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TAXATION OF PARTNERSHIP ASSETS RECEIVED BY A DECEASED PARTNER AND HIS ESTATE — The raising of funds to pay taxes will probably be a major problem of business men for many years to come. Closely rivaling it, however, is the problem of computing the tax. Though the economic definitions of income may be relatively simple, the complex business relationships necessitating equally complex accounting procedures often make the computation of income extremely

difficult. This was demonstrated in the recent case of *Helvering v. Enright's Estate*,[1] a tax case arising out of the death of a law partner. At the time of his death there were three types of assets which had been acquired by the firm: cash, accounts receivable, and unfinished business for which a fee had not yet been determined. The immediate issue was whether these items had been accrued to the decedent during his lifetime, but the discussion opened up the problem of the correlation of the income taxes imposed upon the decedent and those imposed upon his estate.

Under the income tax statute a tax is levied both on the income of the decedent up to the date of his death[2] and on the income received by the estate during the period of settlement.[3] However, there is no income realized on the transfer of the assets of the decedent to his estate.[4] In computing his income, a taxpayer is generally allowed to use either a cash or accrual system of accounting.[5] The *Hearn* case,[6] decided by the Board of Tax Appeals in 1928, illustrates that these provisions at one time presented a loophole through which sizable sums could escape taxation. In this case both the decedent and his partnership were on a cash basis. During the current accounting period before decedent's death, the partnership had earned but not collected $14,000. As the deceased partner's executor continued to report the decedent's income on a cash basis, the return did not show this item. When the decedent's share was finally received, it again escaped taxation as it was not earned by the estate but was merely the liquidation of an asset of the decedent which was already in the estate.

In section 42 of the Revenue Act of 1934[7] Congress took cognizance of this loophole and provided that "amounts accrued up to the date of his death" should be included in a decedent's income for the

[1] 312 U. S. 636, 61 S. Ct. 777 (1941).

[2] "There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax. . . ." Internal Revenue Code (1939), § 11.

[3] "The taxes imposed by this chapter upon individuals shall apply to the income of estates or of any kind of property held in trust, including . . . (3) Income received by estates of deceased persons during the period of administration or settlement of the estate. . . ." Internal Revenue Code (1939), § 161(a).

[4] "No taxable income is realized from the passage of property to the executor or administrator on the death of the decedent. . . ." 2 C. C. H., FEDERAL TAX SERVICE, § 1138 (1941).

[5] "The net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. . . ." Internal Revenue Code (1939), § 41.

[6] Ethel D. Hearn, Admx., 9 B. T. A. 1362 (1928).

[7] "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." 48 Stat. L. 694 (1934), § 42, 26 U. S. C. (1934), § 42. This provision has been retained in § 42 of the present Internal Revenue Code.

period in which he died. The effectiveness of this provision depended upon the meaning of "accrued." If it were inclusive enough, it would completely close this leak. As an accounting term, "accrued" had acquired a fairly restricted technical meaning which had been adopted by the federal courts. Keeping accounts and making returns on the accrual basis as distinguished from the cash basis had been held to mean that, not the receipt, but the fixing of the right to receive money was the critical event in computing income.[8] This required not only the occurrence of the event precedent to the existence of liability, such as performance of services, but also of those events necessary to determine the amount of the liability, such as the final determination of the fee.[9] In applying this concept in the *Fehrman* case,[10] the Board of Tax Appeals came to the conclusion that the effect of section 42 was merely to change the decedent from a cash to an accrual basis of accounting. This effectively prevented the use of cash basis computations to avoid taxation, but did not completely close the loophole as income might be earned but not accrued, a situation which the board found to exist in that case. There the decedent was entitled to a bonus each year based on the yearly net profit of the store which he managed. This profit was computed each January for the preceding year. Fehrman died in July and, although a bonus was paid subsequently based on the proportion of the year he worked, no tax was paid on that bonus.

Even before section 42 was passed, the rule that the amount and liability be definitely determined before income could be accrued had not been adhered to in the case of a partnership continuing after the death of a partner during its fiscal year. In such a case the decedent was taxed only on that part of the total year's profits which was proportionate to the part of the year he was a member of the firm,[11] even though disproportionate gains or losses subsequent to his death might have substantially changed the value of his share after his death. This exception was limited, however, to cases where the actual earnings at the time of death could not be determined[12] and therefore should be recognized as a rule of administrative necessity rather than one of policy which might be extended.

With this background the Circuit Court of Appeals for the Third

[8] Spring City Foundry Co. v. Commissioner of Internal Revenue, 292 U. S. 182, 54 S. Ct. 644 (1934).

[9] Schoellkopf-Aniline & Chemical Works v. United States, (Ct. Cl. 1933) 3 F. Supp. 417.

[10] Lillian O. Fehrman, Extx., 38 B. T. A. 37 (1928).

[11] Darcy v. Commissioner of Internal Revenue, (C. C. A. 2d, 1933) 66 F. (2d) 581, cert. denied 290 U. S. 705, 54 S. Ct. 372 (1933); First Trust Co. of Omaha v. United States, (Ct. Cl. 1932) 1 F. Supp. 900.

[12] People's-Pittsburgh Trust Co. v. United States, (Ct. Cl. 1935) 10 F. Supp. 139.

Circuit held, when the *Enright* case came before it,[13] that the decedent's share of the cash and accounts receivable could be definitely determined and became distributable on the death of the partner and hence was accrued. As there was then no right to receive any payment for the unfinished business since its value had not been determined, that sum was not yet accrued. This rule seemed consistent with the Revenue Code and had the added advantage that it permitted the definite determination of the income of the deceased partner within a relatively short time after his death. If there should be any escape from taxes, the factors making it possible were sufficiently outside the control of the taxpayer to prevent serious purposeful avoidance.

When the case came before the Supreme Court,[14] however, the circuit court was reversed as to the treatment of the item of unfinished business. The Court expanded the meaning of "accrued" to include everything which was "attributable to the partner's interest" and, therefore, held that a share of the value of the unfinished business of the firm should be included in the distributable share of the decedent. By thus defining "accrued" the Court removed the limitations placed on the revenue acts by the more technical definitions which had previously been followed. If followed in the future, it will mean that all assets in excess of the capital received by a deceased partner from the partnership must be included in the return of the decedent for the fiscal year of his death. The Court recognized the difficulty of properly determining the value of the assets in cases such as this, but did not feel that it was insuperable. It was conceded that the collectibility of the items should be considered in such a determination, as presumably would also be permitted in regard to liquidated accounts receivable. While the *Enright* case involved a partnership which was dissolved by the death of one partner, the Court, in dicta, indicated that the accrual would be necessary even though the state law and the articles of partnership permitted the continuance of the partnership after death.[15]

The net effect of the *Enright* case is to obliterate the partnership completely for tax purposes on the death of one of the partners. This places an especially heavy income tax burden upon partners, as earnings from several past years may have been accrued by the partnership but for various reasons have been retained there and not made dis-

[13] Enright's Estate v. Commissioner of Internal Revenue, (C. C. A. 3d, 1940) 112 F. (2d) 919.

[14] Helvering v. Enright's Estate, 312 U. S. 636, 61 S. Ct. 777 (1941). Pfaff v. Commissioner of Internal Revenue, 312 U. S. 646, 61 S. Ct. 783 (1941), was decided at the same time on the basis of the reasoning of the Enright case.

[15] The effect of the Enright case is also discussed in 40 MICH. L. REV. 481 (1942).

tributable to the partners. These earnings from past taxing periods along with all the current earnings, some of which would ordinarily be reported in the future, suddenly become taxable in one year and therefore subject to higher rate brackets. The Court, however, felt that the intent of Congress, in view of the loophole which had existed, was clearly to tax all earnings that had not yet been reported. Congress may not constitutionally set up an accounting system which would convert what is not income into income by legislative fiat,[16] and although lip service has been paid to this proposition, it nowhere appears to have been considered very seriously in this type of case. Before the *Enright* case was decided, it had been thought that the use of the technical word "accrued" indicated an intent by Congress to exclude unliquidated accounts which could not be accrued under the accounting usages then prevalent.[17] Because of the language of the Court in that case, however, and the existing fiscal emergency, it seems likely that the *Enright* case will be given full effect so far as it holds that anything attributable to the partner's interest becomes distributable upon the dissolution of the partnership.

The broad scope of the *Enright* decision materially reduces the amount of income which might formerly have been taxed in the estate and thereby makes problems in computing the estate's income tax relatively less important as only very rarely would an estate's income tax be in the higher brackets. When the income taxable to the decedent has been determined, most of the difficult problems have been decided. Even when the money paid to the estate is clearly earned after the death of the partner, the courts have been very reluctant to consider it income to the estate. Usually the question is raised, not by the administrator or executor of the estate, but by the surviving partners who wish to exclude these earnings from their own incomes on the ground that they are being distributed to the deceased partner as his share of the partnership income under the articles. Generally the courts hold that this is a purchase of the assets of the deceased partner by the survivor. Hence it is a capital transaction and the income is included in the current income of the surviving partners but not of the estate.[18] The courts do not investigate the actual value of the assets received by the survivors to determine whether there is a fair equivalent, although apparently some assets are required in addition to good will.[19] Nor do

[16] Darcy v. Commissioner of Internal Revenue, (C. C. A. 2d, 1933) 66 F. (2d) 581, cert. denied 290 U. S. 705, 54 S. Ct. 372 (1933).

[17] 50 YALE L. J. 170 (1940); 1 MONTGOMERY, FEDERAL TAX HANDBOOK 1940-41, p. 359 (1940).

[18] Edwards v. Commissioner, (C. C. A. 10th, 1939) 102 F. (2d) 757; James B. Brown, 10 B. T. A. 1036 (1928).

[19] Bull v. United States, 295 U. S. 247, 55 S. Ct. 695 (1935).

the facts that no specific price is set and that the amount paid is measured by or paid out of subsequent income deter the courts from designating it a capital transaction.[20]

Thus in only a very few cases is the payment included in the estate's income. In these the activity which produces the income must clearly take place after the death of the partner and the possibility of designating it a capital transaction must, in some way, be eliminated. In the case of *Bull v. United States*,[21] there was no capital in the partnership and the Court felt that the bare right of continuing the partnership could not be capital; hence the money paid to Bull's estate under the articles must be income to the estate. Where there was a distinct separate capital settlement, the Board of Tax Appeals held that the payments were income and not a liquidation of capital.[22] The same decision was reached where there was no legal obligation to make the payment but merely a desire to help the widow of the deceased partner.[23]

The net result of these interpretations of the present income tax law is that all income which has in any way been acquired by a person during his lifetime through a partnership is reported in his tax returns, either during his life or in the final return filed for him by his representative. This achieves the ultimate aim of the income tax law. The injustices which arise through the cumulation of income in the last accounting period arise not so much through the unfairness of the law in that regard as through the leniency of the law in recognizing the mechanical imperfections of accounting systems used in ascertaining income taxable in preceding years. From the standpoint of the individual taxpayer, it is probably at least as desirable to square his account from his assets after his decease as to further complicate the accounting problems involved in making his periodic returns.

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[20] Lawrence W. Zonsius, 3 C. C. H., FEDERAL TAX SERVICE, ¶ 7461-B (1941); Benedict v. Price, (D. C. N. Y. 1929) 38 F. (2d) 309.

[21] 295 U. S. 247, 55 S. Ct. 695 (1935).

[22] Richard P. Hallowell, 2nd, 39 B. T. A. 50 (1939).

[23] Loe M. Randolph Peyton, 44 B. T. A., No. 195 (1941).