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Taxation -- Interrelation of Income and Gift Taxes -- Gift Tax Status of Income of Trust Which Is Taxable to Donor

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In *Graham v. Hoke*,¹³ however, the plaintiff rendered personal services to deceased in reliance on his promise of \$2,000 to be paid out of his estate at death. The court held that "the plaintiff having declared on a 'written agreement' as a special contract, she is not allowed to likewise declare upon an implied contract of *quantum meruit*, and in truth she has not so declared. True she may have pleaded an implied contract as well as a special contract in the alternative, but when the case came on for trial she could have been compelled to elect upon which declaration she would proceed." This decision was a departure from the established line of decisions, as well as from the spirit and purpose of the Code System. Sufficient facts were set out to establish a cause of action in *quantum meruit*, and in allowing a demurrer the court was reverting to the technical pleading of common law by placing more emphasis on the form or theory of the action than on the facts presented.

The principal case clarifies the position of the court and indicates a return to, and reaffirmance of, the liberal policy of the Code to allow any relief to which the facts proven may entitle the plaintiff to recover.¹⁴ It establishes the rule that a plaintiff may declare on an express oral contract to devise realty and, if sufficient facts are alleged and proven of services rendered, recover on *quantum meruit* when the contract is unenforceable because within the Statute of Frauds, thus clearly indicating that there will be no *binding* election in this situation.

Notwithstanding that relief may be secured under this mode of pleading, it is submitted that the desirable method is to set out the express contract and implied contract separately, or to state the express contract as an inducement or explanation of the implied contract and allege that the deceased received the benefits of service induced thereby.¹⁵

ROBERT G. STOCKTON.

Taxation—Interrelation of Income and Gift Taxes—Gift Tax Status of Income of Trust Which Is Taxable to Donor

The Commissioner assessed gift taxes against the respondent for the net gains and profits from trading in securities and commodity futures of two trusts created by the respondent and his wife for the benefit of their three children. The trusts were irrevocable, and the settlor retained no right to alter or amend the trust instrument, or to change the beneficial interests. The trusts consisted of trading accounts on the books of a partnership composed of the respondent, his

¹³ 219 N. C. 755, 14 S. E. 2d 790 (1941).

¹⁴ CLARK, CODE PLEADING §43 (2d ed. 1947).

¹⁵ MCINTOSH, NORTH CAROLINA PRACTICE AND PROCEDURE §410 (1929); 1 MORDECAI, LAW LECTURES 127 (2d ed. 1916).

wife, and children. The net worth of each trust in each of the years for which gift taxes were assessed was more than sufficient to provide the margins required to cover the trading carried on for it. In a prior case involving the same trusts, it was held that the income from trading on margin realized by the trusts was taxable to the settlor as this income was directly attributable to the voluntary exercise of his personal skill in trading for the account of the trusts and constituted a voluntary assignment of a portion of his personal earnings.¹ *Held*: the net income derived from trading on behalf of the trusts accrued immediately and directly to the trusts; respondent never owned or held an economic interest in such income; and he could not withhold any part thereof from the trusts. Hence the income did not represent a taxable gift from the respondent.²

The interrelation of the income, estate and gift taxes, or the lack of it, has claimed the attention of writers³ and of the courts.⁴ In *Higgins v. Commissioner of Internal Revenue*⁵ the court remarked, ". . . without further aid from Congress it is perhaps impossible for the courts to work out a complete integration of the three taxes." An analysis of the cases will demonstrate the difficulties and confusion.

In *Commissioner of Internal Revenue v. Prouty*⁶ the taxpayer had created three trusts. In 1935 she relinquished all reserved power to revoke or amend the instruments and the Commissioner assessed gift taxes at that time. The court found that in two of the trusts the taxpayer's husband-beneficiary had no substantial adverse interest before the surrender of powers by the taxpayer and that gift taxes were properly assessed in 1935. Finding a substantial adverse interest in the third trust prior to the surrender of powers led the court to hold that as to this trust the transfer was completed prior to the effective date of the gift tax. The Commissioner contended that under the *Clifford*⁷ rule the taxpayer remained in substance the owner of the corpus and that the gift being regarded as incomplete for income tax

¹ *Hogle v. Commissioner of Internal Revenue*, 132 F. 2d 66 (C. C. A. 10th 1942). This case contains a detailed account of the trusts and shows the first trust had a liquidating value of slightly over \$745,000 in 1940 and the second trust \$200,000 at the same time.

² *Commissioner of Internal Revenue v. Hogle*, 165 F. 2d 352 (C. C. A. 10th 1947).

³ *Greenfield, Correlation of Federal Income, Estate, and Gift Taxes*, 16 *TEMPLE L. Q.* 194 (1942). *Griswold, A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 *HARV. L. R.* 337 (1942). 2 *PAUL, FEDERAL ESTATE AND GIFT TAXATION* §17.03 *et. seq.* (1942).

⁴ *Commissioner of Internal Revenue v. Beck's Estate*, 129 F. 2d 243 (C. C. A. 2d 1942), *Higgins v. Commissioner of Internal Revenue*, 129 F. 2d 237 (C. C. A. 1st 1942).

⁵ 129 F. 2d 237, 239 (C. C. A. 1st 1942).

⁶ 115 F. 2d 331 (C. C. A. 1st 1940).

⁷ *Helvering v. Clifford*, 309 U. S. 331 (1940).

should be similarly regarded for purposes of the gift tax. The court stated that it was far from clear that the *Clifford* rule applied but that if it did the gift tax was not so closely integrated with the income tax that taxing the income of a trust to the grantor would lead to the conclusion that no gift tax was payable upon the creation of the trust.

In *Commissioner of Internal Revenue v. Beck's Estate*⁸ the taxpayer transferred securities and insurance policies on his life to the trustee. The income of the trust was to be used to pay premiums on the insurance and at the taxpayer's death the proceeds of the policies were to become a part of the corpus. The taxpayer, in computing the gift tax, deducted the capitalized value of the income necessary to pay the premiums during his life expectancy on the theory that this portion was not a gift as the income remained taxable to him by virtue of Section 167 (a) of the Internal Revenue Code. The court held the taxpayer liable for the gift tax on the amount deducted. This created a situation where the taxpayer was liable for the gift tax on property because he transferred it away, and yet remained liable for the income tax on the income of the same property.⁹

In *Lockard v. Commissioner of Internal Revenue*¹⁰ the taxpayer created an irrevocable short-term trust in 1938 and in 1939 transferred additional property to the trust. In 1941 the taxpayer claimed the full \$40,000 exemption.¹¹ The Commissioner disallowed a portion of this exemption on the ground that the taxpayer had claimed an exemption on the gifts of 1938 and 1939. The taxpayer contended that, as she was taxed on the income of the trusts under the *Clifford* rule, no gifts were made until the income was distributed to her beneficiary. The court dismissed this contention saying that the income tax and the gift tax each had its own independent criteria and that for purposes of the gift tax the transfers were complete in 1938 and 1939 and the gift tax exemptions then claimed must stand.¹²

The rule of these cases seems to be that when under applicable law, the legal title to income vests in one person when it arises, but under federal revenue laws is taxed to another, there is no gift tax liability when the income is paid over to the former. This doctrine would seem to apply to family partnership of the *Tower*¹³ or *Lusthaus*¹⁴ variety

⁸ 129 F. 2d 243 (C. C. A. 2d 1942).

⁹ See 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION §17.19 (1942) for a criticism of the B. T. A. decision in favor of the taxpayer in the *Beck* case.

¹⁰ 166 F. 2d 409 (C. C. A. 1st 1948).

¹¹ INT. REV. CODE §1004 (exemption now \$30,000).

¹² In the Tax Court it was held that the transfers in trust were complete in 1938 and 1939 for gift tax purposes on the authority of *Hogle v. Commissioner of Internal Revenue*, 7 T. C. 986 (1946) without a discussion of any difference in the cases. *Lockard v. Commissioner of Internal Revenue*, 7 T. C. 1151 (1946).

¹³ *Commissioner of Internal Revenue v. Tower*, 327 U. S. 280 (1946).

¹⁴ *Lusthaus v. Commissioner of Internal Revenue*, 327 U. S. 293 (1946).

in that under partnership law¹⁵ the ownership of the income would be in the donee while the donor remained taxable on the same income. The income in the *Hogle* case was profits arising directly from the personal activities of the settlor and the analogy to the partnership cases is close.

The courts have determined that the "broad sweep" of Section 22 (a) does not require the penetration of the legal form of the transaction when incidence of the gift tax is the subject of the inquiry¹⁶ because the gift tax issue is ownership while the income tax issue in trust cases is whether the settlor retained rights equivalent to substantial ownership¹⁷ and in partnership case is whether the donor earned the income.¹⁸

The *Hogle* case says that it represents a refusal to make an unjustified extension of the *Clifford* doctrine,¹⁹ but does it? The gift tax is imposed in the year in which the transfer is consummated.²⁰ In the present case the real gifts appear to have come in the years for which the Commissioner assessed the gift tax and to have been incomplete before that time.²¹ At the time the trusts were created they consisted of trading accounts and no property was transferred.²² The income sought to be made subject to the gift tax arose from the personal efforts and skill of Hogle and not from the corpus of the trust.²³ The court appears to have indicated a method whereby a taxpayer can transfer to his beneficiaries the fruit of his skill and labor without the transfer being subject to either gift or estate taxes.²⁴ In any event, the lack of forceful and convincing reasoning to support the *Hogle* decision indicates the need for clarification either by Congress or the Supreme Court.²⁵

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¹⁵ UNIFORM PARTNERSHIP ACT §24.

¹⁶ Commissioner of Internal Revenue v. Prouty, 115 F. 2d 331, 337 (C. C. A. 1st 1940); Lockard v. Commissioner of Internal Revenue, 166 F. 2d 409, C. C. A. 1st 1948). See 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION §17.17 (1942).

¹⁷ Helvering v. Clifford, 309 U. S. 331 (1940).

¹⁸ Commissioner of Internal Revenue v. Tower, 327 U. S. 280 (1946).

¹⁹ Commissioner of Internal Revenue v. Hogle, 165 F. 2d 352, 352 (C. C. A. 10th 1948).

²⁰ Burnet v. Guggenheim, 288 U. S. 280 (1933).

²¹ This is the theory on which the dissent in the tax court would have imposed the gift tax. *Hogle v. Commissioner of Internal Revenue*, 7 T. C. 986, 990 (1946).

²² *Hogle v. Commissioner of Internal Revenue*, 7 T. C. 986, 987 (1947).

²³ Commissioner of Internal Revenue v. Hogle, 165 F. 2d 352, 353 (C. C. A. 10th 1947).

²⁴ By setting up trading accounts in trust as was done in the *Hogle* case or by the gift of a portion of a partnership to a member of the family. Compare the gift tax status of a salaried man who makes an assignment of unearned future income. See PAUL, FEDERAL ESTATE AND GIFT TAXATION §16.12 (1942).

²⁵ The government has indicated it will not appeal the *Hogle* case. CCH FED. EST. & GIFT TAX REP. ¶9800 (1946).