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Taxation--Tax Consequences of Intra-Family Assignments

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Recent Cases

TAXATION—TAX CONSEQUENCES OF INTRA-FAMILY ASSIGNMENTS—Petitioner, taxpayer, invented and owned a patentable invention. He sold his patent rights to a manufacturing corporation, under a contract of sale by which he was to receive a stipulated sum based on the number of units sold. He received payment under this arrangement for six years, then made an absolute assignment of the contract and all payments to be received thereunder to his wife. A federal gift tax was paid and the wife received all subsequent payments for her sole use and benefit. Although the Commissioner conceded such payments to be gain from the sale of a capital asset, a deficiency was determined against petitioner for the taxable year 1947, based on the Commissioner's contention that the transfer was merely an anticipatory assignment of future income. The court, in affirming the lower court, held the assignment to be an absolute conveyance of property and property rights, making the income from such property taxable to the assignee and not the assignor. *Commissioner of Internal Revenue* v. *Reece,* 233 F. 2d 30 (CA 1, 1956) 24 T.C. 187 (1955).

Under the present Internal Revenue Code, a taxpayer in the higher tax brackets is subjected to a progressive tax burden at a rate much greater than his earning increase.[1] An often-used method of avoiding such an undesirable situation is to shift a portion of this income to other members of the family who are in lower rate brackets.[2] In the case at hand, tax minimization achieved through the device of gratuitous intra-family assignments was judicially approved, subject only to the qualification that the income-producing property be completely separated from the assignor.

Since our tax system regards the individual as the unit of income taxation, assignment is obviously highly beneficial as a means of rate reduction to the high-income taxpayer. Since the 1948 Amendment to the statute permits the spouses, by their election, to file a joint return and thus achieve the income-splitting advantage, property transfer between husband and wife is no longer necessary.[3] Nevertheless,

[1] Int. Rev. Code, Sec. 1(a) (1954). Under the rate set out a person making $100,001 would pay $67,320.89—if his income increases to $150,001 his tax is $111,820.90; thus as his income increases by 50%, his tax rate increases over 66%.

[2] See, e.g., Lucas v. Earl, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930); Blair v. Comm'r, 300 U.S. 5, 57 S. Ct. 330 81 L. Ed. 465 (1937); Helvering v. Eubank, 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81 (1940), etc.

[3] Int. Rev. Code, Sec. 6013 (1954).

the principle of saving taxes through income splitting has great potential when applied to the high bracket taxpayer who transfers property to members of his family, *other* than his spouse, who are in a lower bracket. Though most intra-family assignment cases arose before the joint income option and do involve property transfers between husband and wife (as does the present case), they provide valuable analogies applicable to situations involving other gratuitous assignments.[4]

Due to lack of any definite provision in the Code regarding the intra-family assignment, the duty of defining the validity and tax consequences resulting from these attempts at lessening taxes vests squarely upon the courts. In cases involving assignments, in order to determine who is taxable the court must generally make two basic findings:

(1) Was there an assignment in fact?
(2) If so, what was assigned?

As to the assignment itself, there is usually little controversy since both assignor and assignee are best served if they can establish an assignment. It is in deciding what was assigned that the court has the more difficult task.

Assignments generally concern income derived from labor, trusts, or capital.[5] Where income derived from labor is assigned, it is taxable to the assignor regardless of attempts at diversion.[6] Assignment of trust income, though formerly governed by the nature of the trust and the circumstances of the case, is now treated in the Regulations, and certain of determination.[7] Therefore, the present area of dispute appears fairly limited to those instances of assignment of capital realization.

The decisions of the courts as to whether tax shall be imposed upon the assignor or assignee have developed along two well-defined lines. The first situation is where the owner of an income-producing property assigns the *income* therefrom to another. In cases arising under such circumstances the courts hold the income taxable to the assignor regardless of the good faith and validity of the assignment.[8] For example, if the taxpayer makes a gift of an interest coupon, but retains the income-producing bond itself, he is taxable upon the income realized from the coupon.[9]

[4] See, e.g., Helvering v. Seatree, 72 F. 2d 67 (CA DC, 1934), Carl G. Dreymann v. Comm'r, 11 T.C. 153 (1948).

[5] For complete categorization and explanations, see Soll, "Intra-Family Assignments", 6 Tax L. Rev. 435 (1951), and 7 Tax L. Rev. 61 (1952).

[6] Lucas v. Earl, Helvering v. Eubank, supra note 2.

[7] Income Tax Regulations, Sec. 39.22(a)-21 et seq. (1956); Int. Rev. Code sec. 671 et seq.

[8] Floyd v. Scofield, 193 F. 2d 594 (CA 5 1952).

[9] Helvering v. Horst, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655 (1940).

The second line of decisions arises from an absolute assignment of the income-producing property, itself. In these cases, the courts hold such assignments constitute the assignee the sole taxable person as to income derived from the assigned property.[10] Thus, where the taxpayer, a retiring partner, assigned his right to payments under a partnership agreement providing compensation for good will, the income thereunder was not taxable as income of the assignor.[11]

As a simple illustration, let us suppose that A, a father in a high tax bracket, owns rental property. If he assigns only the rent to be realized from the property to B, his son in a lower bracket, A is still held to be the taxable person and has not lessened his tax burden; but if A assigns the *property itself* to B, then B is the taxable person and A has avoided the higher tax rate.[12]

The rule, while easily stated, is not always so easy in its application. It is especially difficult to apply in the cases involving contracts under patent rights and/or for royalties. The assignment may be of the contract which substitutes for the patent right (the *Reece* case), in which case it will be a transfer of property, taxable to the assignee only. In the case of *Nelson* v. *Ferguson*,[13] the court considered a contract quite similar to that in the Reece case. In defining the nature of the assignment, the court said:

> [I]t must be kept in mind that the thing assigned was not . . . future salary or personal earnings . . . but was an existing thing, namely: property in a contract. The assignment being of property was therefore not merely an assignment of income when earned, though from the property assigned profits and income were expected to flow.[14]

On the other hand, the contract may contemplate personal services to be, or having been, performed by one party with a percentage of gross sales fixed as the rate of compensation. In this instance, the assignor remains taxable on the income though he has completely assigned it to another. Such a case was *Strauss* v. *Comm'r*,[15] where the taxpayer, by virtue of personal services rendered, received a certain percentage of the royalties paid on a patented process for the manufacture of colored film. He assigned all his right, title, and interest to his wife, who reported income derived therefrom. The court held such income taxable to the assignor, and stated the rule:

[10] Helvering v. Seatree, supra note 4.
[11] Ibid.
[12] There is nothing legally wrong or morally reprehensible about avoidance of taxes; see Learned Hand's dissent in Comm'r v. Newman, 159 F. 2d 848, 850 (CA 2, 1947).
[13] 56 F. 2d 121 (CA 3, 1932).
[14] Id. at 124.
[15] 168 F. 2d 441 (CA 2, 1948).

> It has been well settled since Lucas v. Earl . . . that compensation derived from personal service is taxable to the one who performs the services whether or not he actually receives the compensation or transfers the right to receive it before it is earned.[16]

The court, in the *Reece* case, had to determine the exact nature of the contract. In deciding that the substituted contract was "property" and thus not taxable to the assignor, the court reached the proper result. Had the court decided to the contrary, it might well have been argued that all gratuitous assignments—whether made to persons in or out of the family—were nullities as far as tax diversion was concerned.

The *Reece* decision is important not only for its recognition of the intra-family assignment, but also for its refusal to impose judicial taxation in an area omitted in the Code. The problem of tax consequences of assignment has been a center of controversy and litigation for several decades. Yet, as the court here noted, Congress has not seen fit to prescribe a cure.[17] It is only logical to expect a certain reluctance on the part of the courts to adjudicate a tax under the circumstances, but here the court went beyond mere refusal and affirmatively stated a limitation on the function of the court.[18]

The effect of the *Reece* decision is very favorable to the taxpayer. If one makes an actual and absolute assignment, and is careful to assign, not the income alone, but the entire property, such taxpayer may effectively divert the income thereon to his assignee for purposes of taxation. Further, the tax benefits from assignments have survived the 1948 Amendment and the 1954 Code, and will remain available under current decisions, unless and until Congress legislates to the contrary.

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ZONING—WHEN HAS ONE AN EXISTING USE? Appellant Caruthers purchased 12.09 acres of land one month before the city of Bunker Hill, Texas was incorporated and five months before the enactment of its zoning ordinance. After the property had been surveyed for the purpose of developing twenty-three building sites as a residential subdivision and a plat completed, Caruthers staked out pins to mark each lot. He constructed a single street, placed a shelltop on it and added a concrete curbing on its sides. A concrete culvert was constructed at

[16] Id. at 442.

[17] 82d Cong. 1st Sess., S. Rep. No. 781 (1951): "Income from property is attributable to the owner of the property . . . If an individual makes a bona fide gift of real estate, or a share of corporate stock, the rent or dividend income is taxable to the donee."

[18] Reece v. Comm'r, 233 F. 2d 30, 33 (CA 1, 1956).