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Rev. Rul. 75-125

Advice has been requested concerning the treatment, for Federal income tax purposes, of appreciated securities acquired by a decedent during his lifetime under the circumstances described below.

An employee retired in 1969 and under a retirement plan established by his corporate employer received at that time a lump sum distribution from an exempt employees' trust created under the plan. The distribution to him consisted entirely of securities of his corporate employer and had a basis to the trust of 5x dollars and a market value on the date of distribution of 10x dollars. The employee's contribution to the trust under the plan was 1x dollars. The retired employee died on June 30, 1974, leaving the securities, with a fair market value at the date of his death of 12x dollars, to his widow. His widow sold the securities on September 24, 1974, for 13x dollars.

Section 402(a)(2) of the Internal Revenue Code of 1954, with respect to distributions made before January 1, 1970, provided, in part, that, in the case of an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if the total distributions payable with respect to any employee are paid to the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, the amount of the distribution, to the extent exceeding the net amounts contributed by the employee (if any), shall be considered a gain from the sale or exchange of a capital asset held for more than six months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation.

Section 1.402(a)-1(b)(1)(i) of the Income Tax Regulations provides, in part, that the amount of net unrealized appreciation on employer securities that is excludable under section 402(a) of the Code shall not be included in the basis of the securities in the hands of the distributee. However, such net unrealized appreciation shall be considered as a long-term capital gain to the extent realized in a subsequent taxable transaction. If the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, this excess shall constitute a long-term or a short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

Section 1.402(a)-1(b)(2)(i) of the regulations provides, in part, that the amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust.

Section 1014(a) of the Code provides, in part, that the basis of property in the hands of the person acquiring the property from a decedent or to whom property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. Section 1014(b) describes the nature of property considered to have been acquired from or to have passed from

the decedent for purposes of section 1014(a). However, section 1014(c) states that section 1014(a) shall not <Page 255> apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

Section 1223(11) of the Code, as amended by the Revenue Act of 1971, provides with respect to a decedent dying after December 31, 1970, that in the case of a person acquiring property from a decedent or to whom property passed from a decedent (within the meaning of section 1014(b)), if (A) the basis of such property in the hands of such person is determined under section 1014, and (B) such property is sold or otherwise disposed of by such person within 6 months after the decedent's death, then such person shall be considered to have held such property for more than 6 months.

Section 691(a)(1) of the Code provides that the amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including 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) shall be included in the gross income, for the taxable year when received, of (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reasons of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 691(a)(3) of the Code provides, in part, that the right to receive an amount of income in respect of a decedent shall be treated in the hands of the decedent's estate or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent acquired such right, and shall be considered as having the same character it would have had in the hands of the decedent if the decedent had lived and received such amount.

Section 691(c) of the Code allows a person, who must include in his gross income for the taxable year any amount of income in respect of a decedent, to deduct for the same taxable year that portion of the Federal 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 amount. See Rev. Rul. 67-242, 1967-2 C.B. 227, for the proper method of computing the deduction allowed under section 691(c).

In Rev. Rul. 69-297, 1969-1 C.B. 131, an employee designated his estate as the beneficiary of his interest in an exempt employees' profit-sharing trust. The employee died and his entire interest in the trust was distributed to his estate within one taxable year. The distribution included appreciated stock of the employer corporation. That Revenue Ruling provides, in part, that for the taxable year in which the distribution is made the estate is required to include the amount specified under section 402(a)(2) of the Code in its gross income as income in respect of a decedent under section 691(a). It further holds that the net unrealized appreciation in the securities of the employer is includible in gross income in respect of a decedent in the taxable year of their disposition, in a taxable transaction, by either the executor or the residuary legatees.

In the instant case, the employee was required, under section 402(a)(2) of the Code, to include 4x dollars in his 1969 gross income. This represented the total distribution to him in 1969 of securities having a market value of 10x dollars reduced by his contribution to the trust of 1x dollars and further reduced by the net unrealized appreciation of 5x dollars attributable to the securities of the employer corporation that were distributed.

Under section 1014(a) of the Code, the basis of the securities to the deceased employee's widow is 7x dollars. The basis is computed by subtracting the net unrealized appreciation attributable to the employer securities of 5x dollars from the fair market value of such securities as of the date of the employee's death in the amount of 12x dollars. The net unrealized appreciation constitutes a right to receive income in respect of a decedent as provided under section 691(a).

The gain that is taxable to the deceased employee's widow on the sale of the employer securities is 6x dollars, computed as follows:

Determination of Total Gain:

Amount realized from the
sale of the employer
securities 13x dollars

Less: Basis of the
securities under section
1014(a) of the Code 7x dollars

Total gain from sale of
the securities 6x dollars

Analysis of Total Gain

Determined Above:

Gain attributable to the
net unrealized appreciation 5x dollars

Amount of the total gain
in excess of the gain
attributable to the net

unrealized appreciation 1x dollars

Total gain from the sale
of the securities (as above) 6x dollars

Accordingly, the gain of 5x dollars attributable to the net unrealized appreciation is taxable to the deceased <Page 256> employee's widow in 1974 as a long-term capital gain since the gain retains the same character it would have had in the hands of the decedent if the decedent had lived and received such amount. Due to the operation of section 1223(11) of the Code, the gain of 1 x dollars in excess of the net unrealized appreciation is taxable to the widow in 1974 as a long-term capital gain, even though the widow held the securities for a period of less than six months (June 30, 1974, to September 24, 1974). Furthermore, a deduction is allowable to the widow under section 691(c) for that portion of the Federal estate tax attributable to the amount of the net unrealized appreciation included in the decedent's estate