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# Taxation -- Capital Gains and Losses -- Sale of Life Interest in Testamentary Trust

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be granted a lessee who, by contract binding upon the tenant for life and his estate, has the rights of the lessor.

The nature and size of the trade fixtures in the instant case, and the acts of the lessees in retaining possession and use of the warehouse for the next complete tobacco season following the death of their lessor and in providing for a remedy through the lessor's bond conditioned upon the exact contingency which occurred, undoubtedly had their effect upon the decision. Whether the absence of these elements would have altered the result would be mere speculation.

The impact of the instant case upon the previous existing law is difficult to ascertain since the court did not discuss the former case of *Overman v. Sasser*.<sup>25</sup> It is clear, however, that the court did not hold that the warehouses in question were not trade fixtures. The result would seem to be that the personal representative of a tenant for life has as against the remaindermen the right to remove trade fixtures placed on the land by the tenant for life within a reasonable time after the termination of the life estate;<sup>26</sup> but the lessee of such tenant for life has as against the remaindermen the right to remove trade fixtures placed on the land by the lessee only during the term of the lease.<sup>27</sup>

LOUIS J. POISSON, JR.

#### Taxation—Capital Gains and Losses—Sale of Life Interest in Testamentary Trust

Testator's will set up a trust fund of \$100,000, the income of which was to be paid to his son, *A*, for life, and upon *A*'s death without issue, to *A*'s wife, *B*, for her life, and upon her death the residue was to go to the testator's wife, *C*, and to his other son, *D*, thus terminating the trust. The testator died in 1926 and his widow died in 1935. *A* died without issue in 1937. His widow, *B*, found his assets insufficient to pay the debts of his estate. She had only corporate stock which was then unsaleable at a fair market price. Testator's will and codicil contained provisions which clearly indicated that he did not desire the life beneficiaries to dispose of their interests. To end "extended family litigation" and to obtain the necessary funds, *B* petitioned the New Jersey Court of Chancery to end the trust. In the petition, she stipulated that she would release all interest in the trust and consent to its termination in consideration of a payment to her of \$55,000 by *D*, the remainderman, and his promise to purchase her stock for a specified amount. (The stock purchase does not otherwise figure in the case.) The parties consented and the court so decreed. In her 1940 income tax return, *B* re-

<sup>25</sup> *Overman v. Sasser*, cited *supra* note 5.

<sup>26</sup> *Id.*

<sup>27</sup> *Haywood v. Briggs et al.*, cited *supra* note 20.

ported a capital loss of \$8,790.20 on this transaction, which was the difference between the amount she received, \$55,000, and the value of the life estate she had released, \$63,790.20, computed under an appropriate Income Tax Unit Ruling.<sup>1</sup> The commissioner disallowed this loss and made a deficiency assessment based on his reasoning that the \$55,000 received by the taxpayer was taxable as gross income under Internal Revenue Code Section 22(a).<sup>2</sup> This was upheld by the United States Tax Court (formerly the Board of Tax Appeals).<sup>3</sup> In *McAllister v. Commissioner of Internal Revenue*,<sup>4</sup> the circuit court of appeals, in a 2 to 1 decision, reversed the Tax Court and held the \$55,000 was a receipt from the sale of a capital asset, taxable under Internal Revenue Code Section 117(a)(1).<sup>5</sup> Because the parties were in conflict as to the valuation of the life estate, the case was remanded to the Tax Court for computation.

This decision was recently followed in *Allen v. First National Bank and Trust Company in Macon*.<sup>6</sup>

In the *McAllister* case, the court determined the issue to be whether the case was within the rule of *Blair v. Commissioner of Internal Revenue*<sup>7</sup> or *Hort v. Commissioner of Internal Revenue*,<sup>8</sup> and, after deciding that the *Blair* case controlled, Judge Clark, speaking for the majority, stated, "Petitioner's right to income for life from the trust estate was a right in the estate itself. Had she held a fee interest, the assignment would unquestionably have been regarded as the transfer of a capital asset; we see no reason why a different result should follow the transfer of the lesser, but still substantial, life interest."

These words aptly indicate that any determination of the fundamental issue in the principal case depends upon the answer to the inquiry—what is the nature of the beneficiary's interest in an estate from which she has the right to receive yearly income for life from a fund held in trust? The interest of the beneficiary would hardly seem to extend beyond the right to receive such payments for her life and the right to obtain them from the trustee. As to whether the beneficiary's interest is solely *in personam* against the trustee or whether it also extends in some intangible fashion into the corpus, which in the principal case would go to the remainderman upon the death of the life beneficiary, has aroused much legal discussion. The prevailing view is that the beneficiary's interest is a dual one—partly *in personam* and partly *in*

<sup>1</sup> I. T. 2076, III-2 CUM. BULL. 18 (1924).

<sup>2</sup> 26 U. S. C. A. §22(a).

<sup>3</sup> Beulah E. McAllister, 5 T. C. 714 (1945).

<sup>4</sup> 157 F. (2d) 235 (C. C. A. 2d, 1946).

<sup>5</sup> 26 U. S. C. A. §117(a)(1).

<sup>6</sup> 157 F. (2d) 595 (C. C. A. 5th, 1946).

<sup>7</sup> 300 U. S. 5 (1937).

<sup>8</sup> 313 U. S. 28 (1941).

*rem.*<sup>9</sup> It thus appears that even the holder of the right to receive income from the corpus for life has an equitable interest in that corpus which may be defined as a "property."<sup>10</sup>

The sale, surrender or assignment of the life interest in the income of a trust for adequate consideration can well be the anticipation of future income in addition to the giving up of a valuable property right. If viewed as anticipation of future income, it would appear that the consideration received by the taxpayer in the principal case would be taxable under the broad provisions of Section 22(a) as in the *Hort* case. In that case, the question was whether the amount received for the cancellation of a lease of realty acquired by bequest was taxable as ordinary income, or as a capital return as the petitioner therein contended. The Supreme Court held the amount to be taxable as ordinary income. While indicating that the amount in question was a form of rental payment,<sup>11</sup> rents being specifically included in the provisions of Section 22(a), the court, nevertheless, regarded the lease as a "property."<sup>12</sup>

Many transfers of "property" have been held to be outside the provisions of the capital gains section when they begin to take on the color of advance payments of future income.<sup>13</sup> Thus, deemed to be without the capital provisions were a payment of a deposit for the breaking of a lease,<sup>14</sup> the amount received for the sale of partnership interests where the vendor had contributed no capital to the formation of the legal firm,<sup>15</sup> payments made to a partner for the use of his stock exchange seat which was never carried as an asset on the partnership books,

<sup>9</sup> 1 BOGERT, TRUSTS AND TRUSTEES (1935) §183; RESTATEMENT, TRUSTS (1935) §§130, 132; Scott, *The Nature of the Rights of the Cestui Que Trust* (1917) 17 COL. L. REV. 269, 289; see Stone, *The Nature of the Rights of the Cestui Que Trust* (1917) 17 COL. L. REV. 467.

<sup>10</sup> *Allen v. First National Bank and Trust Co. in Macon*, cited *supra* note 6; *McAllister v. Com'r of Int. Rev.*, cited *supra* note 4; *Bell's Estate v. Com'r of Int. Rev.*, 137 F. (2d) 454 (C. C. A. 8th, 1943), noted (1944) 57 HARV. L. REV. 382; *accord*: *Blair v. Com'r of Int. Rev.*, cited *supra* note 7; *Helvering v. Horst*, 311 U. S. 112 (1940); *Brown v. Fletcher*, 235 U. S. 589 (1915); *Irwin v. Gavit*, 268 U. S. 161 (1925); *Senior v. Braden*, 295 U. S. 422 (1934).

<sup>11</sup> 313 U. S. 28, 31 (1941).

<sup>12</sup> *Ibid.*

<sup>13</sup> *See* *McAllister v. Com'r of Int. Rev.*, 157 F. (2d) 235, 237 (C. C. A. 2d, 1946) (dissenting opinion).

<sup>14</sup> *Warren Service Corp. v. Com'r of Int. Rev.*, 110 F. (2d) 723, 725 (C. C. A. 2d, 1940); *cf.* *Com'r of Int. Rev. v. Langwell Real Estate Corp.*, 47 F. (2d) 841 (C. C. A. 7th, 1931).

<sup>15</sup> *Helvering v. Smith*, 90 F. (2d) 590, 592 (C. C. A. 2d, 1937); *accord*: *Doyle v. Com'r of Int. Rev.*, 102 F. (2d) 86 (C. C. A. 4th, 1939); *cf.* *Williams v. McGowan*, 152 F. (2d) 570 (C. C. A. 2d, 1945) (where sale of a business including cash on hand, merchandise, fixtures, notes and bills receivable was held not the sale of a single property and the gains and losses were to be computed on each item, then classified as capital or ordinary). *But cf.* *Bull v. United States*, 295 U. S. 247, 254 (1934); *Hill v. Com'r of Int. Rev.*, 38 F. (2d) 165 (C. C. A. 1st, 1930); *McClelland v. Com'r of Int. Rev.*, 117 F. (2d) 988 (C. C. A. 2d, 1941); *Stilgenbaur v. United States*, 115 F. (2d) 532 (C. C. A. 9th, 1940). See note (1946) 15 *FORDHAM L. REV.* 135.

which payments were under the agreement due him as additional compensation regardless of whether or not his old seat was returned,<sup>16</sup> and proceeds of the sale of the right to collect dividends already declared on certain stock, but not yet payable.<sup>17</sup>

The term "property" can have far too many meanings to be determinative of the nature of the transfer in every situation. The *Hort* case and the principal case can be distinguished. The Board of Tax Appeals, in its holding in the *Hort* case,<sup>18</sup> which was affirmed,<sup>19</sup> suggests two distinguishing points. The taxpayer in the *Hort* case could establish no separate basis for gain or loss on the lease apart from the basis of the property leased, while in the principal case, the basis of the taxpayer's life estate was fixed by statute<sup>20</sup> and a valuation provided for in Income Tax Unit Ruling 2076. And in the former case, there was no sale or exchange of the lease; only an extinguishment. The taxpayer still had the property to rent again. In the principal case, the taxpayer's right to receive income was sold completely to the remainderman.

From a tax standpoint, the holder of a life estate has a chameleon-like interest. The income from his estate is included in gross income.<sup>21</sup> If his life estate be acquired by gift, bequest or inheritance, his income cannot be diminished by deductions for shrinkage due to the lapse of time or by any other deductions except those allowed in Internal Revenue Code Sections 23(1) and 23(m).<sup>22</sup> He has an alienable property interest in the absence of restriction.<sup>23</sup> The unadjusted basis of a life estate is determined by statute depending upon whether acquired by purchase,<sup>24</sup> gift,<sup>25</sup> transfer in trust<sup>26</sup> or by bequest, devise or inheritance,<sup>27</sup>

<sup>16</sup> *Levinson v. Com'r of Int. Rev.*, 154 F. (2d) 60 (C. C. A. 2d, 1946). *But cf.* *Munson v. Com'r of Int. Rev.*, 100 F. (2d) 363 (C. C. A. 2d, 1938).

<sup>17</sup> *Rhodes' Estate v. Com'r of Int. Rev.*, 131 F. (2d) 50 (C. C. A. 6th, 1942).

<sup>18</sup> 39 B. T. A. 922, 925-926 (1939).

<sup>19</sup> 112 F. (2d) 167 (C. C. A. 2d, 1940) (memorandum opinion).

<sup>20</sup> INTERNAL REVENUE CODE §113(a)(5), 26 U. S. C. A. §113(a)(5).

<sup>21</sup> INTERNAL REVENUE CODE §22(b)(3), 26 U. S. C. A. §22(b)(3); *Irwin v. Gavit*, 268 U. S. 161 (1925).

<sup>22</sup> INTERNAL REVENUE CODE §24(d), 26 U. S. C. A. §24(d); *Codman v. Miles*, 28 F. (2d) 823 (C. C. A. 4th, 1928), *cert. denied*, 278 U. S. 654 (1928); *Friend v. Com'r of Int. Rev.*, 119 F. (2d) 959 (C. C. A. 7th, 1941).

REGULATIONS III, §29.24-8 says, "Amounts paid to the holder of a life or terminable interest acquired by gift, bequest or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the lapse of time. (See section 113(a)(5))."

"However, in the case of property held by one person for life with remainder to another person and in the case of property held in trust, see section 23(1) as to depreciation and section 23(m) as to depletion."

<sup>23</sup> *Bell's Estate v. Com'r of Int. Rev.*, 137 F. (2d) 454 (C. C. A. 8th, 1943); *Estate of Camden v. Com'r of Int. Rev.*, 139 F. (2d) 697 (C. C. A. 6th, 1943); *Sayers F. Harman*, 4 T. C. 335 (1944); *Elmer J. Keitel*, 15 B. T. A. 903 (1929).

<sup>24</sup> INTERNAL REVENUE CODE §113(a), 26 U. S. C. A. §113(a).

<sup>25</sup> *Id.*, §113(a)(2), 26 U. S. C. A. §113(a)(2).

<sup>26</sup> *Id.*, §113(a)(3), 26 U. S. C. A. §113(a)(3).

<sup>27</sup> *Id.*, §113(a)(5), 26 U. S. C. A. §113(a)(5).

such basis being adjusted as in Section 113(b).<sup>28</sup> Until a sale by the holder of such interest, few of the aspects of capitalization have been allowed, but upon sale, the interest blooms into a full-fledged capital asset.<sup>29</sup> On the other hand, the vendee of a life estate can exhaust his investment by deduction of charges against income over its duration.<sup>30</sup>

Whether there is an element of tax avoidance in allowing the sale of a life estate to be considered as the sale of a capital asset would depend upon a great many factors. In the *McAllister* case, while the life beneficiary would no longer receive taxable income from the trust, the remainderman's income would be swelled by that amount and he may or may not be taxed in the higher brackets. If the life estate had been sold to several diverse parties rather than the single remainderman, there would certainly be a loss of revenue. A primary factor bearing on avoidance in such cases would be what adjustments, if any, the remainderman would be able to make to the statutory unadjusted basis provided for him by Section 113(a)(5),<sup>31</sup> which would be the fair market value of the property at the time of acquisition—date of the death of the decedent,<sup>32</sup> subject to a special rule where the property was valued at the optional, year later valuation date under Section 811(j).<sup>33</sup> Whether any depreciation would be allowed would be another complicating factor bearing on the determination of gain upon the sale of the property.<sup>34</sup> As pointed out previously, nothing in Section 24(d) prevents the vendee of a life estate from reducing income received by the deductions therein provided, but some doctrine of merger may prevent this. It does not seem that it should prevent it from an income tax standpoint<sup>35</sup> since the estates could be treated separately and the re-

<sup>28</sup> *Id.*, §113(b), 26 U. S. C. A. §113(b).

<sup>29</sup> *Allen v. First National Bank in Macon*, 157 F. (2d) 595 (C. C. A. 5th, 1946); *Bell's Estate v. Com'r of Int. Rev.*, 137 F. (2d) 454 (C. C. A. 8th, 1943); *Estate of Camden v. Com'r of Int. Rev.*, 139 F. (2d) 697 (C. C. A. 6th, 1943); *Sayers F. Harman*, 4 T. C. 329 (1944); *cf. Quigley v. Com'r of Int. Rev.*, 143 F. (2d) 27 (C. C. A. 7th, 1944) (an unusual case wherein taxpayer agreed with her brothers not to contest a will which had set up spendthrift trusts for them, in consideration of certain annuities to be paid to her by them from the income and her later surrender of the right to receive these payments for a lump sum was deemed a capital transaction).

<sup>30</sup> *Elmer J. Keitel*, 15 B. T. A. 903 (1929) (taxpayer, who owned one-half life interest in a co-partnership and who was also one of six remaindermen, purchased the other part of the life estate in consideration of monthly payments and was allowed to deduct yearly exhaustion spread over the vendor's life expectancy under §214(a)(8) of Revenue Act of 1921); *Floyd M. Shoemaker*, 16 B. T. A. 1146 (1929) (where life tenancy in a going business was purchased by taxpayer for an annuity, the court said that the amount paid each year should be deducted under §214(a)(8) of Revenue Act of 1921).

<sup>31</sup> See note 20 *supra*.

<sup>32</sup> REGULATIONS III, §29.113(a)(5)-1.

<sup>33</sup> Internal Revenue Code §811(j), 26 U. S. C. A. §811(j).

<sup>34</sup> *Id.*, §114(a), 26 U. S. C. A. §114(a).

<sup>35</sup> *Elmer J. Keitel*, 15 B. T. A. 903 (1929); *cf. Citizen's National Bank of Kirksville, Mo. v. Com'r of Int. Rev.*, 122 F. (2d) 1011 (C. C. A. 8th, 1941).

mainderman has at least purchased the present right to receive income, an interest which he did not have before. Notwithstanding the possible merger feature of the principal case, if the sale of a life interest to a third party be the sale of a capital asset, it offers possibilities for loss of revenue to the government, and should be subject to close scrutiny by the courts, especially when a family transaction and in spite of conceivable hardship cases such as the principal case.

The instant decision is doubtlessly deeply rooted in the substantive law. Regardless of any tax avoidance problem, the decision still may have a questionable effect upon the trusts field which heretofore has been a spawning ground for tax devices. Under the present ruling, the settlor of a testamentary or *inter vivos* trust now has the knowledge that whenever his life beneficiary of income desires to sell such interest for a lump sum consideration, the transaction will be taxable only as the sale of a capital asset—a small gain; conceivably a loss. This could be a stimulus to seek court action to circumvent the provisions in wills such as the one in the principal case directing that the beneficiary's interest be not transferred, assigned or encumbered or subject to anticipation or sale. The question, however, of whether or not such an interest is assignable or saleable under the will is a matter for the state court based on local law and its decision is conclusive upon the federal court dealing with the tax question.<sup>36</sup>

THOMAS G. DILL.

<sup>36</sup> Blair v. Com'r of Int. Rev., cited *supra* note 7; McAllister v. Com'r of Int. Rev., cited *supra* note 4. *But cf.* Craig v. United States, 69 F. Supp. 229, 239 (W. D. Pa. 1946) (an income tax case turning on the interpretation of a will wherein the court indicates that by virtue of the recent family partnership cases, the law has been modified so that the state court's decisions of questions over which they have the final say, cannot decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax; it was therefore necessary for the federal court to interpret the will as a step toward the uniformity of federal tax laws).