14 T.C. 237

Payments received from an inherited contract right are taxable income to the extent they exceed the fair market value of the contract at the time of inheritance, as the inherited property is the contract itself, not the payments.

Summary

May D. Hatch inherited a contract from her deceased husband's estate, which obligated a corporation to make annual payments. The contract was valued at $243,326.70 for estate tax purposes. Hatch received payments exceeding this value and argued they were tax-exempt inheritances. The Tax Court held that while the contract itself was inherited property, the payments exceeding its estate tax value constituted taxable income. The court reasoned that Hatch's basis was the contract's fair market value at inheritance, and payments beyond that represented taxable gain from the contract, not tax-exempt bequests. The court rejected the argument for capital gains treatment or income allocation over the contract's life.

Facts

Frederic H. Hatch, petitioner's husband, had an employment agreement with Frederic H. Hatch & Co., Inc. providing for a salary and a percentage of net earnings. Upon his death in 1930, the agreement stipulated that the corporation would pay his estate $30,000 annually for ten years, and potentially a percentage of net earnings. May D. Hatch, as the sole beneficiary of her husband's will, inherited this right to payments. The contract's value for estate tax purposes was determined to be $243,326.70. By 1941, payments to Hatch exceeded this value. The Commissioner of Internal Revenue determined that these excess payments were taxable income.

Procedural History

The Commissioner determined deficiencies in Hatch's income tax for 1941 and 1943. Hatch contested this determination in the United States Tax Court, arguing the payments were tax-exempt inheritances. The Tax Court upheld the Commissioner's determination. Dissenting opinions were filed by Judges Van Fossan and Hill.

Issue(s)

1. Whether payments received by Hatch under the inherited contract, exceeding the contract's estate tax value, constitute taxable income or tax-exempt inheritance under Section 22(b)(3) of the Internal Revenue Code.

2. Whether, if taxable, this income should be allocated over the life of the contract.

3. Whether, if taxable, this income qualifies as capital gain under Section 117 of the

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Internal Revenue Code.

4. Whether the statute of limitations had expired for the assessment of deficiency for 1941.

Holding

1. No. The payments exceeding the fair market value of the contract at the time of inheritance are taxable income because they represent gains from the inherited contract right, not tax-exempt bequests.

2. No. The income cannot be allocated over the life of the contract; it is taxable when received after exceeding the basis.

3. No. The income is not capital gain because it arises from the discharge of a contractual obligation, not from a sale or exchange of property.

4. No. The period of limitations for assessment for 1941 had not expired due to an extension agreement and the omission of income exceeding 25% of gross income.

Court's Reasoning

The court reasoned that Hatch inherited the contract right, not the payments themselves as tax-exempt bequests. Citing *Helvering v. Roth*, the court stated that collecting payments exceeding the inherited contract's value results in taxable gain. The court emphasized that Section 22(a) of the Internal Revenue Code defines gross income broadly to include "gains, profits, and income derived from…dealings in property." Hatch's basis in the contract was its estate tax value, $243,326.70. Payments beyond this basis are taxable income. The court distinguished *United States v. Carter*, which Hatch relied on, deeming it an incorrect interpretation of law, and favored the reasoning in *Helvering v. Roth*. Regarding capital gain, the court held that the payments were not from a "sale or exchange," but from the liquidation of a contract obligation, thus failing to meet the requirements for capital gain treatment under Section 117. The court also dismissed the income allocation argument, finding no statutory basis for it outside specific provisions like installment sales or annuities. On the statute of limitations, the court found that because Hatch omitted income exceeding 25% of her reported gross income for 1941, the five-year statute of limitations under Section 275(c) applied, which was further extended by agreement, making the deficiency notice timely.

Practical Implications

Hatch v. Commissioner clarifies that inheriting a contract right, even one providing for future payments, establishes a basis equal to its fair market value at inheritance. Subsequent payments exceeding this basis are treated as ordinary income, not tax-free inheritances. This case is crucial for tax planning involving inherited assets that generate future income streams, such as contracts, annuities, or royalties. It

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highlights that while the inherited asset itself is excluded from income, the income derived from that asset, beyond its established basis, is taxable. This principle is consistently applied in cases involving the taxation of payments from inherited rights, ensuring that beneficiaries cannot avoid income tax on the economic gain realized from such assets beyond their initial inherited value. Later cases distinguish *Hatch* by focusing on whether the payments are truly 'income from property' or are more akin to the property itself being received in installments.

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