Marquette Law Review

Volume 32
Issue 4 *February 1949*

Article 3

1949

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FEDERAL TAX TREATMENT OF THE FAMILY*

FRANCES M. RYAN**

I. INTRODUCTION

That the family presents a special and complex problem in the tax field is evident, even before one becomes acquainted with the countless pages of case reports, statutes, and congressional materials which stand as records of the constant effort to solve it. There is nothing particularly sensational or shocking about the fact that a large proportion of tax litigation involves the family unit, however.[1] As in all his endeavors, one of man's most pressing motives for conserving his income and his estate is to protect and to provide for his family, and experience has proven to those so motivated (and to the less worthily impelled, also) that the community living and natural ties of the family make that very group the best and safest one within which to carry out the property and income-shifting necessary to tax savings.

Even though emotionalism over these efforts is uncalled for, the avoidances are serious and must be curtailed. They result in loss of revenue to the government and, eventually, in a heavier burden on other taxpayers. But blocking them is difficult, since the imposition of heavy tax penalties on certain types of devices may completely nullify the advantages of their use to achieve other worthwhile purposes.[2]

Moreover, isolated efforts, no matter how successful, to stop the use of the family relationship to achieve tax advantages can never be completely satisfactory. In order to make the ability-to-pay philosophy function as a basis of our tax system, we must find some way of evaluating in dollars and cents and with approximate accuracy the basic obligations of the head of a household and the opportunities for savings afforded its members by group living and then work out a system, not only technically perfect, but which, because its demands are more even-

*This paper was submitted by the author in partial fulfillment of the requirements for the L.L.M. degree at the Law School of the University of Michigan. It is being published as two articles, of which this is the first. The second will appear in the May issue of the Review. This article deals with the law before the Revenue Act of 1948. The effect of the Revenue Act of 1948 is considered at length in the second article.

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[1] A survey made by John W. Ervin, author of "Federal Taxes and the Family," 20 S. Cal. L. Rev. 243 (April, 1947), showed that of the 295 cases considered by the Tax Court between January 7 and November 21 of 1946, 98 of them involved the family group.

[2] The trust presents a striking example. Its one-time value as a means of providing an independent income to the beneficiary without risking the capital to his management has been considerably lessened by the conflicting requirements, confusion, and unforeseeability of results in this part of the tax field.

ly distributed and less noticeably burdensome, will not be a constant temptation to tax avoiders.[3] That such an objective is only a goal toward which we may move, but will never reach, must be conceded. Circumstances vary with every house in the block and no rule or regulation can take all of them into account. Better drafting and enforcement of tax law should stifle to some extent the urge to defeat tax policy, but there will always be hopeful challengers.

The history of recent attempts at basic changes in family tax-law has shown, too, that even the idea of change meets with opposition. Perhaps one of the greatest difficulties lies in the use by the states of two radically different concepts of property law and marital relationships.[4] Each guards its own system zealously and prefers legislation which would achieve equality between the groups at the expense of the other. Suggested innovations in the family tax-law field have been attacked, also, by women's rights groups which feel that identification of the wife as a member of the family unit rather than as an independent individual for tax purposes is a long step backward toward inequality of the sexes.[5] And even among those who do not press for advantages for certain classes, the outlook differs. A more conservative faction, rapidly losing ground, would write tax statutes and decide tax cases strictly on the basis of property concepts; while others would disregard "technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes."[6] These conflicting views and desires have resulted in the lack of a co-ordinated system and a uniform policy of dealing with the taxation problems involving the family situation, which, in turn, has meant unfair treatment of certain taxpayer groups, the passage of "loophole-prevention" legislation, even greater overlapping and complexity in the law, and increasing difficulty for the head of a family in his efforts to plan an amply secure future for his dependants.

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[3] Magill has aptly described the present situation in the following words: "The collection of the income tax possesses some of the aspects of a game of hide and seek, in which the government is always 'it,' and good-naturedly counts for a year or two before it starts to hunt." *The Impact of Federal Taxes* (1943), p. 196.

[4] States originally belonging to the community-property group were Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. In efforts to save taxes for their citizens Oklahoma, Oregon, Michigan, Nebraska, Pennsylvania and the Territory of Hawaii also adopted the community-property system. Pennsylvania's law was declared unconstitutional in 1948 and Michigan repealed its statutes after the adoption of the 1948 Revenue Act.

[5] See, for example, the letters of women's clubs, addressed to the House Ways and Means Committee, opposing the mandatory joint return provision of the 1942 Revenue Bill. Hearings before Committee on Ways and Means, Revenue Revision of 1942, 77th Congress, 2nd Session (1942), at 3571.

[6] Helvering v. Clifford, 309 U.S. 331, 334, 60 S. Ct. 554 (1940).

II. Particular Problems Involving the Family

Until the passage of the 1948 Revenue Act[7] husband and wife were regarded as separate entities for taxation purposes.[8] Under such a tax scheme many of the burdens and disadvantages of our system can be avoided and obvious savings in income taxes can be made by shifting the right to or the ownership of income to the spouse (or other family member) whose total income will place him or her in the lower surtax brackets. Likewise, estate-tax savings can be achieved by passing property during life from the owner to those who would, otherwise, obtain it after his death. To make these changes in ownership without affecting his actual status as recipient of the benefits of the income or property transferred is generally the taxpayer's aim.

A. Property Ownership

This has been done in a variety of ways, but one of the most frequent attempts is the employment of some form of joint ownership of income-producing property. If property is held in joint tenancy or by the entireties, either of which type of ownership carries with it the right of survivorship, the property does not pass by inheritance and is not included in the probate estate of the owner first to die.[9] For this reason joint ownership or the holding of property by the entireties has often been advised in the case of small estates. There is, however, no saving in estate taxes, since the 1942 Revenue Act, as well as those of previous years,[10] provides that an estate tax shall be levied on all property

> "To the extent of the interest therein held as joint tenants by the decedent and any other person, or as tenants by the entirety by the decedent and spouse . . . except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth."[11]

If the property was given to husband and wife as joint tenants or tenants by the entirety, one half is included in the estate of the individual first to die.[12] In such a case, of course, the survivor would be taxed upon the whole of the property at his or her death, unless it occurred

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[7] Problems taken up in this section will be discussed without reference to the 1948 Revenue Act. The effect of this legislation will be considered in Part V.

[8] Exceptions to this rule are discussed at a later point. See also: Paul and Havens, "Husband and Wife under the Income Tax," 5 Brooklyn L. Rev. 240 (March, 1936).

[9] Walsh, *Commentaries on the Law of Real Property* (1947), Sec. 116, 121.

[10] The provision, in its essentials, is included in the Revenue Act of 1916. (39 Stat. 778, Public No. 271, 64th Congress, 1st Session). In its present wording it dates back to the Revenue Act of 1926. (44 Stat. 71, Public No. 20, 69th Congress, 1st Session).

[11] I.R.C., Sec. 811(e).

[12] *Ibid.*

within five years of that of the spouse.[13] Other disadvantages urged with regard to these types of ownership are: (1) that they may result in an unfair tax burden falling upon those who take property from the decedent by will or descent, since the tax on the jointly held property will usually be collected from the residue of the estate, (2) that any saving in state inheritance taxes is partly nullified because it serves to cut down the amount of the eighty per cent credit allowed against the estate tax for inheritance taxes paid to the state, (3) that the survivor takes the original purchase price as his cost basis even though an estate tax has been paid on the present market value, which may be much higher,[14] (4) that, although both an estate and gift tax must be paid (in cases in which one of the spouses did not contribute a part of the purchase price proportionate to the interest received from the other), the full credit for the latter against the former will seldom be obtained, (In cases in which the donee dies first, it appears that no credit may be had.)[15] (5) that proving the amount of contribution by the survivor requires a great deal of tracing and record-keeping and is often, in fact, impossible, and (6) that an unexpected gift-tax liability may be discovered at the time of the donor's death.

This is often due to the fact that persons do not realize that a husband who buys property in the joint names of himself and his wife is considered to have made a gift to her at that time,[16] and if the tax is not paid, the burden of paying it will fall upon the estate, or, if its assets are not sufficient, upon the survivor.[17] This gift consists of two parts: the value of the wife's present interest in the property and the value of her right of survivorship.[18] Since the latter is a future interest, the $3,000 annual exclusion from value is not applicable.[19]

The right of the parties to split the income from property held by the entirety or as joint tenants depends upon the law of the state in which it is located.[20] In a state, such as Massachusetts, where the husband is entitled to all profits arising from such ownership, the entire

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[13] I.R.C., Sec. 812(c).
[14] Paul and Mertens, *Law of Federal Income Taxation* (1934), Sec. 18.93, and authorities there cited.
[15] I.R.C., Sec. 813(a); Commissioner v. Hart, 106 F.(2d) 269, (C.C.A. 3rd, 1939); Alexander, "Why Joint Tenancies?", 84 Trusts and Estates 547 (May, 1947).
[16] Commissioner v. Hart, 106 F.(2d) 269 (C.C.A. 3rd, 1939); Lilly v. Smith, 96 F.(2d) 341 (C.C.A. 7th, 1938), cert. den., 305 U.S. 604, 59 S.Ct. 54 (1938), motion for rehearing den., 307 U.S. 651, 59 S. Ct. 1040 (1939). However, if a husband established from his separate funds a joint bank account for himself and his wife, a gift would result to the wife only to the extend of the amount drawn by her. Treas. Reg. 108, Sec. 86.2(a)(4).
[17] Treas. Reg. 108, Secs. 86.34 and 86.35.
[18] Treas. Reg. 108, Sec. 86.19(h); Alexander, *supra,* note 15.
[19] I.R.C., Sec. 1003(b).
[20] Paul and Mertens, *Law of Federal Income Taxation* (1934), Sec. 14.03 and 14.04; *1948 Federal Tax Service,* Para. 7211.

income is taxable to him, but in other states in which the wife has a present right to one half the income, she is taxable upon her share.[21]

The only possible advantage of joint ownership lies, therefore, in the right to split income or profits for income-tax purposes. In cases in which the wife contributes her proportionate share to the purchase price from her separate property, however, the couple gains nothing, as she already had the privilege of reporting the income from her separate funds herself, regardless of how they were invested. In cases in which the wife contributes nothing or less than her proportionate share to the purchase price, the couple, depending upon state law, acquire the right, which they did not formerly have, of splitting the income from the assets invested by the husband. However, they pay for this privilege in a gift tax levied against the interest acquired by the wife and an estate tax at the husband's death upon the whole of the property (less any portion for which the wife furnished the purchase price) plus the retention by the wife of a cost basis, which in many cases will be lower than the value at which the estate tax was figured. Should the wife who has furnished no part of the purchase price die first, there will be no estate tax imposed, but the gift-tax credit will be lost.

If, however, large capital gains are expected to accrue from the sale of the property, joint tenancy or ownership by the entireties has sometimes been reverted to in order to obtain the income-splitting advantage.[22] They may also be used to achieve splitting of profit from a business in a situation in which a partnership for like purposes would not be effective.[23] But the courts, scrutinizing closely family transactions, have on occasion refused to recognize joint ownership arrangements which were not bona fide or were intended merely to achieve an income-tax saving.[24]

This dead-end for the taxpayer's hopes was brought about by the simple expedient of relying first on the technical aspects of ownership to justify the imposition of the gift tax on the interest of the donee and later on the economic aspects to uphold the feasibility of an estate-tax levy on the whole property.[25] In this way any advantage accruing

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[21] *Ibid;* Cooley v. Commissioner, 75 F. (2d) 188 (C.C.A. 1st, 1935), cert. den., 295 U.S. 747, 55 S. Ct. 825 (1935).

[22] McInerney v. Commissioner, 82 F. (2d) 665 (C.C.A. 6th, 1936).

[23] Edwin F. Sandberg, 8 T.C. 243 (1947).

[24] *Supra,* note 22; Matern v. Commissioner, 61 F. (2d) 663 (C.C.A. 9th, 1932).

[25] See Commissioner v. Hart, 106 F.(2d) 269 (C.C.A. 3rd, 1939) in which the Court speaks of the "technical" property view used to justify the gift tax and the "economic" or "use interest" view, relied upon to uphold the imposition of an estate tax upon the same realty. In Tyler v. United States, 281 U.S. 497 (1930), taxpayers objected to the levying of an estate tax upon property held by the entireties and upon the wife's share of which a gift tax had previously been paid. In the process of brushing aside the "technical" and adopting the "economic" view, the Court stated (at page 503): "According to the amiable fiction of the common law . . . husband and wife are but

to husband and wife from joint ownership is routed and the only possible criticism which might be leveled at the method used is that the estate-tax theory is not co-ordinated with that of the gift and income taxes; or, in other words, that a transfer complete for one purpose is not recognized as final for another.

If property is held by the spouses as tenants in common, each has a right to the use of the whole during his lifetime, but his interest falls into his probate estate upon his death.[26] Consequently, each is taxed upon his proportionate share of the income during his life,[27] and only his own interest in the whole property is subject to the estate tax.[28] Thereafter, the cost basis of that portion is raised to its market value at the time of the death of the decedent.[29]

If husband and wife acquire, as tenants in common, property purchased by the husband, he has made a completed gift to his wife of a present property interest, against which the $3,000 annual exclusion is applicable. To avoid the gift tax entirely, the husband might give his wife each year a fractional interest in the property, small enough to fall within the annual exclusion, which he could not do if they were to hold as joint tenants.[30]

In other words, if husband and wife hold property as tenants in common, each is treated exactly as he would be if he acquired as sole owner a piece of property having half the value of that he owns in common with his spouse; or, in the case of the donor, as if he gave to his spouse as sole owner a piece of property of that value. There is no tax penalty to this type of ownership, but if income-tax shifting is achieved through purchase by the husband of property as tenant in

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one person, and the point made is, that by the death of one party to this unit no interest in property held by them as tenants by the entirety passes to the other. This view, when applied to a taxing act, seems quite unsubstantial. The power of taxation is a fundamental and imperious necessity of all government, not to be restricted by mere legal fictions . . . To include in the gross estate, for the purpose of measuring the tax, the value of property, no part of which originally belonged to one spouse, but which came to the tenancy, mediately or immediately, as a pure gift from the other, and which, as a consequence of the latter's death, was relieved from restrictions imposed by the law in respect of tenancy by the entirety so as to produce in the survivor the right of sole proprietorship, is obviously neither arbitrary nor capricious."

[26] Walsh, *Commentaries on the Law of Real Property* (1947), Sec. 118.

[27] *1948 Federal Tax Service,* Para. 17,618; Magill, *Taxable Income* (Revised ed., 1945), p. 313.

[28] Estate of Marcel Lemer, 23 BTA 256 (1931); Estate of Lester L. Fletcher, 44 BTA 429 (1941); also *1948 Federal Tax Service,* Para. 23,743, and authorities there cited.

[29] Treas. Reg. 111, Sec. 29.113(a)(5).

[30] Suggested by Dane in "Tenancies, Joint, in Common and by the Entirety," 25 Taxes 634 (July, 1947). The requirement that the four unities of time, title, interest and possession be present in a joint tenancy precludes piecemeal gifts from husband to wife. Since only unity of possession is required in a tenancy in common, the interest of the wife may be increased from year to year. (See Walsh, *supra,* note 26, Secs. 115 and 118).

common with his wife, he compensates the treasury by paying a gift tax for the privilege he has acquired.

B. Assignments

Joint ownership by husband and wife not only has the disadvantages pointed out in the foregoing section, but such a transfer effected too complete and final a severance of property rights to suit the purposes of many taxpayers. The possibility of sudden and unforeseen changes either in family relationships or in tax law made a more informal and flexible instrument of tax avoidance desirable. Moreover, one was needed which could be applied to intangibles; expectations of, or rights to, compensation and profit. The assignment showed indications of being such a tool, and it was eagerly grasped, both by those who desired to share salaries, as yet unearned, with their spouses and those who wished to transfer to them (in restricted form) the income benefits arising from their properties.

Obviously, unless some limits were to be placed on the use of assignments, almost every astute householder could, by assigning fractional parts of his income to each member of his family, substantially reduce his total tax bill, and the surtax would, in truth, become "the inverse reward of fertility."[31]

Because the early California community-property law was interpreted to place all present rights to income earned by him (including the right to pay the tax on the whole of it) in the husband,[32] California taxpayers made frequent attempts to achieve the otherwise denied benefits of income-splitting by means of assignments of a part of their future earnings to their wives. Prior to the decision in Lucas v. Earl,[33] these cases were decided on a technical ground. If the assignment was worded so as legally to effect a conversion of the husband's future earnings into the separate property of husband and wife, each could report half the income; otherwise, the husband was taxed upon the whole of it.[34]

In 1930, however, the case of Lucas v. Earl[35] reached the Supreme Court and Justice Holmes. The facts were typical of other assignment cases involving California taxpayers. The spouses had entered into a written contract in 1901, whereby they agreed that henceforth any property or earnings then held or later acquired by either should be their joint property. The treatment of attorney's fees earned by the

[31] Statement of Judge Clark in Clapp v. Heiner, 51 F.(2d) 224, 225 (C.C.A. 3rd, 1931).
[32] Robbins v. United States, 269 U.S. 315, 46 S. Ct. 148 (1926).
[33] 281 U.S. 111, 50 S. Ct. 241 (1930).
[34] Blair v. Roth, 22 F.(2d) 932 (C.C.A. 9th, 1927), cert. den., 277 U.S. 588, 48 S. Ct. 436 (1928); Wehe v. McLaughlin, 30 F.(2d) 217 (C.C.A. 9th, 1929).
[35] *Supra,* note 33.

husband in 1920 and 1921 was under consideration. Justice Holmes indicated, in passing, that, since the husband alone was party to the contracts under which the fees were earned, it seemed that for some small moment of time the income must be his, subject to the assignment, and, therefore, taxable to him. However, he did not rely on such "attenuated subtleties,"[36] but on the "import and reasonable construction of the taxing act."[37] This import, and the reasoning process by which it was discovered, he set forth in two sentences:

> "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from than on which they grew."[38]

Henceforth, it was clear, assignments of future income might have other effects; but they would not result in income-tax savings.

The treatment of income accrued before assignment has not been at all uniform. In some instances the courts have blindly relied on Lucas v. Earl,[39] either unaware of, or choosing to overlook, the fact that Justice Holmes spoke of "anticipatory arrangements."[40] In other cases a distinction has been noted and Lucas v. Earl has been rejected as a precedent.[41] The claim to income already earned was treated as a property right. In some cases it has been held capable of assignment.[42] But in later decisions[43] there has been a tendency to follow the Horst case,[44] discussed below.

A problem, originally even more complex, however, was presented by attempted assignments of the income rights to property. Some of

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[36] *Supra,* note 33, at 114.
[37] *Ibid.*
[38] *Ibid.*
[39] The decision is cited as authority, for example, in Daugherty v. Commissioner, 24 BTA 531 (1931), affirmed 63 F.(2d) 77 (C.C.A. 9th, 1933), and in Emery v. Commissioner, 78 F.(2d) 437 (C.C.A. 1st, 1935), both of which cases involved assignments of income earned prior to its transfer.
[40] *Supra,* note 33, at 114.
[41] Hall v. Burnet, 54 F.(2d) 443 (C.A., D.C., 1931), cert. den., 285 U.S. 552, 52 S. Ct. 408 (1932); Nelson v. Ferguson, 56 F.(2d) 121 (1932), cert. den., 286 U.S. 565, 52 S. Ct. 646 (1932).
[42] *Ibid;* Commissioner v. Ross, 83 F.(2d) 18 (C.C.A. 6th, 1936). See, also, cases cited in Commissions on Renewal Premiums," 83 A.L.R. 91.
[43] Helvering v. Eubank, 311 U.S. 122, 61 S. Ct. 149 (1940) and cases noted in "Commissions on Renewal Premiums," 131 A.L.R. 665. An earlier case based on similar reasoning is Van Meter v. Commissioner, 61 F. (2d) 817 (C.C.A. 8th, 1932.
[44] Helvering v. Horst, 311 U.S. 112, 61 S. Ct. 144 (1940).

the difficulties they have presented have been described by one author thus:

> "But suppose the owner, A, does not vest in another full rights to property and income, but shares his rights in either by transferring some of them to B. The revenue acts do not add up the rights of A on the one hand and the rights of B on the other and divide the tax accordingly. That A owns the property and B receives the proceeds—a typical situation—will not result in taxation of part of the proceeds to A and part to B. Under the present Act as applied by the courts only one of the two may be taxed on the proceeds and he must be taxed in full. As A was originally taxable the approach is to determine whether sufficient rights have been given to B to make him the subject of the tax. The transfers . . . generally leave the transferor with ownership or control of the property producing the income, but with the transferee alone actually receiving the proceeds. Under what circumstances, then, may a person be taxed on income when the actual payments are made to others? The background of the cases is a fear of tax avoidance."[45]

Perhaps it was this fear which in 1940 motivated the Supreme Court's decision in Helvering v. Horst.[46] The taxpayer in 1934 and 1935 had detached, shortly before their maturity, negotiable interest coupons from notes owned by him and had given them to his son, who later in each of the years collected the interest on the matured coupons. Reversing the Circuit Court of Appeals, the Supreme Court held the donor taxable on the interest received by the donee, stating that:

> "The holder of a cupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing the capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons . . . Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.
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> "Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by

[45] Surrey, "Assignments of Income and Related Devices: Choice of the Taxable Person," 33 Col. L. Rev. 791, 792 (May, 1933).
[46] *Supra,* note 44.

which he obtains the fruition of the economic gain which has already accrued to him . . . .

"In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income. . . .

"Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income . . . . Even though he never receives the money, he derives money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.

". . . To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor, because he has assigned them over to the donee, is to affront common understanding and to deny the facts of common experience."[47]

The Supreme Court had answered Mr. Surrey's query: "Under what circumstances, then, may a person be taxed on income when the actual payments are made to others?"[48] That answer amounted to "any." It reached that conclusion, first, by thinking of ownership in terms of a number of rights, and, secondly, by developing the "enjoyment" theory; that elastic notion that whatever a person voluntarily does with his property, he does because he wants to, and, since he intended his act, the non-material satisfaction derived therefrom is realization of income, just as much as if he had actually obtained the income itself and then used it to achieve the same result.

Some time ago an economist noted this trend in another field of the law and climaxed a résumé of the cases therein by stating that "the transition from the meaning of property as physical things to that of the most ethereal invisibility"[49] had been reached, which, if true when

[47] *Supra,* note 44, at 115 ff.
[48] *Supra,* note 45, at 793.
[49] Commons, *Legal Foundations of Capitalism* (1924) at 18.

written, is even more true today. In explaining the change in outlook, he spoke of the disappearance of the old common-law notion of property, saying:

> "... 'corporeal property' in the original meaning of the term, has disappeared, or rather, has been relegated to what may be described as the internal economy of a going concern or a household in the various processes of producing and consuming physical objects, according to what the economists call their 'use-value.' And instead of the use-value of corporeal property, the courts are concerned with its exchange-value. This exchange-value is not corporeal—it is behavioristic. It is the market-value expected to be obtained in exchange for the thing in any of the markets where the thing can *or might be* sold."[50] (Italics supplied.)

The Court in Helvering v. Horst had followed just such a theory and had taxed the grantor of property on the basis of "exchange-value," putting a price, not on the interest itself, which was never paid to him, but on his pleasure in making the gift, which, it decided, was equivalent to the amount which he would have obtained in dollars and cents for the coupons if he had collected them himself. Such a philosophy, of course, both complements and extends the underlying theory and purpose of Lucas v. Earl. It is no longer of moment that the latter case really applies only to assignments of future earnings; accrued earnings can be looked upon as a property right, having a definite exchange-value. If the owner desires to realize that exchange-value in the coin of "enjoyment," he may still be taxed.

Although the assignment cases and the legal principles relating to them are not peculiar to family situations, the reasoning of the Horst case is important to the whole field of family tax-law, for "realization" through "enjoyment" by the head of a household can be found in almost any family property reallocation which he may make. The doctrine achieves the effect of nullifying transfers between spouses or between parent and child for income-tax purposes without the necessity of disregarding them under local law or for estate and gift taxes.

Since an assignment, although ineffective as an income-tax conservator, will, if properly made, be recognized at local law, it will remove the property involved from the grantor's estate (unless, of course, the transfer is found to have been made in contemplation of death). In many cases, however, the thing assigned is only an income right effective for some period during the life of the grantor and the assignment has no direct connection with the estate tax.

Because the assignment is complete under local law, a gift tax is due whenever one is made for less than full and adequate consideration,

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[50] *Ibid.*

even though the grantor may still have to pay an income tax on the subject matter. The treasury might look at the assignment itself as the gift and use actuarial tables and mathematical formulae to estimate its value or it might consider the individual payments under the assignment as separate gifts and levy a tax upon each.[51] The latter method is, of course, preferable from the point of view of the grantor, as it enables him to take advantage to a greater extent of the annual exclusions from value.

C. Partnerships

Simple proof that the legal relationship between intra-family assignments and family partnerships is close can be found in the effect of the decision of Lucas v. Earl upon such partnership agreements. Prior to 1930 a husband could safely count on income-tax savings through the use of the partnership as an income-splitting device. The partnership could be established by a gift to the wife of an interest in the business; by a contribution by her of money or assets previously acquired from her husband; or by a contribution of capital or services proportionately less than the business interest she was to obtain.[52] Generally the only requirements were intent to form a partnership and compliance with state law.[53] However, husband-wife partnerships were sometimes recognized for tax purposes even though the law of the state forbade them.[54] As stated by one author, "In this period before 1930, the general technique of analysis of the validity of the family partnership seems to have been that if the parties to the challenged partnership were satisfied, the tax collector could not complain."[55]

After the Lucas v. Earl decision was handed down, however, the requirements for recognition for tax purposes were made more stringent. Intent to form a partnership and self-serving evidence to show

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[51] In Cerf v. Commissioner, 141 F.(2d) 564 (C.C.A. 3rd, 1944), the value of the right to receive income was taxed at the time the assignment was made. See, however, Rabkin and Johnson (1944), Part G1, Section 4, for a discussion of the other method of valuation and analogous cases which might be used as authority for it. The gift tax possibilities in partnership cases, in which similar problems arise, are treated in Tuttle and Wilson, "The Confusion on Family Partnerships," 9 Ga. Bar Jr. 353 (May, 1947) at 363 and in Polisher, "Gift and Estate Tax Implications of Family Partnerships," 51 Dickinson L. Rev. 145 (March, 1947) at 153.

[52] Partnerships could always be formed, of course, by means of a capital contribution of the wife from her separate funds, but this in no way changed the tax picture, since she would be treated as owner of the property and its income, both before and after the partnership was organized.

[53] See Barkan, "Family Partnerships under the Income Tax," 44 Mich. L. Rev. 179, Sec. II (Oct., 1945). This article gives a detailed history of the legal treatment accorded family partnerships.

[54] Albert Kahn, 14 BTA 125 (1928); Elmer Klise, 10 BTA 1234 (1928); L. F. Sunlin, 6 BTA 1232 (1927); Commissioner v. Barnes' Estate, 30 F.(2d) 289 (C.C.A. 3rd, 1929). See also, Paul and Mertens, *Law of Federal Income Taxation* (1934), Sec. 15.12, for a more generalized discussion of the reasoning used to substantiate the disregard of local law in these cases.

[55] *Supra,* note 53, at 187.

that intent were no longer considered sufficient. Local law was less frequently used in determining whether a partnership was valid for tax purposes. The courts began to refuse to recognize personal-service partnerships; those in which the income was attributable, for the most part, to the personal efforts or professional skill of the husband and in which capital did not play an important role as a profit-producing factor. This, of course, was a necessary corollary of Lucas v. Earl. Since the wife in such cases did little or nothing toward the earning of the income, tax recognition of any arrangement whereby the husband allowed her to collect it would not be compatible with the wording of that case.[56] Sub-partnerships, arrangements whereby the husband assigned to the wife a portion of his interest without making her a member of the firm, were also disregarded for tax purposes.[57] Since the income flowed from the partnership to the husband and through him to the wife, legal consistency required the application of the doctrine of Lucas v. Earl. The sub-partnership was, in reality, only a dressed-up form of assignment.

Helvering v. Clifford,[58] decided in 1940, although a trust case, has also had its effect on partnership tax problems. The admonition that "special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more devices which, though valid under state law, are not conclusive so far as Section 22(a) is concerned,"[59] and the stress placed by the Court as a decisive factor on the control retained by the husband over the property were not overlooked.[60]

The culmination of these ideas is to be found in the Tower and Lusthaus decisions, handed down in 1946. The facts in the Tower case[61] were these: since 1927 taxpayer Tower had controlled a manfacturing business, owning four hundred forty-five of the five hundred shares of stock. His wife owned five and was vice president, but took no active part in the business. In 1937 respondent, for the purpose of saving taxes, gave one hundred ninety shares of his stock to his wife, on condition that she contribute the assets represented thereby to a new partnership. Liquidation of the corporation took place three days after the gift was made, and a partnership was immediately

[56] Earp v. Jones, 131 F.(2d) 292 (C.C.A. 10th, 1942), cert. den., 318 U.S. 764, 63 S. Ct. 665 (1943); Rossmoore v. Anderson, 1 F. Supp. 35 (D.C., S.D., N.Y., 1932), affirmed in 67 F.(2d) 1009 (1933) and in 292 U.S. 630, 54 S. Ct. 640 (1934); Tinkoff v. Commissioner, 120 F.(2d) 564 (C.C.A. 7th, 1941).

[57] Burnet v. Leininger, 285 U.S. 136, 52 S. Ct. 345 (1932); Mitchell v. Bowers, 9 F.(2d) 414 (D.C., N.Y., 1924), affirmed 15 F.(2d) 287 (C.C.A. 2d, 1926), cert. den., 273 U.S. 759, 47 S. Ct. 473 (1927).

[58] 309 US. 331, 60 S. Ct. 554 (1940).

[59] *Ibid*, at p. 335.

[60] This idea is also a derivative of Corliss v. Bowers, 281 U.S. 376, 50 S. Ct. 336 (1930), an older trust case.

[61] Commissioner v. Tower, 327 U.S. 280, 66 S. Ct. 532 (1946).

formed. The wife's contribution to capital was noted on the books, but under the terms of the partnership agreement she became only a limited partner, having no voice in the affairs of the business and rendering it no services. Respondent continued to manage and control the organization as before and the profits paid to the wife as her share were used to take care of household expenses formerly met by the taxpayer himself. The circuit court of appeals reversed the decision of the Tax Court, which had found that the wife was not a partner in the business and had sustained the comissioner's contention that the husband was taxable on the whole of the profits from the purported partnership.

The Supreme Court upheld the Tax Court, stating that there was sufficient evidence to support its finding that the partnership was not valid, at least for income-tax purposes. It declined to consider whether or not the gift from the husband to the wife was efficacious, stating that intent to form a partnership, rather than the validity of the gift under local law, was the primary consideration and, further, that:

> "There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other purposes. If she either invests capital *originating with her* or substantially contributes to the control and management of the business, or otherwise performs vital and additional services, or does all of these things she may be a partner."[62] (Italics supplied.)

Justice Rutledge, who concurred in the Tower case, and Justice Reed, who dissented in the Lusthaus case,[63] (a companion case involving a somewhat similar, although less bold, arrangement) both stated that the majority opinion in the Tower case had determined as a rule of law that a wife could not become a limited partner, contributing no services of any kind, on the strength of a gift to her of a partnership interest or the money with which to purchase it. The capital must originate with her and be an actual and additional contribution to the business; a "paper reallocation" is no longer sufficient.

Undoubtedly, that is the effect of the decisions, and much of the criticism,[64] both pro and con, which they have invoked, has been directed to this point. The judiciary, applying the "special scrutiny"

[62] *Ibid,* at 290.

[63] Lusthaus v. Commissioner, 327 U.S. 293, 66 S. Ct. 539 (1946). In this case the wife did contribute minor services, both before and after the partnership was formed. She "bought" her interest, using money given to her by her husband (some of which he had borrowed for that purpose and immediately repaid) in part-payment. The balance was covered by promissory notes which were to be paid from the wife's share of the proceeds of the business.

[64] See, for example: Works, "Taxation of Family Partnerships and Family Corporations," 19 Rocky Mt. L. Rev. 209 (April, 1947) and notes in 30 Minn. L. Rev. 402 (April, 1946), 41 Ill. L. Rev. 669 (Jan.-Feb., 1947), 21 Tulane L. Rev. 154 (Oct., 1946) and 32 Va. L. Rev. 659 (Apr., 1946).

rule had again used its "legislative" powers to curtail tax avoidances among family groups by adding another requirement to the characteristics of partnerships as requisite either at common law[65] or by statute for income-tax purposes.[66] When this condition is traced back to its source, its resemblence to the Horst doctrine (discussed in the section on assignments) becomes apparent. Here, as there, the Supreme Court has demanded continued payment of taxes upon income arising from property transferred by the husband to the wife, and the "enjoyment" theory is, at least, an implicit basis of the decisions.[67]

As a result, the lower courts have either refused point-blank to recognize for tax purposes any partnership formed by gift from husband to wife,[68] or take the view that such a gift is incomplete because of the control retained over it by the husband who acts as manager of the business,[69] an interest in which was the subject matter of the gift.

Another tendency, noticeable since the decisions in the Lusthaus and Tower cases, has been to disregard bona fide capital contributions of the wife, unless of major proportions or combined with services.[70] This, of course, is unfair to the husband and is in opposition to the principles of Lucas v. Earl, as it results in taxing him on that portion of the income earned by capital which he does not own. A suggested solution, used in a few cases,[71] has been an apportioning of profits; disregarding the division agreed upon in the articles of co-partnership and setting aside one part as the earnings of the capital investment and the other as attributable to the services of the husband. Thereafter, that portion found to be earned by capital is divided between the part-

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[65] Meehan v. Valentine, 145 U.S. 611, 12 S. Ct. 972 (1892), sets forth the common-law requirements of a partnership as: (1) a joining-together of individuals to carry on a trade for their common benefit, (2) a contribution of capital or services by each, and (3) a community of interest in the profits on the part of all the partners.

[66] I.R.C., Sec. 3797(a)(2): "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."

[67] The Horst case, cited in the Tower opinion, relies, in turn, on Corliss v. Bowers as authority.

[68] Maudlin v. Commissioner, 166 F.(2d) 666 (C.C.A. 4th, 1946); Belcher v. Commissioner, 162 F.(2d) 974 (C.C.A. 5th, 1947), cert. den., 332 U.S. 824, 68 S. Ct. 165 (1947); Esther Rosenberg, 7 T.C. 73 (1946).

[69] Tuttle and Wilson, "The Confusion on Family Partnerships," 9 Ga. Bar Jr. 353 (May, 1947) at 358; Vernon, "Taxation of the Income of Family Partnerships," 59 Harv. L. Rev. 209 (Dec., 1945) at 255. These authors believe that the ultimate criterion is the intent of the spouses actually to form a partnership and that the matter of intent is a question of fact, not to be decided only on the narrow rules of the Tower case. They would give weight to the fact that the donor partner usually retains his powers over the gift of the interest in the business as an agent of the partnership.

[70] Claire L. Canfield, 7 T.C. 944 (1946); Maudlin v. Commissioner, *supra,* note 68.

[71] Claire L. Canfield, *supra,* note 70.

ners according to their capital contributions. This method of apportionment has been criticized on the ground that payment for services should be the same from year to year, and the fixing of a reasonable salary has been suggested, instead.[72] In any event, some allocation, in cases in which the wife's contribution in either capital or services is minor, is necessary, and it is not correct to disregard it altogether, and thus discourage completely partnerships between spouses in an age when more and more women are in a position to take some active part in the business affairs of the family.

As indicated by the recent decisions of the Tax Court in the Sandberg[73] and Durwood[74] cases, the Lusthaus and Tower decisions have not completely cleared the field of problems. The former case, referred to in an earlier portion of this article, concerns the successful use of the tenancy-by-the-entirety form of property ownership to achieve income-tax splitting in a partnership between spouses, although the partnership alone would not have been effective for that purpose.

In the Durwood case a wife used money given her by her husband to purchase from another partner an interest in the business. The case suggests a fairly simple means of avoiding the consequences of the Lusthaus-Tower rule.

Treatment similar to that accorded husband-wife partnerships is given to cases in which a parent takes one or more of his minor children into the firm, although the rules have been relaxed somewhat if the child is of an age to contribute services and is being trained to take a place in the family business.[75] However, the more ludicrous attempts, in which infant children owning no separate property have been made partners,[76] have been dealth with summarily.

Unless the court finds that the gift of an interest to a wife or child is only an empty gesture or was made in contemplation of death, the organization of a partnership through gifts to family members does serve to reduce the estate of the family-head and, thus, to reduce death taxes.

The gift tax situation is more unsettled. If the partnership is denied recognition because the gift itself is invalid, there will be no gift tax,[77]

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[72] See Robinson's discussion of "The Allocation Theory in Family Partnership Cases," 25 Taxes 963 (Nov., 1947) at 968.

[73] *Supra,* note 23.

[74] Durwood v. Commissioner, 159 F.(2d) 400 (C.C.A. 8th, 1947).

[75] See Works, "Taxation of Family Partnerships and Family Corporations," 19 Rocky Mt. L. Rev. 209, 220 (April, 1947). Also *1948 Federal Tax Service,* Para. 15,508(9), and Rabkin and Johnson, *Federal Income, Gift and Estate Taxation* (1944), p. 907i, and cases there cited.

[76] Tinkoff v. Commissioner, 120 F.(2d) 564 (C.C.A. 7th, 1941), is an example of one such decision. There an infant son was made a partner in his parents' accounting firm on the day he was born.

[77] Earnest Strong, 7 T.C. 953 (1946), affirmed, Strong v. Commissioner, 150 F.(2d) 915 (1945).

but the mere fact that it is overlooked for income-tax purposes does not prove conclusively that such is the case, and if the gift is a valid transfer of property under local law, a tax on the value of the interest transferred must be paid at the time of the gift.[78] If the wife receives income as a result of the partnership agreement, but really obtains no property interest thereby, a gift tax is due upon each payment to her.[79] It has been suggested, however, that under the more stringent rules of the Tower case, there should be no gift tax whenever the splitting of partnership income is allowed.[80] Since the courts are not recognizing partnerships arising from husband-to-wife gifts, an inference arises that the wife has furnished adequate consideration in such cases.

Although very little is said in the Code concerning the treatment of partnerships, the amount of time and attention the problem has received from the judiciary is vast. As a result, family partnerships have been put in a class by themselves, not only subject to special scrutiny, but also to the rule, derived from the Clifford and Corliss[81] cases, that the husband must not maintain dominion and control of the property transferred to the firm and, finally, to its more categorical application in the Tower and Lusthaus decisions that no partnership will be recognized unless the capital originates with the wife or she contributes services of some type to the business. Although open to attack because of its disregard for technical property law and its judicial origin, the rule in itself seems sound and certainly serves to curtail to a large extent tax avoidance by the use of this particular device. One can, of course, conceive of a wife's accepting a gift from her husband in the form of, or which she invests in, a partnership interest in a firm controlled by him without thought of the resulting tax penalties.[82] However, that must be the exceptional case, and in this day and age there is no reward for such artlessness. Those who have motives other than tax savings in mind must still be guided in their decisions by the revenue laws and their multifarious by-products.

D. Corporations

Up to the present time the corporation has not caused the disturbance in the family tax field that the partnership has evoked. The general rule is that the corporation will be recognized, whether its stockholders are family members or strangers to one another, even

[78] I.R.C., Sec. 1000; Polisher, "Gift and Estate Tax Implications of Family Partnerships," 51 Dickinson L. Rev. 145, 154 (March, 1947).
[79] *Supra,* note 51.
[80] Polisher, *supra,* note 78, at 156.
[81] Corliss v. Bowers, 281 U.S. 376, 50 S. Ct. 336 (1930).
[82] It has been suggested that the present harsh treatment of such cases results from the assumption that the standards for determining intent to form a partnership as set forth in the Tower case are exclusive; a conclusion some writers feel to have been unwarranted.

though it was formed to reduce or avoid taxes.[83] However, there are exceptions; cases in which the corporate form is disregarded because considered to be only a sham, and some of the family corporations, naturally, have fallen within this group.[84]

This unusual lack of concern on the part of the treasury over the use of an income-splitting device can be explained in only one way; it is not too highly successful. The corporation itself must pay a tax on its profits,[85] which serves to make up for any revenue lost because the wife reports the income distributed to her in the lower surtax brackets.

It has been sugested, however, that gifts of stock from husband to wife should not be recognized for income-tax purposes if the husband, both before and after the gift, continues to control and manage the corporation. In such a case the dividends received by the wife may represent not only the increment on capital invested by the husband, but may result in part from his personal efforts, which by indirection he has assigned to his spouse. However, the inclination of the managing stockholder to vote himself an adequate salary and thus increase the corporate deductions probably acts as a rough solution of this problem.[86]

The Internal Revenue Code also provides for two penalty taxes, one of which has been quite successfully aimed at the destruction of personal holding companies, organizations peculiar to families of wealth. Section 501 provides that the income of such companies not distributed yearly shall be taxed at rates of from 75 to 85 per cent.[87] A personal holding company is defined in the Code as a corporation in which (1) at least 80 percent of the income arises from dividends, rents, interest and other named sources, and (2) more than half the

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[83] Commissioner v. Montgomery, 144 F.(2d) 313 (C.C.A. 5th, 1944); Alexandre, "The Corporate Counterpart of the Family Partnership," 2 Tax L. Rev. 493 (Apr.-May, 1947); Paul and Mertens, *Law of Federal Income Taxation* (1934), Sec. 14.08.

[84] See, for example, Sewell v. Commissioner, 151 F.(2d) 765 (C.C.A. 5th, 1945), cert. den., 327 U.S. 783, 66 S. Ct. 683 (1945), in which it was held that income from stock given by husbands to their wives was taxable to the former, since they had retained the same control they would have had if there had been no transfer.

[85] I.R.C., Secs. 13 and 15.

[86] According to Mannheimer, author of "Income Tax Status of Gifts of Family Corporation Stock," 25 Taxes 604 (July, 1947), no cases have yet arisen of a corporate officer's receiving less than an adequate salary.

[87] Sec. 501, *et. seq.*, applies to domestic personal holding companies. Sections 331-340, I.R.C., provide that the undistributed net income of a foreign holding company shall be included in the return of stockholders affected by the federal income tax law in proportion to their interests in the organization. For a detailed explanation of the uses made of foreign and domestic holding companies to achieve tax savings, see Paul, "The Background of the Revenue Act of 1937," 5 Univ. of Chi. L. Rev. 41 (Dec., 1937) at pages 49 and 58 respectively.

stock of which is held, either directly or indirectly, by not more than five persons. Section 503(a)(2) provides that:

> "An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of this paragraph the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."

Obviously, the prohibitive rates and the broad family-units concept of ownership work together to outlaw this type of tax-saver.

The second corporate penalty tax is imposed by Section 102, which provides for surtaxes of 27½ to 38½ per cent upon undistributed income of corporations, other than that of personal holding companies, which is permitted to accumulate over and above the reasonable needs of the business. Although its wording contains nothing to suggest that it is meant as a weapon against the close corporation, the tendency has been to enforce it against those organizations, in which an agreement to delay dividend distribution for the tax benefit of one or more of the stockholders can be more easily reached than in larger concerns. It has never, however, been very effective.[88]

Predictions have been made that as a result of the Tower decision there will be a noticeable tendency to replace family partnerships with family corporations. Should this occur and the problem require attention, courts, even in the absence of legislation, would have three possible remedies open to them. They might (1) disregard the corporate entity entirely on the theory that it is only a sham for purposes of tax avoidance; (2) treat the husband as actual owner of the stock transferred to his wife, using the "dominion and control" theory, or (3) attribute to him a greater portion of the income of the corporation as salary for his personal services.

By the Revenue Act of 1937 Section 24 was added to the Code. It provides, in part, that interest and other expenses listed under Section 23(a) and paid by one family member to another will not be recognized as deductions, and defines as the "family" of the taxpayer his brothers, sisters, spouse, ancestors and lineal descendants. In order to prevent the continued use of artificial deductions through the corporate device, it is further stated that such deductions will not be allowed between an individual and a corporation more than 50 per cent of the stock of which is owned, "directly or indirectly, by or for such individual," and that a person will be considered the owner of stock held by or for his family. Consequently, a corporation controlled by the husband may not take as a deduction interest on a loan to it by the wife, since the wife under the statute constructively owns the stock of the husband,

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[88] Magill, *The Impact of Federal Taxes* (1943), p. 142.

and, therefore, the transaction falls within the penalized class of those between "an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned . . . by . . . such individual." Since the constructive ownership theory cannot be applied twice, however, the interest on a loan made to the corporation by the wife's brother, for example, would be an allowable deduction. If the husband owned less than 50 percent of the stock, the interest would be deductible, even though the loan was made to the corporation either by him or by his wife.

Since shares of stock are considered to be property interests, the gift of stock from one spouse to another causes no particular gift or estate-tax problems. The pivotal question is merely whether the gift is valid. The answer determines whether the donor will pay a gift tax and no estate tax upon the property transferred or an estate tax and no gift tax, although, of course, the contemplation of death provisions could always result in the imposition of both.