excluded such items of income as were so contingent or uncertain as to be undeterminable even for estate tax purposes. Such items when received would be taxable income in their entirely to the estate.[21] Thus, the same Court held, in *Estate of Putnam*,[22] that where a dividend was declared before the decedent's death but the decedent died before both the record date and the payment date, the dividends were not income to the decedent. Income that was entirely contingent was not to be accrued in a decedent's last return.

As earlier noted, the unreported income items of both cash basis and accrual basis decedents were all included in the last return of the decedent. This treatment had the inequitable effect of piling up an abnormal amount of income in one return so that it was subject to unduly high surtax rates. It brought to the test the right to compute income by a combination of the two systems.[23] I was to relieve this situation that the U.S. Congress in 1942, enacted the radically new section 126 of the 1939 Tax Code which changed the time of imposition of the tax, thus removing bunching and facilitating elimination of the importance of death in the taxation of income.[24] The provisions of section 691 of the 1954 Code are substantially the same as the provisions of section 126 of the 1939 Code.[25] This 1942 amendment, which eliminated the compulsory artificial accrual of income by reason of death and left receipts to be taxed to the estate or beneficiaries of the decedent according as they actually accrue or come in, was proposed by the U.S. Treasury Department, pointing out that under the then existing system of requiring the inclusion of income accrued at death the "bunching" up of such income could work severe hardship, putting the income of decedent in a much higher tax bracket.[26]

---

[20] Gemmill, *Accruals to Date of Death for Income Tax Purposes*, 90 U. PA. L. REV. 704 (1942).

[21] 2 MERTENS, *supra*, note 13 at sec. 12:101.

[22] 324 U.S. 393-400, 89 L. Ed. 1023, 65 S. Ct. 811, 158 A.L.R. 1426 (1945).

[23] Parlin, *supra*, note 12 at 300.

[24] Income in Respect of Decedents, *supra*, note 9.

[25] STANELY & KILCULLEN, *supra*, note 6 at 247.

[26] [illegible] MERTENS, *supra*, note 13 at 12:102b.

Note that section 451(b) of the 1954 Code, substantially the same as section 42(a) of the 1939 Code, provides that items of income shall not be included in the last return of a deceased accrual basis taxpayer if they accrued only by reason of his death.[27]

PHILIPPINE RULE: A CRITICISM

The National Internal Revenue Code has no provision similar or analogous to section 691 of the U.S. Tax Code. It is at least three decades behind the times, still retaining as it does section 39 which provides as follows:

> "In the case of death of a taxpayer, there shall be included in computing net income for the taxable period in which falls the date of his death, amount *accrued* up to the date of his death if not otherwise properly includible in respect of such period or a prior period.".[28]

This provision is elaborated by the Income Tax Regulations, which provides as follows:

> ". . . . If a taxpayer has died there shall also be included in computing net income for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, *regardless of the fact that the decedent may have kept his books and made his returns on the basis of cash receipts and disbursements.*" [29]

Note that this particular provision, section 39, is an exact reproduction of section 42 of the 1934 U.S. Tax Code, which has already undergone various amendments. It was the subject of constant controversy and the object of attacks and criticisms for its "bunching" or "accordion" effect. Yet our statute books still contain such an objectionable provision.

There is, however, no decided case on the point as yet which probably explains why the provision has escaped notice, scrutiny and attacks. Doubts may still be raised as to the treatment of such "life-death" income, section 39 notwithstanding. The Bureau of Internal Revenue,[29a] treats receivables of cash basis decedents as part of the gross estate but not as taxable income to him. The receivable, or merely the "right to receive the income, is valuated at the time of his death, for estate tax purposes. If it is valued at 100% its face value, its subsequent collection by the administrator or heirs will not result in taxable income to them there being merely a return of capital. If it is valued at less than 100%, the excess over the valuation, where collected later, will be treated as income and taxable as such.

Construing section 39, however, the Court of Tax Appeals considers the death of a taxpayer, regarding such income earned but not received up

[27] 26 U.S.C.A., sec. 451(b) (1967).
[28] TAX CODE, sec. 39.
[29] Income Tax Regulations, sec. 170.
[29a] Interview with Mr. Aquilino Larin, Chief of the Financing, Real Estate and Transfer Division.

to the date of death, as an exception to the application of the cash basis method.[30] The problem is illustrated thus: A is a lawyer with a promissory note worth ₱10,000 for attorney's fees. The receivable was uncollected when he died on February 9, 1972. His final income tax return would cover the period from January 1, 1972 to February 9, 1972. The ₱10,000 note would be included in such return. The same would also be included in his gross estate. Its discounted value, say ₱9,500, would constitute part of his gross estate, subject to the estate tax. If the heirs collect the ₱10,000 upon maturity of the note, the ₱500 would be taxable income to them. If, however, the note was payable on demand, the entire ₱10,000 would be subject to the estate tax and its subsequent collection would no longer result in taxable income.

We see, therefore, that aside from the unfairness of its "bunching" effect, section 39 may result in the same amount of income (in our example, the ₱500) being subject to income tax twice. Our Congress, therefore, should avoid such unjust consequences and clear away all doubts by enacting an amendment similar to section 691 of the present U.S. Tax Code. A detailed analysis of how such income was treated in the United States prior to the passage of section 691, and of tthe present rule in the United States, might serve as helpful guides.

JUDICIAL TREATMENT OF RECEIVABLES IN THE UNITED STATES PRIOR TO SECTION 691.

A. *No tax burden*

Before the 1934 and subsequent Acts in the U.S., there were many possible ways such amounts were or could be treated. Where the amount had not been accurable, or where the decedent had been on a cash basis, decedent would not have reported the amount and there was a possibility that no tax would be imposed when the successor collected it.[31] Prior to the 1924 Act accrued income of a cash basis taxpayer was not included in the last income tax return of the decedent or in the income tax return of the estate. The statute merely left such income without any tax burden other than the estate tax.[32]

B. *Tax on decedent*

The amounts could in some cases be brought into the decedent's return as distributable partnership income. Thus, in *Darcy v. Commissioner*[33] the

[30] UMALI, REVIEWER IN TAXATION 170 (Rev. ed,. 1971). The author is a Judge of the Court of Appeals.

[31] Income in Respect of Decedents, *supra*, note 9.

[32] 2 MERTENS, *supra*, note 13 at sec. 12.100.

[33] 66 F. 2d 581 (1933).

partnership agreement provided that, in case of death of a partner during the currency of any business year, his interest "shall be continued until the expiration of said year." The court held that where the partner, on a cash basis, died before the end of the fiscal year of the partnership, *pro rata* part of the distributive share of the deceased partner in the partnership income from January 1 until his death in June was taxable as income.

A constructive receipt theory was also possible. The holding of *Schoenheit v. Lucas,*[34] decided in 1930, was that although the taxpayer did not actually accept salary for services, it appeared that the salary was authorized and entered on the books of the corporation at the direction of the active head with the approval of corporate officials. Funds from which payment could be made at any time were available and the taxpayer had unqualified right at any time to reduced credit to cash. It was likewise held,[35] where interest coupons matured prior to the death of the decedent and were uncollected simply because of his illness, such coupons, being unqualified subject to the taxpayer's demand, were income to the decedent for the year in which they matured. The court ruled that for taxation purposes, income is "received" or "realized" when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession.

C. *Tax on estate*

But mostly unable to tax this kind of income to the decedent, the U.S. Commissioner of Internal Revenue, prior to the 1934 Act, had sought to treat such income as income to the estate. The attempt was defeated on the reasoning that: (a) a deceased taxpayer and his estate are separate entities: (b) income accrued but not collected by the decedent was an asset which passed to his estate as corpus; and (c) subsequent collection by the executor or administrator was merely a conversion into cash of that asset and did not result into taxable income.[36]

Indeed, some courts might have taxed the successor-estate as the decedent would have been taxed. In *Mulqueen v. Commissioner,*[37] the deceased taxpayer specialized in condemnation proceedings thru which the city acquired property for public use. The cases were conducted on a contingent fee basis. At the time of his death, some of the cases remained unfinished, whereupon a lawyer associated with the deceased entered into a contract with the deceased's surviving widow, who was also the executrix of his es-

[34] 44 F. 2d 476 (1930).
[35] Loose v. U.S., 74 F. 2d 147 (1934).
[36] 2 MERTENS, *supra,* note 13 at sec. 12.100.
[37] 65 F. 2d 365 (1933), cert. den., 290 U.S. 644, 78 L. Ed. 559, 54 S. Ct. 62 (1933).

tate, under which it was agreed that the lawyer should have himself substituted as attorney, complete the cases, and divide the fees thus obtained with the executrix. The court held that the money paid under such contract was income to the estate. As Mulqueen's fees were contingent, his estate had no forcible claim against his clients unrer contracts not performed when he died.

CORPUS AND/OR INCOME

In any case, however, the decedent and his estate were conceded to be separate and distinct taxable entities. [38] Thus, upon the taxpayer's death, the accrued income became a capital item which passed to his estate as corpus. In *U.S. v. Carter*,[39] the court held "that the interest of the deceased's estate in the partnership of which he was a member at the time of his death was the right to receive a designated share of the net amount realized from the business which was in the hands of the firm at that time. What appellees have received from that source came to them as part of the corpus of the estate of the deceased." *Wood v. Commissioner* [40] is authority for the holding that the right of a decedent's estate to share in the profits of a partnership for an agreed period subsequent to his death constituted property subject to be included in the gross estate.[41]

Its subsequent collection by his estate might result in two tax possibilities. First, it may be considered a mere conversion of the corpus or asset into cash, not a change of its character into income, without further tax consequences. Thus, it was held in *Estate of A. Plumer Austin v. Commissioner* [42] that a debt due to the decedent at the time of his death passed to his estate as capital or corpus of the estate and the subsequent payment thereof, not in excess of the value of the debt at the date of decedent's death, was not taxable income to the estate, but a mere conversion of capital asset from which no gain was derived. When the debt was paid, petitioner acquired nothing in addition to what it previously owned. The payment simply reduced to cash an asset of the same value as the amount of money received, and thus was nothing more than a change in the form of a part of the corpus. The revenue laws do not impose an income tax upon the corpus of an estate or upon the conversion of a part thereof into the cash equivalent of its value at the date of acquisition.

In *Nichols v. U.S.*,[43] a decedent on the cash basis was a member of a partnership dissolved by his death. Commissions earned before death but

[38] Frank v. Commissioner, *supra*, note 5.
[39] 19 F. 2d 121 (1927).
[40] 26 B. T. A. 533 (1932).
[41] See also Frank v. Commissioner, *infra*.
[42] 10 B.T.A. 1055 (1928).
[43] 64 Ct. Cl. 241.

unpaid to the partnership were valued in the estate tax and collected by the partnership after death for payment to the executors. The Court of Claims held the sums paid the executors were part of the corpus and not income.

In *Kemper v. Commissioner,*[44] amounts due the decedent for salary and bonus, covering periods prior to his death, were held not be income to his estate when collected by the administrator. Likewise, in *McCarthy v. Commissioner,*[45] a decedent at the time of his death had an asset in the form of unpaid salary and his estate received payment of the same. The estate did not have income.

Moresoever, deposit certificates and accrued interest having been included at their fair market value as of the date of decedent's death in the taxable estate and the tax thereon paid, the U.S. Board of Tax Appeals held that no income accrued to the estate on the occasion of the subsequent payments.[46] *Frank v. Commissioner*[47] ruled that the accrued interest owing to the decedent at the time of his death was property in the form of a debt due him. While the interest would have been taxable income to the decedent if he had received it during his lifetime, in the hands of the estate after his death such interest took on a different character. It then became a part of the corpus of the estate. An account receivable or interest receivable in the hands of a decedent at the time of his death was held to be as much a part of the estate of the decedent as any other asset, and the payment thereof, not income to the estate.

Heller v. Commissioner[48] involved a decedent on cash basis. At his death certain rents and interests had been earned which had not been received by him in his lifetime. The court ruled that such rents and interest were properly a part of the gross estate and when collected did not constitute income to the estate.

The collection by the estate of dividends declared prior to but payable to decedent after death on stocks owned by him was a mere conversion in cash of capital assets of his estate, as laid down in *Vanderbilt v. Commissioner.*[49]

Clark v. Commissioner[50] held that pension due for a period preceding taxpayer's death and received by his estate were not taxable income to the estate.

---

[44] 14 B.T.A. 931 (1928).
[45] 9 B.T.A. 525 (1927).
[46] Bank of California v. Commissioner, 25 B.T.A. 179 (1932).
[47] 6 B.T.A. 1071 (1927).
[48] 10 B.T.A. 53 (1928).
[49] 11 B.T.A. 291 (1928).
[50] 12 B.T.A. 425 (1928).

Or secondly, the subsequent collection by the estate may be treated like the sale or exchange of a tangible asset, being taxed only to the extent that realization exceeded a basis attributed to the right. This may be called the allocation method. The leading case was *Blodget v. Commissioner*[51] where the court ruled that only the excess realized on a chose in action over the value thereof at the date of the death of a decedent constituted taxable income when received by the executors. For federal income tax purposes, the executors of the estate of a decedent took over the assets of the decedent including choses in action at their fair market value on the date of decedent's death, and not at the cost of such assets to the decedent. In this particular case, the right of the estate of Blodget to receive a share in the net profits of the company in the year following his death was valued at $49,346 by the Commissioner. Only $21,283 was paid over to the executors. The court held that this was less than the capital value of the right to receive such profits. The amount received, therefore, was considered simply the return of a part of the capital represented by the chose in action.

Hatch v. Commsioner[52] involved a contract under which a corporation agreed to pay $30,000 per year for 10 years to the estate of a decedent. The contract was given a commuted value of $243,000. The amounts received by the widow in excess of such valuation were held taxable gains to her. Said the court: "Amounts received annually by the widow were to be allocated for income taxation purposes between income and return of capital in the same ratio as valuation for estate tax purposes bore to the fact value of the obligation. When Mrs. Hatch acquired the contract under her husband's will, it was obviously worth less than $300,000, the total salary payments called for by its terms, since a promissor's obligation to pay $30,000 a year for 10 years is not the equivalent of an obligation to pay $300,000 forthwith. The present value of the contract was computed by discounting the future payments. When the obligation shall have been discharged in full, Mrs. Hatch will have received a return of the acquisition value of the contract, $243,000, plus the discount of $57,000 by which the face amount of the contract was reduced. The former amount is excluded from taxation as the 'value' of property acquired by bequest, the latter taxable as 'gain.' When the obligation is discharged in periodic payments, it is no more correct to say that the part payment was all a return of capital than it is to say it was all a return of income. We think that each installment payment received by Mrs. Hatch should be *allocated* between the non-taxable bequest and the taxable gain."

[51] 13 B.T.A. 1243 (1928).
[52] 190 F. 2d 254 (1951).

In the case of *Estate of Richard Bray*,[53] the decedent, prior to his death, bought securities at $108,461.25, which were returned for the purpose of the federal estate tax at a valuation of $98,084. They were sold by the estate during the taxable period for $97,657.83. The court held that the estate was not entitled to a deduction of $10,803.42 (the difference between) the cost to the decedent and the sales price), since the cost to the decedent was the basis from which he could compute a gain or loss on the sale, but was not the basis for his estate, which was the value at the time of receipt by it.

Other decisions holding that the collection of an account receivable acquired by the estate did not constitute taxable income to it except to the extent that the cash received exceeded the value of such account receivable at the time of the death of the decedent were *Frank v. Commissioner, McCarthy v. Commissioner, Clark v. Commissioner,* and *Vanderbilt v. Commissioner.*

A law professor at the University of the Philippines adheres to the allocation method, at least with respect to the treatment of installment obligations transmitted upon the death of the holder-creditor.[54]

Normally, receivables form part of the estate of the deceased, at their fair market value at time of death. For income tax purposes, their basis will be the fair market value to which they have been subjected vis-a-vis death taxes.[55] If the administrator of the deceased, therefore, elects to include the installment notes as part of the gross estate of the holder-decedent, they acquire a basis identical to the fair market value at which they have been taxed for estate and inheritance purposes. This will consequently alter the profit ratio originally determined under section 43 of the Tax Code. If the valuation at the time of death involves an upward revision of the basis, it may well be that the profit-portion initially computed in each installment would disappear.[56]

If the estate desires to avoid this complication, it could exclude the installment receivables from the gross estate but should report for income tax purposes the profit on each installment payment as determined originally.[57]

To make an intelligent election, the executor must weigh several factors, including: (a) the amount of the increase in tax if the gain is included in the decedent's final return, as compared with the anticipated tax if included in the income of the estate or of the legatee to whom it may

[53] 4 B.T.A. 42 (1926).

[54] Professor Demosthenes Gadioma. This was also the U.S. treatment of installment obligations prior to the 1928 Act. Now, such items are income in respect of a decedent. See note 43.

[55] Gadioma, *Sales on Installment and Deferred Payment Plans in* SIXTH ANNUAL INSTITUTE ON TAX LAW 89 (U.P. Law Center, 1970).

[56] *Ibid.* at 90.

[57] *Id.*

be distributed; and (b) the likelihood of the installment obligation being paid in accordance with its terms, it being remembered that if the fair market value of the installment obligation is reported at less than face value but is actually collected in full, the amount of the discount will probably be taxable as ordinary income at the time collected, not as long term capital gain. (The collection of a debt is not a "sale or exchange" so as to bring the capital gain provisions into play.) [58]

By way of illustration, A is the holder of installment notes totalling ₱100,000 payable in 10 equal yearly installments. The profit ratio originally determined under section 43 is 40%, meaning that on each installment of ₱10,000, ₱4,000 is taxable profit.[59]

After receiving the fourth installment, A dies. If the installment receivable of ₱60,000 is included as part of gross estate of the decedent, with a fair market value of ₱60,000 or 100% of face value, then it is at this valuation that the estate and inheritance taxes due will be computed. The estate, however, is entitled to recompute the profit ratio for income tax purposes applicable to each future installment received. In this case, the formula will be:

$$\frac{\text{FMV}}{\text{face value of receivable}} \times \text{installment received} = \text{return of capital}$$

$$\frac{₱60{,}000}{₱60{,}000} = 100\%$$

This means that each installment payment received by the estate represents a return of capital, no portion of which shall be subject to income tax.[60]

Note that statutory authority is not essential to the use of the allocation method in a case where the amount of future gain is definitely determinable.[61] The holding in the well-known case of *Burnet v. Logan* [62] was that the allocation method may not be applied to a contract in which the ultimate amount to be received thereunder could not be determined with reasonable certainty as where the promise of the obligor was conditional on the amount of iron which it might mine.

It is obvious in the example above given that electing to report the installment receivable as part of the decedent's gross estate might result in

[58] KENNEDY, *supra*, note 52 at 37-38. In the United States, an additional factor to be considered is that if taxed in the decedent's final return the increase in the income tax will constitute a debt deductible for estate and inheritance tax purposes.
[59] Gadioma, *supra*, note 55 at 90.
[60] *Ibid.*
[61] Hatch v. Commissioner, *supra*, note 52.
[62] 283 U.S. 404-414, 75 L. Ed. 1143, 51 S. Ct. 550 (1931).

some tax savings because generally the rates of death taxes are lower than those of income taxes. The estate, however, might have its own reasons for preserving the profit ratio determined under the provisions of section 43 of the Tax Code and exclude the installment notes from the taxable gross estate.[63] Under such election, the view has been ventured that the BIR will compute the taxes due under each alternative and take the position favorable to increased revenue.[64] Indeed, many doubtful tax cases have been resolved in favor of taxability because of the balancing consideration that a transaction must not go untaxed, irrespective of the niceties of power, rules of statutory construction, and the like. The background thought, "They shall not pass," reveals itself time after time. Someone has benefited; the government must have its due.[65] Of course Congress can clear away all doubts with one stroke by enacting the appropriate amendatory legislation.

PRESENT RULE IN THE UNITED STATES: INCOME IN RESPECT OF DECEDENTS

The general plan of section 691 of the U.S. Tax Code is that the unreported income items are reported in the income tax return of the person who receives them after the death of the decedent.

Section 691(a) refers to the income items. Section 691(a)(1) provides that any income items which were not properly includible in any of the returns of the decedent (including his last return) shall be included, when received, the gross income of:

(A) The estate, if the estate acquires from the decedent the right to receive the income;

(B) Any person who, by reason of the death of the decedent, acquires the right to receive the income, in cases where the estate does not acquire such right from the decedent; (If, for example, a husband and wife owned a bond jointly and the husband died prior to the payment of the bond, the wife would include in her income, in the year the bond was paid, the full amount of the payment that represented income. A part of this income would have accrued prior to the husband's death but the full amount would nevertheless be includible in the wife's gross income when received) [66]

(C) Any person who acquires the right to receive the income by bequest, devise or inheritance, and receives the income after the right to it has been distributed to him by the estate.[67]

---

[63] This may be done by assigning a zero value to the receivables, on the claim, perhaps, that the probability of collection is nil.
[64] Gadioma, *supra*, note 55 at 91.
[65] HENDERSON, *supra*, note 16 at 141.
[66] STANELY & KILCULLEN, *supra*, note 6 at 248.
[67] 26 U.S.C.A., sec. 691 (1967).

The 1954 Code added a new provision to the effect that the income items include "the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent, or by bequest, devise, or inheritance from the prior decedent, . . ." [68] Under this successive decedents rule, if taxpayer B acquires rights to income by reason of the death of A but dies before all the income is received, and taxpayer C acquires the rights to the income upon B's death, the income is taxable to C. Under prior law, the transfer of the rights from B to C by reason of the death of B would have made the income taxable in the last return of B, resulting in a bunching of income.[69]

Section 691(a) (2) provides that, if any person (including the estate) who has the right to receive the income transfers the right to another (as by a sale or exchange or by gift), the fair market value of the right to the income shall be included in the income of the transferor for the year of the transfer. If the right is transferred for a consideration that is greater than its fair market value, the full amount of the consideration is included in income. The term "transfer" is so defined that it specifically includes the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of a decedent or a transfer to a beneficiary of a decedent.[70]

Section 691(a) (3) provides that, when any of the income items are reported in the return of the estate or of any other person receiving the income, the character of the income remains the same as it would have been if the income had been received (or accrued) and reported by the decedent, or in the case of successive decedents, by the original decedent. Thus, if the income would have been capital gain to the decedent, it remains capital gain to the person reporting it; if it would have been tax-exempt interest to the decedent, it remains tax-exempt interest.[71]

Section 691(a)(4) is a new subsection, added by the 1954 Code. It provides, briefly, that the income from installment obligations owned by a decedent at the time of his death and acquired on an installment sale properly reportable under the provisions of section 453 is subject to tax under this section.[72] Under prior law the income from such installment obligations was not technically "income in respect of a decedent" with the result that certain court decisions had held that the credit for the estate tax attributable thereto, was not allowable.[73]

---

[68] 2 MERTENS, *supra*, note 13 at sec. 12.102b.
[69] STANELY & KILCULLEN, *supra*, note 6 at 248.
[70] 26 U.S.C.A., sec. 691 (1967).
[71] *Ibid.*
[72] *Ibid.*
[73] STANELY & KILCULLEN, *supra*, note 6 at 249.

In effect, therefore, under the above-mentioned solution, income items which qualify as "income in respect of a decedent" are taxed to the decedent's estate or legatee in the same manner and at the same time as if the decedent had lived to receive them and was on the cash method. If the right to receive an item of income in respect of a decedent is sold prior to its realization, the seller will be required to include the proceeds of sale in his gross income for the year in which the sale occurs. Likewise, a gratuitous transfer (other than at death) of a right to income in respect of a decedent is treated as a realization by the transferor of the fair market value of the right at the time the transfer is made. Items received by an estate or legatee as income in respect of a decedent retain the same tax character (e.g. capital gain) as they would have had in the hands of the decedent.[74]

Section 691(c) permits a person who is taxed on an item of income in respect of a decedent to deduct, in computing taxable income, that portion of the estate tax on the decedent's estate which is attributable to the inclusion in the estate of the value of the right to receive such item.[75] This adjustment is designed to minimize the impact of two taxes on the same item and, in some degree, to equalize the position of a decedent who had deferred income with that of a decedent who had realized and been taxed upon all income at the sate of his death, and whose gross estate would have been reduced, in effect, by the income tax so paid.[76]

It should be noted that section 691 cuts across section 1014 [77] of the U.S. Tax Code, in that items included in income as a result of section 691 retain the decedent's basis. Prior to the adoption of the predecessors of section 691, assuming that the income was not reportable in the decedent's final return, only the excess over the estate tax valuation would have been taxable under the income tax.[78]

Section 691 thus creates an exception to the usual rules (a) that inherited property takes on a new basis equal to its value at the date of death, and (b) that property acquired by bequest, devise or inheritance is not taxable as income to the recipient.[79]

Thus, holding that an item is income in respect of a decedent may have crucial tax consequences. This is because an item acquired from a decedent but not found to be "income in respect of a decedent" will have

---

[74] TAXATION IN THE U.S., *supra*, note 8.
[75] 26 U.S.C.A., sec. 291 (1967).
[76] TAXATION IN THE U.S., *supra*, note 8.
[77] 26 U.S.C.A., sec. 691 (1967). This section provides that property transmitted to the estate by the death of a decedent acquires a new basis equal to its fair market value at the time of his death.
[78] TAXATION IN THE U.S., *supra*, note 8.
[79] BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION, 1075 (1964).

as a basis the fair market value at the date of decedent's death. In other words, an item received as a corpus takes a new or stepped-up basis. The recovery of such a basis against the amount received may free a substantial part or all of the item from payment of income tax. A full inclusion in income which follows when the item is found to be "income in respect of a decedent" is thus a denial of this tax advantage to the recipient.[80]

INCOME IN RESPECT OF DECEDENTS: NATURE AND SCOPE

The U.S. Congress did not define what it meant by the phrase "income in respect of a decedent," either in the statute itself or in the committee reports. In terms which are approxiate only, it has been suggested that the phrase might be defined as the receipt of an amount which would have been reportable as income by the decedent had he lived to receive it, which the decedent had neither actually nor constructively received before his death if he reported his income on the cash basis, or which had not accrued as income to him under normal accounting concepts if he reported his income on the accrual basis, and concerning the ultimate realization of which no further affirmative action remains to be taken.[81]

It has been said that an item need not have accrued during the decedent's life to be income inrespect of a decedent, phasis instead being upon whether the amount received was attributable to activities of the decedent during his lifetime.[82]

The U.S. Tax Court has stated, in *Estate of O'Daniel*[83] that in order for amounts to be taxable as income in respect of a decedent it was *not* necessary for the decedent to have had a legally enforceable right to the amount at the time of his death. "Congress meant that no income earned by the decedent should escape income tax and meant to tax to the estate amounts of such income received by it after the death of the decedent where the estate acquires the right to such amount by reason of the death of the decedent."

It appears, under court decisions, that where amounts are received by the estate or beneficiaries by reason of personal services of the decedent, such amounts will be treated as income "in respect of a decedent' even where the income did not accrue within the meaning of the term as extended by *Helvering v. Enright*.[84]

---

[80] 2 MERTENS, *supra*, note 13 at sec. 12.102c. There may, of course, be a cost or other basis in the hands of the decedent to be considered in determining the gain.

[81] KENNEDY, *Income Tax Problems of Decedents and Their Estates*, 48 N.W. U.L. REV. 42 (1953).

[82] Estate of Riegelman v. Commissioner, 253 F. 2d 315 (1958).

[83] 10 T.C. 631 (1948).

[84] 2 MERTENS, *supra*, note 13 at sec. 12.102c.

When property was sold by a decedent prior to his death but the proceeds to the sale were received by his estate after his death, the proceeds to the extent that they represented gain on the sale have been held taxable to the estate.[85]

If the partnership agreement provided that a deceased partner would receive no share of partnership earnings for the year of his death other than his contractual drawings prior to death, no right to income passed to the estate and hence there was no income for any period subsequent to his death.[86]

The major problem under section 691, as we have noted, related not to its basic principles, which operate satisfactorily, but to the scope of application of those principles. Where the dividing line is between the right to section 691 income and "property" entitled to death-value basis under section 1014 depends on the meaning of the key phrase "income in respect of a decedent." which appears in section 691(a). Since the U.S. statute does not enumerate the items to be so regarded, the scope of this language must be found in the Regulations and in case law. Despite some inconsistencies among the decided cases, certain patterns of interpretation do appear.[87] If our lawmakers should decide to adopt a similar provision, they should bear this in mind.

Accrued Items

Income items which have accrued in the accounting sense, such as fixed rent, interest and salaries or wages relating to a definite period up to decedent's death, are perhaps the clearest and most common examples of income in respect of a decedent. Thus, interest accrued on a bond, but unreported by the owner prior to his death, is section 691 income when collected by the co-owner or beneficiary on maturity of the bond. Similarly, alimony arrears paid by a husband to the estate of his deceased wife have been held taxable to the estate under section 691. Dividends paid to the estate of a deceased shareholder would also be so treated where the shareholder's death had occurred prior to receipt of the dividend but after the record date.[88]

Personal Service Income

As respects compensation for services, the scope of section 691 has not been limited by the courts to salary or wage items that are accruable in an accounting sense. Thus, where a corporation, following past practice,

[85] Dixon v. U.S., 96 F. Supp. 986 (1950).
[86] Estate of Frank Knipp v. Commissioner, 25 T.C. 153 (1955).
[87] TAXATION IN THE U.S., *supra*, note 8 at 946.
[88] *Ibid.*

paid a year's salary to the estate of a deceased employee, the amount was held taxable to the estate. While the court also thought the salary taxable as compensation under the general gross income section, inclusion under section 691 permits the estate to obtain a deduction for the estate tax. In another instance, a discretionary bonus, which was not voted until after the deceased employee's death and to which the employee had no enforceable right during his life, was held to be section 691 income when received by the estate. Clearly, the bonus could not have accrued as an accounting matter because of the absence of a legally enforeceable right to it. But inclusion was nevertheless held to be required because "the payment clearly represented compensation for the decedent's services and any right to receive it that was realized by his estate was acquired through him and never arose in any other way or through any other source." [89] The renewal commissions of a deceased life insurance agent, earned after his death, have also been taxed under section 691.[90]

The foregoing decisions, of course, suggest that items received by an estate or legatee as the result of the personal services of a decedent are to be regarded as "income in respect of a decedent" even though they are neither accruable from an accounting standpoint nor "accrued" in the sense that they represent unmatured or inchoate rights in existence at the time of decedent's death.[91]

Income from Sale of Property

Income derived from the sale of property has been the most difficult to classify. Here, especially, the scope of section 691 as an exception to the general policy of section 1014 has not been easy to determine, although the element of uncertainty is apparently less serious now than formerly.[92]

Where a sale of property by the decedent had been consummated during his life and all that remains to complete the transaction is delivery of the property to the buyer and collection of the proceeds of the sale, the amount that would have been regarded as gain to the decedent had he lived will be recognized and taxed to the estate or legatee. If the gain would have been a capital gain to the decedent, it will be so treated in the hands of the estate or legatee. On the other hand, if the property is sold by the estate or legatee, even though pursuant to a contract binding the decedent's representatives to sell following his death, section 691 will not apply and there is no income in respect of a decedent with respect to the appreciation

[89] O'Daniel's Estate v. Commissioner, 173 F. 2d 966 (1949).
[90] Latendresse v. Commissioner, 243 F. 2d 577 (1957).
[91] TAXATION IN THE U.S., *supra*, note 8 at 948.
[92] *Ibid.*

in value of the property to the date of the decedent's death. These rules are clearly appropriate where the property sold is a capital asset, such as real estate or securities.[93]

But the question remains whether the same lines of division between sections 691 and 1014 must be followed where the property is of a type which would produce ordinary income to the decedent had he lived to dispose of it, such as appreciated inventory, or where the property represents the fruit of personal effort, such as a copyright. The issues here appear to run parallel to those in connection with judicially-approved rules of income attribution to prevent a shifting of income from a generally high-bracket done to a lower-bracket done. The policy of the latter rules requires taxation of the donor, while the policy of section 691 requires taxation of the estate or legatee, but the objectives seem sufficiently alike to suggest that development might properly move along similar lines.[94]

This suggestion appears to find support in the U.S. Revenue Service's reaction to the *Linde case*.[95] There, the decedent, a vineyard operator, had delivered his harvested crops of fruit to a cooperative marketing association of which he and other grape-growers were members. The cooperative mingled the fruit received from its members into a pool for processing and sale. The decedent was assigned a percentage interest in the pool based upon the quantity of fruit delivered by him. Following the decedents death, the cooperative made a cash distribution to his estate representing his share of the proceeds of sale of the pool, which included fruit harvested by the decedent over a number of years. The Commissioner sought to treat this distribution as section 691 income; the taxpayer-estate contended that section 1014 applied instead to give the fruit a basic equal to its value at the date of the decedents death.

In the U.S. Tax Court, the question principally argued was whether, in view of the decedent's arrangement with the cooperative, a sale of the fruit had taken place before or after the decedent's death. Finding that the fruit had not been sold prior to death, the Court held that section 1014 was applicable and that only the difference between its value at the time of decedent's death and the amount ultimately distributed would be taxed to the estate. On appeal, the Court of Appeals reversed and held the distribution taxable to the estate under section 691. The Court found it specifically unnecessary to accept the Commissioner's position on whether the sale occurred before or after death. Instead, it based its holding on the broader ground that Congress, by section 691, had intended "to see to it that the tax upon income which would have been derived had the

[93] *Ibid.*
[94] *Id.* at 949.
[95] 213 F. 2d 1 (1954).

decedent lived should not be lost to the treasury in consequence of his death." In this connection, the Court made reference to the ordinary income character of the amounts received and emphasized that the result it reached was consistent with the personal service situations in which the courts have uniformly held that a bonus or other discretionary payment received by a decedent's estate is taxable under section 691 despite the absence of a fixed and enforceable right to the amount at the time of the decedent's death.

The implications of the *Linde* decision thus favored a broad construction of the phrase "income in respect of a decredent"—broad enough to bring within the scope of section 691 any items which the decedent would have realized in the form of ordinary income had not the customary flow of receipts been diverted by reason of his death.[96]

To summarize, the relationship between the federal estate and income taxes in the United States has evolved slowly. If income has been received by an individual prior to his death, he has an asset which, to the extent unspent, will be included in his gross estate.

Income such as rent, interest, and dividends accruing on property after the owner's death is not included in his gross estate if it is the estate which first becomes entitled to receive it.

If income was receivable but unreceived prior to death, a taxpayer computing his income tax on a cash receipts basis would normally not have included it in gross income in the income-tax return for the period before death. The value of the receivable would be included in his gross estate, and would also be taxable as income to the estate or beneficiary receiving payment. The items includable in the gross estate are not limited to items which customary accounting would have accrued as income for the period before death. The gross estate would also include the value of the right to receive the income attributable to work of an individual even if the amount of the income were so indefinite that it would not normally be accrued until a later date. Both kinds of unreceived income are well illustrated by Revenue Ruling 54-618,[97] holding that an insurance agent entitled to receive renewal commissions under a contract extending beyond his death owned both a debt equal to the unremitted commissions on policies actually renewed prior to his death and a claim for the commissions on renewals anticipated over the balance of the contract. Both the debt and the claim are included in the federal gross estate, the debt normally at face value, and the claim normally at a discount for the uncertainty and delay anticipated in realization. Assuming the usual cash basis and that the amounts are received by the executor, they would be included

[96] TAXATION IN THE U.S., *supra*, note 8 at 950.
[97] *Id.* at 195.

in the estate's gross income in the year of receipt. Double taxation in this case is avoided by allowing the federal income tax attributable to such income (called "income in respect of a decedent") as a deduction from the gross income of the estate.

CONCLUSION: NEED FOR EQUITABLE TREATMENT

As we have seen, in the United States, the tax treatment of receivables caught outstanding by the unexpected death of a cash-basis taxpayer is a field of broken lances. The battles for a more equitable taxation has been long and hard-before bar associations, before the courts, and before the legislature. Yet it is far from over. Although the U.S. Congress has laid down the broad policy in section 691, thru the concept of "income in respect of decedents, the smoke has not cleared. The fight has shifted from the question of how such income should be treated to the narrower ground of whether a particular income, or receivable, is "income in respect of a decedent" with the contemplation of Congress. And within the broad confines of the section-691-concept, there is still that veritable no man's land, where the government and the taxpayer ferociously dispute every inch, from case to case. Indeed, to the victor belong the spoils, or in this instance, the tax windfall.

In this jurisdiction, where does the tax wind blow? Apparently, it has even stopped blowing. Section 39 of our Tax Code, whose counterpart in the United States Tax Code is long dead, buried and resting in peace, continues to haunt deceased taxpayers. And the conflicting interpretations of the Bureau of Internal Revenue and the Court of Tax Appeals is not a bit reassuring to the decedent who carries his tax worries even to the grave. Perhaps our Congress can at least be just, if not merciful in matters of taxation. Section 39, can actually be unjust, if not harsh, in the way it "bunches" or piles up income which would have been spread over a number of years at lower tax rates. It is about time a provision similar to Section 691 of the U.S. Tax Code is enacted here. The solution under section 691 is not perfect nor fool proof but at least it is more kind to the taxpayer whose only fault is to die without collecting all receivables.