Denver Law Review

Volume 19 | Issue 8 Article 4

July 2021

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Recommended Citation
Norman W. Baker, Legal Services on the Installment Plan, 19 Dicta 201 (1942).

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Legal Services on the Installment Plan

By Norman W. Baker*

Since the wheels of the law grind slowly, particularly in our congressional law factory, may it not be pertinent to inquire what, if anything can be done within the limits of our present revenue code to alleviate the alleged harsh effects of the requirement that so-called income for personal services be accrued on the final income tax return for a decedent? I refer, of course, to the article appearing in DICTA of April, 1942, *American Bar Reports on Income Tax Amendment to Avoid Accrual Method in Death Cases,* which explains the requirements of the federal income tax law that upon the death of a person, there shall be considered as income in his final return and tax paid thereon, all "amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period," often including large uncollected sums for personal services such as doctor's fees, attorney's fees and the like. It is submitted that several avenues are open to soften the effects of that section, as interpreted by the courts, while we await the uncertain outcome of requests for congressional relief.

First, let it be stated that the decisions of the United States Supreme Court referred to in that article, *Helvering v. Enright's Estate*[1] and *Pfaff v. Commissioner of Internal Revenue*[2], should not have been too surprising. Section 42 was first enacted in the 1934 Revenue Act and the regulations issued since then have clearly required such accrual and foretold the present result. As the Board of Tax Appeals in the *Ledyard Estate* case said: "Decisions of this Board and the courts are uniform in holding that the effect of Section 42 is to put the decedent on the accrual basis of reporting income in his final return. * * * The accrual method of accounting and reporting income is not new. It has been a part of income tax laws since the 1916 act. The unconstitutionality of the method was apparently assumed in *United States v. Anderson,* 269 U. S. 422, and in *United States v. American Can Co.,* 280 U. S. 412. * * * Other cases hold that a deceased partner's distributive share of partnership profits not reduced to possession constitutes income includible in the final income tax return of the decedent who had kept his books on the cash basis. *Bull v. United States,* 295 U. S. 247; *Guaranty Trust Co. v. Commissioner,* 303 U. S. 493."[3] Assuming that an

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[1]312 U. S. 636, 61 S. Ct. 777, 85 L. ed. 1093 (1941).

[2]312 U. S. 646, 61 S. Ct. 783, 85 L. ed. 1099 (1941)

[3]Estate of Lewis Cass Ledyard, Jr. v. Commissioner of Internal Revenue, 44 B.T.A. 1056 (1941).

unwarrantedly heavy burden of taxes thus does result to estates found in this position, let us carefully examine the two United States Supreme Court decisions and the two Board of Tax Appeal cases mentioned by Mr. Cobourn.

In the first decision, it appears that John M. Enright was an attorney and member of a law partnership, the partnership agreement providing that on Mr. Enright's death, his estate should become entitled to his partnership percentage of monies on hand, outstanding accounts receivable and "the earned proportion of the estimated receipts from unfinished business." This calculation of values was made by his senior surviving partner, to be used in both the state inheritance tax return and the federal estate tax return, resulting in a value of $2,056 on the accounts receivable and of $40,856 on the unfinished legal work. It was the taxing barb on the latter item that caused the greatest pain, but even the Board of Tax Appeals had held "that the evidence did not show the situation of the unfinished work in sufficient detail to enable the Board to determine independently that it was not accruable."[4] A good point to remember: Prepare your evidence in cases before the Board as thoroughly as in any case before the courts.

The next point of importance here, referred to in the *Enright* case, is that from such accrued *gross* income on decedent's final return may be deducted accrued items of expense, such as interest, taxes, reasonable expenses of collection, and the like[5] as provided by Section 43 of the Revenue Act.[6] This source of relief is perhaps the most frequently overlooked. In addition, it might be desirable for anyone responsible for the preparation of such tax return to make a careful search for any additional deductions in the form of capital losses and bad debts (capital assets often ascertained to be worthless from an examination of decedent's records, safety deposit box contents, etc., and never previously deducted).

Actually in numerous cases the results of the accrual rule are not so terrifically bad. Congressional purpose is explained by the court thus: "Accruals here are to be construed in furtherance of the intent of Congress to cover [convert?] into income the assets of decedents, earned during their life and unreported as income, which on a cash return, would appear in the estate returns. Congress sought a fair reflection of income."[7]

In many of these cases it is advisable to keep in abeyance as long as possible the final correct valuation on, or amount of, the accrued income,

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[4]Helvington v. Enright's Estate, 312 U. S. 636, 638, 61 S. Ct. 779, 85 L. ed. 1093 (1941).

[5]Helvington v. Enright's Estate, 312 U. S. 636, 643, 61 S. Ct. 781, 85 L. ed. 1093 (1941).

[6]Regulations 103 Income Tax, Internal Revenue Code for 1940, page 193.

[7]Helvington v. Enright's Estate, 312 U. S. 636, 645, 61 S. Ct. 782, 85 L. ed. 1093 (1941).

in order to see what actual collections upon the accounts may be. In doing this, a conservative initial valuation of such assets by the personal representative should be made upon the inheritance tax return and upon the decedent's final income tax return, permitting the government to assess a deficiency if it wishes. The federal government has of course three years after the filing of decedent's final return within which to assess deficiency income tax and the later such deficiency is assessed the longer will be the period of observation herein suggested. Under Section 322 of the Revenue Code, a claim for refund may be "filed by the taxpayer within three years from the time the return was filed by the taxpayer or within two years from the time the tax was paid." By this method it is possible to observe the actual recovery or collection made on such so-called "accrued income" for as long as five years, and if collections do not reach expectations, a claim for refund is in order.

The corpus valuation placed upon such accrued items of income for inheritance tax purposes, while not binding upon the federal revenue agent in charge, are persuasive, particularly where supported by the opinion of qualified appraisers. As the Supreme Court points out, "the requirement of valuation comprehends the elements of collectibility."[8] It is only the rare case where *face or book value* of accounts receivable owing to a deceased doctor's or lawyer's estate can be shown by anyone to be collectible to that extent. In his article, Mr. Cobourn gives the example of a lawyer (annual net income $30,000) dying November 1, 1941, having uncollected and undetermined fees of $45,000 (supposedly face amount), with the result that $26,000 federal income tax is added. This writer cannot agree that such is a typical example, for it implies that the account of every client is as gilt-edged and collectible as United States government bonds. Everyone else knows, even if the revenue agent doesn't, that when the professional man dies, his personal representative will be lucky if eventually he collects 25% or 30% of the face or book amount of the accounts receivable for decedent's services, and not 100%.

In the *Pfaff* case,[9] where the decedent was a physician, the Commissioner of Internal Revenue had included in decedent's final income tax return, accounts receivable of $27,000 for services rendered, *but only at one-fifth of their face value*. This writer experienced the case of a deceased physician, who had kept his books on a cash basis, having $135,000 book value of accounts receivable for his professional services when he died, but a value of only $20,000 thereon was satisfactorily established before the Colorado Inheritance Division, based on an estimate of probable collectibility. The same value was found acceptable for

[8]Helvington v. Enright's Estate, 312 U. S. 636, 645, 61 S. Ct. 782, 85 L. ed. 1093 (1941).

[9]*Supra* note 2.

federal estate and income tax purposes. While it is true that "the estate tax and the income tax are wholly different in concept and theory and 'may impinge upon each other in ultimate incidence by striking at the beneficiary so as to diminish first his inheritance and then his income therefrom,"[10] nevertheless a careful evaluation for the first tax will ordinarily result in substantial savings on the latter tax.

That the above contention is true is borne out by the *Wickersham Estate* case. There two types of accrued income were involved, first, commissions of $34,669 as trustee and as guardian of Gloria Morgan Vanderbilt, a minor, and second, the interest of decedent George W. Wickersham in the profits of the copartnership of Cadwalader, Wickersham and Taft, shown on the federal estate tax return as worth $132,000. In the case of both items, the value placed thereon by the executor was accepted by the Treasury Department after audit of the estate tax return; accordingly, the same sums were considered as taxable income includible in decedent's final return. In the *Ledyard* case, the estate tax value of the decedent's interest in partnership uncompleted business was estimated by the executor at $281,778, whereas the income tax value on the same item, assessed by the commissioner, was only $134,535. Where the executor makes his own estimate of value of these items on the estate tax return, how can he object if the same value is used for income tax purposes?

The most important point to attorneys, however, of both the *Wickersham* and *Ledyard* BTA cases and the *Enright* case is the necessity of diminishing the possibility at death of large outstanding accounts receivable for services. With present high rates on income tax likely to continue for years to come, it behooves every attorney, including those whose health is good and whose life expectancy is long, to keep their accounts for fees receivable paid up at periodic, short intervals. These decisions should do much to enhance the movement for monthly billing of clients for services rendered. Many attorneys are still inclined to wait for a payment upon fee account in work extending over many months, or even years, until the conclusion of entire matter; and by reason of the peculiar nature of legal work and lawyer's fees therefor, this is sometimes a rule that must be followed. But with this and other tax inroads ever present, the lawyer who persists in claiming his fees in the time-hallowed method of the country storekeeper—by a lump sum bill once a year, or longer—may well be the last of his family, for the tax gatherer will leave little for the nurture and education of that lawyer's surviving son. Don't we often see leading attorneys too busy for months to render a bill or a request for a fee allowance? One place where some improvement can be made is in the courts, where allowances of fees are

[10]Camille R. Gump, Executrix, 42 B.T.A. 197, 205 (1940).

made in matters running over long periods of time. The Supreme Court itself in the *Enright* case has pointed the way and shown in part at least the medicine for this ailment, by this language: "The completion of the work in progress was necessary to fix the amount due but *the right to payment for work ordinarily arises on partial performance.*"[11] (Italics supplied.) Lower courts called upon to make allowance of fees to attorneys, receivers, trustees, guardians, etc., please take heed!

Note that in the *Wickersham* case the decedent's commissions as trustee and guardian, amounting to $34,669, were allowed on petition to the Surrogate Court months *after death* and theretofore no request has been made to the court for *any* allowance for such commissions.[12] Note also a similar situation in the *Ledyard* case.[13] Ledyard had for years been a director of Chase National Bank, was a partner in the law firm of Carter, Ledyard and Millburn (with which he had an agreement to pay his executors shares of income received after death), and was also executor of two estates and trustee of thirteen trusts. It was said: "The successor partnership took over the incompleted work of its predecessor and carried the matters to completion. In some instances nothing remained except collection of the fee and the other matters were in various stages of completion." Moreover, "No request had been made by the petitioner [*sic.*, decedent] to any court or beneficiary for the allowance of the commissions prior to the decedent's death." While we have no way of telling definitely from the opinions in these cases whether such in fact was the situation, it is likely that substantial shares of such fees and commissions could have been allowed and paid to decedent before the date of death, had they only been asked for. The moral of this story is, that bad though the rule of accrual of income on decedent's final return may be, there are some ways of diminishing its sting, one of the most heartening to the *lawyer* being the prompt and frequent collection of fees and commissions.

Note: As this article is written, it is learned that the House Ways and Means Committee has tentatively approved for the pending 1942 Revenue Act a provision that income accrued at date of death would be taxable to persons actually receiving it instead of being includible in decedent's final return.[14] It remains to be seen just what happens to this proposal as the Revenue Act goes through the Congress.

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[11]Helvington v. Enright's Estate, 312 U. S. 636, 645, 61 S. Ct. 782, 85 L. ed. 1093 (1941).

[12]Estate of Wickersham v. Commissioner of Internal Revenue, 44 B.T.A. 619 (1941).

[13]Estate of Lewis Cass Ledyard, Jr. v. Commissioner of Internal Revenue, 44 B.T.A. 1056 (1941).

[14]Rewrite Bulletin 20 of C.C.H. Standard Tax Service for 1942, Volume 1, p. 128.