Current Tax Developments

Edward N. Polisher

Follow this and additional works at: https://ideas.dickinsonlaw.psu.edu/dlra

Recommended Citation
Edward N. Polisher, Current Tax Developments, 53 Dick. L. Rev. 223 (1949). Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol53/iss4/2

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.
CURRENT TAX DEVELOPMENTS*

By

Edward N. Polisher**

I. INTRODUCTION

The Federal Income Tax Law was first enacted by Congress in 1914, the Estate Tax in 1916 and the present Gift Tax in 1932. As a system of jurisprudence, Federal taxation is thus a matter of recent origin when compared with the venerability of the common law, the civil law and other established legal codes.

The Federal tax pattern is in a fluid and formative state. Its development is being shaped and constantly changed by the Congress, the Courts and the Treasury Department through its regulations and rulings. The cumulative actions of these agencies during any year affect deeply the course of development and the incidence of Federal taxation. During the past year, however, the velocity of change has been accelerated. As a result, it has been a period of significant and extraordinary changes in the law of Federal taxation. The Congress, the Courts and the Treasury Department have each made their contribution to these developments.

II. INCOME TAX DEVELOPMENTS

a. Revenue Act of 1948

The 1948 Revenue Act was enacted by Congress over Presidential veto on April 2, 1948. Its outstanding income tax feature was the adoption of the split income technique in the taxation of the income of married persons. Prior to its passage, husbands and wives residing in community property states enjoyed a distinct income tax advantage over those resident in common law states. In community property states, the income of either spouse during coverture was considered to have been earned by both and was therefore divisible between them for income tax purposes. Since the surtax rates under Federal Income Tax law are progressive, the income, when divided between husband and wife and taxed separately, one-half to each of them, resulted in less income tax than in a common law state where the entire income was taxable solely to the spouse who earned it. To eliminate

---

* This paper was delivered before the Eleventh Annual Institute on Accounting held in connection with the 75th Anniversary of the Ohio State University on May 21, 1949 at Columbus, Ohio.

** LL.B. Dickinson, 1922; Member of the Philadelphia Bar; Lecturer on Taxation, Dickinson Law School; Author "Estate Planning and Estate Tax Saving" (Second edition, 1948).

The author gratefully acknowledges the assistance of his associate, Harry Yohlin, Esquire, in the preparation of this article.
this discrimination, which was based upon the mere fortuitous, geographical resi-
dence of the taxpayer, and to equalize the burden of Federal income taxation among
all the residents of these United States, the 1948 Revenue Act allowed all hus-
bands and wives, wherever resident, to divide their combined incomes. It should
be noted, however, that the splitting of income for tax purposes does not create
any new property rights in the non-earning spouse to that part of the income at-
tributable to such spouse. Regulations governing the filing of joint returns under
the new act have been promulgated and now appear in Reg. 111, Sec. 29. 51-1 (b).

b. Supreme Court Decisions

1. Forgiveness of Indebtedness

There have been a number of significant decisions by the Supreme Court
of the United States during the current session. In Commissioner v. Jacobson, 336
U. S. 28 (1949), the Court severely revised and restricted the test for the tax-
ability of income resulting from a reduction of indebtedness. A proper under-
standing of the implications of this decision calls for a spot of background.

In 1931, the Supreme Court decided, in United States v. Kirby Lumber Co.,
284 U. S. 1, that open market purchases of its own bonds by a solvent corporate
taxpayer for less than the amount due resulted in the realization of income.

In Helvering v. American Dental Co., 318 U. S. 322 (1943), the Court
significantly modified the scope of the Kirby decision. There, a corporate taxpayer,
presumably solvent, compromised its liabilities for unpaid rent and interest on
notes for less than the amount owing, as a result of direct negotiations with its
creditors. The Court held that no income was realized by the debtor by this reduc-
tion of its indebtedness.

Extending the rationale of these decisions, the test subsequently developed
by the lower courts to determine whether taxable income was realized from the
acquisition by the debtor of its bonds or other evidences of indebtedness for less
than their due amount was: (a) whether the purchase had been made in an open
market—that is, through brokers—in which event taxable gain was realized; or
(b) whether the purchase had been made by the debtor as a result of direct negotia-
tions with the creditor, in which event no taxable gain would result.

The Jacobson case involved both such situations. The taxpayer, in straitened
financial circumstances but solvent, repurchased at various times some of his
personal bonds for less than the amounts due thereon. In some instances, the
taxpayer purchased the bonds from the owners directly; in others, the acquisitions
were made through a bondholders committee, or through a broker. In either case,
however, the bondholder knew that the taxpayer was the purchaser.

The Tax Court, following the theory of the Kirby and the American Dental
Co. decisions, held that in respect of the bonds purchased directly by the taxpayer,
no taxable income resulted; but, as to the bonds purchased through agents, taxable
income was realized.
In its opinion, the Supreme Court eliminated this distinction and severely limited the principle which many had believed was implicit in the *American Dental Co.* decision. It held that in either event, taxable income was realized because the transactions were all sales by which each bondholder sold his entire interest in the bond for the best price obtainable; that there was no intention to transfer part of the claims for cash and to make a gift to the debtor of the balance, which had been found to be the fact in the *American Dental Co.* case.

The test now seems to be whether there was a specific intent on the part of the creditors to "sell" a portion of the claim for cash and to forgive the balance gratuitously. The transaction must not have the effect of a sale at the highest price available. The further application of the *American Dental Co.* case, if any, must be limited to open account indebtedness, and claims for rent or interest, in contrast to bond issues.

When bonds are purchased by the debtor for less than face value, when is income realized? Another recent decision held that income was realized upon the purchase of the bonds, even though the bonds remain uncancelled for a long period because of a valid business reason: *Commissioner v. Pittsburgh & West Virginia Railway Co.*, — F. (2d) — (CCA-3, 1949).

2. *The Sansome Rule*

In another decision, the Supreme Court modified the doctrine of *Commissioner v. Sansome*, 60 F. (2d) 931 (CCA-2, 1932), cert. den. 287 U. S. 667 (1933). The *Sansome* rule, as it has become popularly known, was intended to cope with the following situation. A corporation with a substantial surplus of undistributed earnings sought to avoid the distribution of such earnings in the form of taxable dividends. A tax-free reorganization was arranged under which its entire assets, subject to liabilities, would be transferred to a new corporation in exchange for its stock. The successor corporation thereafter would distribute to its stockholders the accumulated funds acquired by it from its predecessor. Since this property was received in exchange for stock, it was contended that it was capital in nature and, therefore, not taxable income. The Circuit Court held, however, that the accumulated earnings of the predecessor became earnings of the successor corporation in a tax-free reorganization; and that a distribution of such earnings resulted in a taxable dividend.

The *Sansome* rule seemed to be based upon the fact that there was a continuity of the business venture. If this were correct, the converse would also be true. Thus, if a predecessor corporation had a deficit, such deficit could be used to reduce the successor corporation's earned surplus. The Supreme Court has rejected this corollary.

In *Commissioner v. Phipps*, — U. S. —, 69 S. Ct. 617 (1949), the parent corporation which had earnings and profits available for distribution, by means of a tax-free merger, absorbed several subsidiaries which had deficits. There-
after, distributions were made to stockholders which were treated as capital distributions. The issue was whether the deficits of the subsidiaries could be used to reduce the surplus from accumulated earnings of the parent. The Court held that they did not. The distribution to stockholders of the earnings attributable to the parent corporation were taxed as dividends. The rationale of the decision was that this was a rule necessary to prevent tax avoidance of corporate earnings of the distributing corporation.

In its opinion, the Court did indicate a solution to the problem. It consists of reversing the technique. Instead of merging the deficit-corporation into the surplus-corporation, the latter should be merged into the former. The deficit-corporation must be the survivor. See *Harter v. Helvering*, 79 F. (2d) 12 (CCA-2, 1935). This merger procedure reduces just as effectively the earnings of the surplus corporation.

3. Allocation of Income Between Parent and Subsidiary Corporations

In another decision, the Supreme Court held that wholly owned subsidiaries, by agreement, cannot allocate their income to the parent for tax purposes.

In *National Carbide Corporation v. Commissioner*, — U. S. — (1949), the parent corporation organized several subsidiaries. These were operated under a contract with the parent whereby the subsidiaries paid to the parent all profits in excess of 6% on their outstanding capital stock which was nominal in amount. The subsidiaries were held taxable not only on the 6% retained, but also on the profits turned over to the parent. The Court stated that although a corporation which engages in "business activity" is not taxable on income which it collects as "agent" for its owner, the subsidiaries under the facts were not in this category.

c. Lower Court Decisions

The recent lower court decisions in the income tax field are numerous. We have chosen only those decisions which are of the widest interest.

1. Partial Liquidations

When is a partial liquidation of a corporation deemed equivalent to the distribution of a taxable dividend under Section 115 (g) of the Code? This has long troubled taxpayers and courts alike. The rule seems to be that where the partial liquidation is prompted by a valid business purpose, it will not be considered a dividend. However, the application of this test has been indefinite. The Tax Court recently furnished an example of a valid business purpose. In *Joseph W. Imler*, 11 TC-No. 101 (1948) (acq.), a corporation with earned surplus was forced to abandon some of its activities as a result of a fire. It used the insurance proceeds to redeem a part of its stock. This distribution was held not to be a dividend because it resulted from a bona fide contraction of business operations and consequent reduction in the capital employed.
Section 115 (g) of the Code received another interpretation by the Tax Court. This section deals with the treatment of distributions by a corporation which are considered equivalent to a dividend. The Estate of Rodman Wanamaker owned all of the stock of John Wanamaker Philadelphia, a corporation, which in turn owned all of the stock of John Wanamaker New York. Both corporations had large earned surpluses. The estate required funds to pay its debts. It could have obtained these funds by having John Wanamaker Philadelphia distribute its earnings as dividends or by redemption of a portion of its shares. This, however, would have resulted in a substantial income tax. Instead, the estate sold some of its John Wanamaker Philadelphia stock to John Wanamaker New York. The Commissioner sought to apply Sec. 115 (g). The Court decided that a redemption of stock to be classified as a taxable dividend must involve repurchase of a corporation's own stock. Here, however, John Wanamaker New York did not purchase its own stock, but that of the parent corporation. Therefore Sec. 115 (g) did not apply: Trustees Common Stock John Wanamaker Philadelphia, et al., 11 TC 365 (1948), appealed to CCA-3.

Thus, the estate got the money it needed and still owned all of the stock through the parent corporation. This may be an additional reason for operating a business in multi-corporate form.

2. Sale of Corporate Assets

Who pays the tax on the gain realized from the sale of corporate assets after liquidation, has been a constant source of litigation in recent years. Where a corporation sells its assets at a profit and then is liquidated, a double tax results; first to the corporation on the gain from the sale and second to the stockholders on the gain over the basis for their stock. Attempts to avoid this double tax have taken two forms. In one, the corporation is first liquidated and then the stockholders sell the assets; in the other, the stock is sold and the buyer then liquidates the corporation.

In the Court Holding Co. case, 324 U. S. 331 (1945), the Supreme Court cast considerable doubt on the effectiveness of the first technique. It held that where a corporation is liquidated and the sale of the assets received by the stockholders in liquidation follows soon thereafter, the transaction will be subject to close scrutiny. If the negotiations for sale of the corporate assets were commenced prior to the liquidation, gain resulting from the sale will be imputed to and taxed to the corporation. The taxpayer must show that no negotiations took place on behalf of the corporation for the sale of the property prior to liquidation, if the tax to the corporation is to be eliminated.

Two recent Tax Court decisions indicate exceptions to this rule. In Steuben-ville Bridge Company, 11 TC-No. 96 (1948), a syndicate, none of whose members was a stockholder, arranged to acquire options to purchase all the stock of a corporation whose chief asset was a bridge. The syndicate then entered into
a contract to sell the bridge to the State of West Virginia. Thereafter, it secured the options, exercised them, liquidated the corporation and then consumated the sale. The Court held no gain was realized by the corporation because the negotiations for the sale of the bridge were not conducted by the corporation but by the members of the syndicate who were not then stockholders of the corporation. The court also stressed the fact that the original stockholders were not aware, at the time they assigned their stock to the syndicate, of the contemplated sale of the bridge; and further indicated that if the negotiations for a sale by the stockholders commence after steps toward liquidation have been taken, the corporation will not be considered as the seller.

An exception even closer to the line results from the decision in *Dallas Downtown Development Co.*, 12 TC-No. 17 (1949). A, a corporation, negotiated with B, a corporation, for the purchase of the building where A conducted its banking business. The acquisition of this property by direct purchase would require an investment in excess of the limit permitted A by Texas law. The officers of A, therefore, formed a dummy corporation which purchased all of B's stock at the price agreed upon for the building, liquidated B, created a mortgage on the building, and then conveyed the property to A, subject to such mortgage. The court held that B corporation realized no taxable gain from the disposition of the building. It is apparently immaterial that the negotiations were for the sale of assets and that the stock was purchased for the purpose of acquiring these assets by an immediate liquidation of the corporation.

Both these decisions seem inconsistent with the realistic approach of the *Court Holding Co.*, supra, and their fate on appeal should be watched with interest.

3. Stockholder Advances to Corporations

Where a taxpayer advances money to a corporation which later becomes defunct, two questions usually arise with respect to the taxpayer's deduction for such loss. The first, whether the advance was an additional capital contribution or a debt; the second, if it is a debt, was it a business or a non-business bad debt. If the advance is deemed a capital contribution, the deduction is limited to a long-term capital loss under sections 23 (g) and 117 (b) of the Code. On the other hand, should it be construed a debt, it may be a non-business bad debt, in which case the deduction will be treated as a short-term capital loss (Section 23 (k) (4) of the Code); or it may be a business bad debt, so that the deduction would be allowed in full (Section 23 (k) (1) of the Code).

Whether an advance is a debt or a capital contribution is a problem which arises most often where a stockholder lends money to a controlled corporation. The Commissioner and the Tax Court generally have considered such loans as capital contributions on the theory that there was no intention to create a debt.

In the recent case of *O'Neill v. Commissioner*, 170 F. (2d) 596 (CCA-2, 1948) cert. den. — U. S. — (1949), the Circuit Court differed with
this approach, although it affirmed the Tax Court's decision. The controlling factor, the Court held, was whether the corporation served a valid business purpose. If so, the dealings between the taxpayer and the corporation should be viewed in the same light as though he did not own or control the corporation. Here, however, the court pointed out the only disclosed reason for creating the corporation was to make it unnecessary for the taxpayer to procure his wife's signature to deeds. This was considered too trivial a reason to constitute a valid business purpose.

The importance of the case rests on the new approach recommended by the Circuit Court where advances are made by stockholders to controlled corporations which have a valid business purpose.

Whether the debt is a business or non-business bad debt has been before the courts in two recent cases: Valentine E. Macy, Jr., 8 TCM 45 (1949) and Maloney et al v. Spencer, —— F. (2d) —— (CCA-9, 1949).

In the Macy case, the finding of a business bad debt was predicated on the taxpayer's promotional activities. The court found that the taxpayer maintained a separate office through which he looked after his interests in numerous and varied enterprises, including real estate, publishing, coal, cotton, railroads, petroleum, etc.

In the Spencer case, the court found that the taxpayer, who was the sole stockholder in three corporations, organized to carry on fruit and vegetable packing and canning, was engaged in the business of acquiring and leasing food processing plants and that the loss was a proximate incident of the leasing.

4. Unreasonable Accumulation of Surplus

The Tax Court recently handed down a liberal decision which has been acquiesced in by the Commissioner in respect of the application of Section 102 of the Code which imposes a penalty on corporations for unreasonable accumulation of surplus.

In the J. L. Goodman Furniture Co., 11 TC 530 (1949), (acq.), the stock of a retail furniture store was owned 90% by a family group and 10% by other stockholders. The company had cash, government obligations and other securities of approximately $920,000.00. The company's average yearly earnings amounted to $125,000.00 and annual dividends were paid in the sum of $36,000.00. Since 1935, the company had planned to open one or two additional branches, which the president personally estimated would cost $500,000.00, but the threat of war and later the war itself, prevented such expansion. No other evidence, such as building estimates, etc., was introduced. Land for this purpose was not acquired until 1947. The Tax Court, nevertheless, held that the earnings were being reasonably accumulated for business purposes.

It is yet too early to determine whether this decision indicates a more liberal approach by the Tax Court to Section 102 problems. In the past, the courts have
generally refused to place much weight on nebulous plans for expansion, unless
the taxpayer could show specific steps taken in that direction and cost estimates
based on something more than the mere opinion of the corporate officers.

5. Reasonable Compensation

The abrogation of the Dobson rule by Congress has afforded taxpayers an-
other opportunity for relief in unreasonable compensation cases. The presumption
of correctness, which surrounds the Commissioner's determination, imposes on
the taxpayer the burden to produce evidence supporting the reasonableness of
the salaries involved. As a practical matter, what the Tax Court has been doing
is to act as a sort of arbitrator and to fix reasonable compensation usually at a
figure somewhere between the salary determined by the Commissioner and that
contended for by the taxpayer. So long as the Tax Court's finding had a reason-
able basis in fact, the Circuit Courts felt themselves foreclosed by the Dobson
rule from reviewing such decisions. In several recent cases, however, the Circuit
Courts have adopted a more positive attitude.

In The Roth Office Equipment Company v. Gallagher, 172 F. (2d) 452
(CCA-6, 1949), the total salaries paid to four officers amounted to $74,000.00.
The Commissioner allowed $41,000.00 and the Tax Court set the salaries at
$61,000.00.

In Wright-Bernet, Inc. v. Commissioner, 172 F. (2d) 343, (CCA-6, 1949),
the officers received $86,000.00 in salaries. The Commissioner allowed $51,000.00
and the District Court $68,000.00.

In both cases, the taxpayers introduced evidence that the salaries paid were
comparable to those paid to similar employees throughout the industry. The Com-
missioner submitted no evidence to refute the reasonableness of salaries paid.

The Sixth Circuit reversed both lower courts and allowed the salaries in
full. It held that the lower courts cannot reduce the amount of salaries actually paid
where qualified witnesses testify to their reasonableness and such evidence is not
contradicted by the Commissioner.

Ordinarily, where the Commissioner disallows part of the compensation paid
to officers, the corporation gets no deduction for the portion disallowed, but the
recipient of the salary nevertheless pays tax on the full amount as income. A
recent case indicates one way to avoid this double tax. In Willis W. Clark, 11
TC 672 (1948) (non-acq.) appealed to CCA-6 (2/28/49), the corporation enter-
ted into an agreement with its president prior to the close of the taxable year 1942,
limiting his salary and bonus for the year 1941, to the amount which would be
allowed by the Commissioner as a deduction to the corporation. The officer gave
the corporation his promissory note for the difference between the amount agreed
upon between the Revenue Agent and the corporation as reasonable compensation
and the sum actually paid to him in 1941 and 1942 for his 1941 services.
The court held that the officer was not taxable in 1942 on that portion of the compensation which, prior to the close of the taxable year, he agreed to return to the corporation.

6. Sale of Business—Goodwill

A troublesome problem in the sale of a going business is the tax implications of gain resulting from the transfer of its goodwill.

A sale of a going business involves the transfer of its several component parts, some of which are capital assets under Code Sec. 117(a)(1), the gain from whose sale is treated as capital gains; others, such as property held for sale to customers in the ordinary course of trade or business, are not capital assets and any profit realized on their sale is treated as ordinary income. Goodwill is considered a capital asset. In preparing the instruments of sale, care must be taken, however, to clearly identify each element transferred and to allocate part of the total price paid for each; otherwise, the courts may refuse to recognize that any part of the price was attributable to the sale of goodwill. This is illustrated in two recent cases.

In *Grace Bros., Inc. v. Commissioner*, — F. (2d) — (CCA-9, 1949), aff'd. 10 TC 158 (1948), the taxpayer sold its entire stock of wine, barrels, labels and list of customers. It did not sell its plant but instead leased it to the buyer. The Tax Court determined the entire gain to be ordinary income because the transaction was merely a purchase of stock-in-trade and other assets and did not constitute a transfer of the goodwill of the business. It stressed the fact that from the agreement of sale it did not appear that the business was transferred as a "unitary whole". The Ninth Circuit in affirming the Tax Court's decision noted that the written instruments relating to the sale nowhere mentioned the element of goodwill.

In *Violet Newton*, 12 TC-No. 30 (1949), the same question was considered with similar result. In that case, the taxpayer sold a pinball machine distributing business. The agreement of sale recited the assets sold as consisting of inventory, accounts receivable, credit deposits, goodwill and the right to use the firm name. No allocation in the selling price had been made for the tangible and intangible assets sold. The taxpayers urged that the entire gain resulted from the sale of intangibles such as goodwill, location, etc. The Tax Court held that insufficient evidence was presented to establish a selling price for goodwill.

In the light of these cases it would seem prudent that in the sale of a going business, the capital assets should be specifically referred to and the part of the price allocable to such assets set forth.

7. Entity Theory of Partnerships

Conflict exists in the law with respect to whether a partnership should be regarded merely as an association of individuals who are co-owners of the partner-
ship property, or as a separate legal entity distinct from the partners who compose it. Each status involves important tax consequences. Generally, the Tax Court has favored the entity theory and has held that a sale by a partner of his partnership interest results in capital gain, irrespective of the nature of the assets owned by the partnership. Commissioner v. Lehman, 7 TC 1088 (1946), aff'd. 165 F. (2d) 383 (CCA-2, 1948), cert. den. 334 U. S. 819 (1948). The Second Circuit, in affirming this decision, also seemed to approve of the entity theory. The Fifth Circuit adopted the same rationale in Commissioner v. Smith, —— F. (2d) —— (CCA-5, 1949), aff'g. 10 TC 398 (1948). In a recent decision, however, the Second Circuit apparently abandoned this theory.

In Commissioner v. Whitney, 169 F. (2d) 562 (CCA-2, 1948) cert. den. —— U. S. —— (1948), a partnership, whose partners controlled a corporation, sold its assets to the corporation. The assets included securities some of which were transferred at a gain and others at a loss. The Commissioner included the gains in the partners’ net income, but denied, under Section 24 (b) of the Code, the losses as arising from a sale between related parties. The Tax Court conceding that the loss would have been disallowed, if the sale had been made by the individual partners, nevertheless permitted the loss on the ground that the partnership entity was not an individual within the meaning of Code section 24 (b). In reversing the Tax Court, the Second Circuit held that the purpose of this section of the Code was to prevent loss deductions where a taxpayer retained the benefits of ownership after sale; and this could not be circumvented by mere legal technicalities.

8. Bargain Sale to Partnership Stockholders

The entity theory of partnerships was also involved in a recent case dealing with a bargain sale to stockholders.

Where a corporation sells its assets to stockholders at less than their market value, the difference is deemed a taxable dividend, to the extent that the corporation has earnings and profits. Does the same rule apply where the assets are sold to the stockholders as a partnership? This was the issue in Shunk v. Commissioner, —— F. (2d) —— (CCA-6, 1949).

A trust taxable as a corporation sold its assets at book value to a partnership composed in part of beneficiaries of the trust. The partnership then continued the business. The Commissioner determined that the difference between the amount paid for the assets and their market value, including good will, was taxable as a dividend. The Tax Court agreed (10 TC 293 (1948)). On appeal, the Sixth Circuit reversed. It held that the sale was not to the beneficiaries but to the partnership, a separate entity which must be recognized.

The entire issue reflects the conflict between legalistic approach and the realistic appraisal of the economics and benefits flowing from such transactions. The latter rationale is that which is usually employed in determining the incidence of Federal taxation.
CURRENT TAX DEVELOPMENTS

9. Family Partnerships

The Supreme Court has again decided to review the income tax implications of a family partnership. When the *Tower* (327 U. S. 280 (1946)) and *Lusthaus* (327 U. S. 295 (1946)) decisions were announced, many tax experts held to the opinion that they sounded the death knell of the ordinary family partnership. However, an impressive line of taxpayer victories followed in the Circuit and District Courts, and to a lesser extent, in the Tax Court. The Commissioner took cognizance of this development in appealing to the Supreme Court the Fifth Circuit Court’s decision in *Culbertson, Sr. v. Commissioner*, 168 F. (2d) 979 (CCA-5, 1948). In his petition for certiorari, the Commissioner complained that the decision “reflects an alarming tendency by some of the Courts of Appeal to circumvent” the *Tower and Lusthaus* cases. The Supreme Court granted certiorari on December 6, 1948.

In the *Culbertson* case, a father purchased his partner’s interest, and pursuant to the dissolution agreement, formed a new partnership with his four sons. The sons gave notes to the father for their shares, which were repaid in part out of the profits of the business, the balance being cancelled as a gift. All four sons entered the military service shortly after the formation of the partnership and hence did not render any services. Thus, in effect, they contributed neither capital nor services. Nevertheless, the Fifth Circuit reversed the Tax Court and recognized the partnership for income tax purposes. The Court held that the primary test is the reality or bona fides of the transaction. Contributions of capital and services are merely circumstances to be considered in determining the actuality of a family partnership.

10. Sales of Real Estate

A tax problem which is difficult, because it precludes, by its very nature, the application of definite standards is the determination of whether a person who engages in the sale of real estate is an investor or a dealer. Where the seller is merely an investor, the profit on such sales is taxed as a capital gain under Code section 117. If he is a dealer, the profit on such transactions is ordinary income. The more common tests applied by the Courts are the number and frequency of such sales and the original purpose for which the property was built or acquired.

*Elgin Building Corporation*, 8 TCM 114 (1949) involved this issue. There, the taxpayer, a corporation, engaged in the building of defense housing under Title VI of the National Housing Act. Some of the houses were constructed for rental purposes, others were immediately sold after construction without ever having been rented. Those properties which were rented, the Court held to be capital assets under Sec. 117 (j) of the Code and the profit realized on their sale was capital gain. With respect to those houses which were never rented, but were immediately sold, the court considered the frequency and regularity of such sales and concluded that they were constructed and held primarily for sale to customers. Therefore, the gain on their disposition was ordinary income.
11. **Constructive Receipt**

The constructive receipt doctrine has long been used by the Commissioner as a spear to prevent tax avoidance. Recently, the First Circuit, in an important decision written by Justice Frankfurter, specially presiding, held that the same theory can be used as a shield by the taxpayer.

In *Ross v. Commissioner*, 169 F. (2d) 483 (CCA-1, 1948), the taxpayer, in 1932, became entitled to amounts as salary which were earned and had been accrued on the corporation's books for that year. Instead of withdrawing the sum due him in that year, which he could have done, he took it in 1941. He did not report such salary as income. The Commissioner sought to tax the amounts received as income in the year 1941. The taxpayer contended that the salaries had been constructively received in 1932 and were taxable in that year. The Statute of Limitations, of course, barred any deficiency for the latter year. The Commissioner took the position that the concept of constructive receipt was available to him only to prevent tax avoidance. The Circuit Court held, however, that the doctrine is a mandatory rule of law; and the mere failure to report such income in the year it was constructively received does not render it taxable in the subsequent year of actual receipt.

The Commissioner advanced the novel argument that the taxpayer had an election to defer the tax to 1941 and his failure to report it in 1932, constituted an election to have it taxed in the year of receipt. The Court disagreed and held that a choice is not binding where the taxpayer has adopted the wrong method and where such a choice is not accompanied by fraud or misrepresentation.

12. **Deductions for Illegal Expenditures**

The profits from illegal enterprises have always been includible in gross income for tax purposes. This rule has been a powerful weapon in the hands of the Treasury in the prosecution of racketeers against whom it was difficult to produce evidence of crime. The converse of this proposition, however, is not necessarily true. The Commissioner has consistently resisted the allowance of deductions for illegal expenditures.

The justice of this rule, however, is open to question, especially where legitimate businessmen were forced, because of economic conditions, to pay over-ceiling prices for goods during the war and post war period. In I.T. 3724, C.B. 1945, 57, the Internal Revenue Bureau ruled that the cost of goods in excess of the OPA ceiling prices is not deductible.

In the recent case, *Lela Sullenger*, 11 TC-No. 127 (1948), the Tax Court, however, drew a distinction between ordinary deductions and allowance for cost of goods sold. It pointed out that under the Constitution, taxable income cannot be determined without taking into account the cost of goods sold. The Court rejected the Commissioner's position and held the entire cost, including the amount paid in excess of the OPA ceiling price, deductible.
On the other hand, deductions for amounts paid in compromise of an antitrust penalty, and payments to underworld characters for services in labor union negotiations, were disallowed in two recent decisions as being against public policy: *Universal Atlas Cement Co. v. Commissioner*, 171 F. (2d) 294 (CCA-2, 1948) cert. appl. 3/15/49; *Excelsior Baking Co. v. United States*, 82 F. Supp. 423 (D. Ct. Minn., 1949).

13. **Charitable Foundations**

The charitable foundation is becoming an increasingly attractive instrument for accomplishing tax savings. This development was given added impetus by the recent Circuit Court opinion in *Commissioner v. Edward Orton, Jr. Ceramic Foundation*, — F. (2d) — (CCA-6, 1949), which affirmed the Tax Court’s decision. There, the decedent, who was engaged in the manufacture and sale of pyrometric cones, provided in his will for the creation of a foundation to which his going business was to be transferred; and that the foundation was to operate the business and devote its income to the study and promotion of the science of ceramic engineering. From the business income, his wife was first to be paid a substantial annuity for life. The annuity amounted to about 30% of the total income of the business over a ten year period. The Court held that the income of the business was exempt from income tax under Sec. 101 (6) of the Code; that it is not the source of the income but its ultimate destination which determines whether the foundation is organized exclusively for charitable purposes; that it makes no difference that the foundation was established in the same instrument which transferred the business and created the annuity to the wife; that the annuity was a contractual obligation which had to be discharged to make the funds available for the scientific aims of the foundation.

14. **Taxation of Annuities**

The Internal Revenue Bureau has recently amended its regulations to provide that the 3% rule for the taxation of annuities will not apply to installment payments under endowment policies and annuity contracts, unless such payments are true technical annuities—that is, those which are computed with reference to the life expectancy of the annuitant according to the mortality tables. The new Bureau ruling, T. D. 5684, effective February 13, 1949, amends Regulation 111, Sec. 29.22 (b) (2)-2. In effect, it adopts the rule announced by the Tax Court in *Thornley*, 2 TC 220 (1943) as to which the Commissioner had originally filed his nonacquiescence. Under the new rule such installment payments will not be taxable until the taxpayer has completely recovered his premium payments.

15. **Alimony**

Alimony paid in the form of "installment" payments to discharge an obligation of a specified principal sum is not deductible by the husband nor taxable to the wife for income tax purposes, unless the payments are to be made over a period of more than 10 years. (I.R.C. Sec. 23 (k)). On the other hand, "periodic" pay-
ments in discharge of an alimony obligation, having no relation to a fixed principal sum, are deductible by the husband and taxable to the wife, without regard to the 10 year requirement. These rules are rather strictly applied by the courts.

In a recent case alimony payments were set at $100.00 per month for a period of 50 months, unless the wife sooner remarried, (Frank R. Casey, 12 TC-No. 33 (1949)). However, the decree also expressly provided that such payments were to be regarded as "periodic" and that the wife was to pay the Federal income tax on those amounts. The Tax Court decided that such payments were in reality " installment" payments and that the language of the divorce decree was not determinative of the incidence of Federal income taxation.

16. Fraud Penalties against Decedents

Until the issuance of G.C.M. 22326, C.B. 1940-2, 159, the Treasury had taken the position that the 50% civil fraud penalty could not be asserted after the taxpayer's death. This was based on the rationale that such penalty was in the nature of an ex delicto claim and, in the absence of any Federal statute relating to its survival, would abate with the death of the tort-feasor. G.C.M. 22326 completely reversed the Treasury's rule. Drawing from dicta of the Supreme Court in Helvering v. Mitchell, 303 U.S. 391 (1938), the G.C.M. declared that civil fraud penalties are not penalties because they involve no element of personal punishment, but are rather remedial in nature and intended to reimburse the government for loss resulting from taxpayer's fraud and expense of investigation.

The first judicial decision to rule squarely on this point since G.C.M. 22326, recently came from the Tax Court. In Estate of Louis L. Briden, 11 TC-No. 131 (1948), the decedent's estate was held liable for the 50% fraud penalty under Section 293 (b) of the Code, despite the fact that notice of deficiency assessment was not issued until after decedent's death.

III. ESTATE TAX

a. 1948 Revenue Act

The amendments made to the Federal estate tax statute by the Revenue Act of 1948 represent the most recent effort of Congress to bring about an equality in the burden of such taxes between the estates of decedents who resided in community property states and those of common law states. The development of this process of equalization presents an interesting narrative.

In community property states, each spouse owns a half-interest in the community property. Generally, such property consists of earnings and property acquired by either spouse during coverture, irrespective of which spouse holds title. Prior to 1942, upon the death of a spouse, only his one-half interest in such property, which he had the right to dispose of by will, was subject to Federal estate tax. The other one-half, being the property of the surviving spouse under the law of community property states, did not form part of the estate of the deceased.
spouse; and was not subject to tax until the death of the surviving spouse. On the other hand, in common law states, neither spouse had an undivided interest in the property of the other during the lifetime of both. Upon the death of the spouse owning the property, or the death of the earning spouse where the property was jointly owned by both spouses, the entire amount thereof was subject to Federal estate tax.

Since the estate tax is imposed at sharply progressive rates which increase in the respective brackets as the size of the estate mounts, the result was that substantially lower estate taxes were assessed against the estates of decedents in community property states than were assessed on estates of similar size in common law states.

The Congress in 1942, by amendment of the Federal estate tax law, attempted to eliminate this discrimination against the estates of decedents who died residents of common law states.

The amendments of that year provided that the entire community property should be included in the decedent’s gross estate, except such portion as could be shown to have been received as compensation for personal services actually rendered by the surviving spouse, or derived originally from such compensation, or from separate property of the surviving spouse. Thus, as in common law states, the entire community property was taxable to the first spouse to die unless some portion of the community was economically attributable to the surviving spouse. A further provision stated that there should be at least included in the estate of the decedent so much of the property over which such deceased spouse had a power of disposition at death.

The 1948 Revenue Act repealed the community property provisions inserted in 1942 and restored the taxability of community property to its pre-1942 status. It created, also, the marital deduction for estates of decedents who resided in common law states. However, the pattern for the includibility of property in the decedent’s gross estate is not disturbed. The same types of property which formed part of the decedent’s gross estate for Federal estate tax purposes prior to the 1948 Revenue Act continue to be subject to the tax on and after January 1, 1948, as of which date the new Estate Tax amendments became effective.

An additional deduction was added to the Estate Tax statute by a new section of the Code known as Sec. 812 (c). Under it, a decedent-spouse is allowed a marital deduction from his gross estate in an amount equal to the value of all interests passing from the decedent to the surviving spouse under certain conditions. The deduction, however, is limited to an amount not in excess of 50% of the decedent’s adjusted gross estate. Community property is generally not available for the marital deduction and is given special treatment.

To qualify for the marital deduction, the interest in property passing to the surviving spouse must either pass outright or by means of a trust. If it passes in trust, the following conditions must be met:
1.—The surviving spouse must be entitled for life to all the trust income which must be distributed annually or at more frequent intervals. Thus, trusts under which the income is to be accumulated, or may in the discretion of the trustee be accumulated and not distributed, will not qualify for the marital deduction.

2.—The surviving spouse must have the power, either during life or at death, or both, to appoint the entire corpus free of the trust to herself or in favor of her estate.

3.—The surviving spouse must have the right to exercise this power alone and in all events.

4.—If any person other than the surviving spouse has the power to appoint any part of the trust corpus, such power must be exercisable only in favor of the surviving spouse.

The 1948 Revenue Act failed to deal adequately with the peculiar problems which life insurance presented. Congress soon thereafter, on July 1, 1949, adopted a Joint Resolution amending Sec. 812 (e) (1) (G) of the Code relating to life insurance with power of appointment in the surviving spouse.

This Resolution provided that where the proceeds under a life insurance, endowment or annuity contract, are held by the insurer and made payable to the surviving spouse in installments, or where such proceeds are held by the insurer subject to an agreement to pay interest thereon to the surviving spouse, such proceeds will qualify for purposes of the marital deduction, if the following conditions are met:

1.—The installments or interest payments must be payable annually or at more frequent intervals commencing not later than 13 months after the decedent’s death.

2.—All amounts payable during the life of the surviving spouse must be payable only to such spouse.

3.—The surviving spouse must have the power to appoint all amounts payable either to herself during her lifetime or to her estate, or both.

4.—This power of appointment must be exercisable by the surviving spouse alone and in all events.

The extent to which the marital deduction should be employed will largely depend upon a comparison of the estates of both spouses. It should be remembered that to the extent that a surviving spouse receives property from a deceased, tax-free, by virtue of the marital deduction, it will be taxable in her estate if she still owns it at the time of her subsequent death.

The Treasury Department on May 18th, 1949 issued estate and gift tax regulations to implement the changes made by the 1948 Revenue Act. Generally speaking, these regulations are liberal. Thus, with respect to the question of the type of trusts which will qualify for the marital deduction, the regulations pro-
vide that the trustee may be given all the usual powers necessary for adminis-
trating the trust; and provided, further, that they do not operate to deprive the sur-
viving spouse of the beneficial enjoyment during life, which the principles of
the law of trusts accord to such a beneficiary. Spendthrift provisions are permissi-
ble and the income can even be accumulated, so long as it is subject to the wife's
power to request distribution annually.

b. Supreme Court Decisions

1. Pre-1931 Trusts with Income Retained

The recent Supreme Court decisions on Federal Estate Tax have indeed been
significant and precedent-shattering. In Commissioner v. Estate of Church, 335 U.
S. 632 (1949), the Court overruled its own decision in May v. Heiner, 281 U. S.
238 (1930).

In May v. Heiner, supra, the Supreme Court held that a transfer, in which
the decedent reserved the income for life, was not taxable as a transfer intended
to take effect in possession or enjoyment at death under Sec. 302 (c) of the Rev-
eneue Act of 1926—now Sec. 811 (c) of the I.R.C. As a result of this decision,
Congress enacted the now famous Joint Resolution of March 3, 1931, amending
the relevant section of the statute to specifically include such property. Subse-
quently, in Hassett v. Welch, 303 U. S. 303 (1938), the Supreme Court decided
that the amendments made by the Joint Resolution could not be applied to trans-
fers made before March 3, 1931, even though the transferor died after that date.

The rules of May v. Heiner and Hassett v. Welch became firmly imbedded
in Federal Estate tax law and were recognized in the Commissioner's own regu-
lations. In fact, the Commissioner, in appealing the Church case, supra, to the
Supreme Court, raised only the question whether the possibility of reverter present
in the case was sufficient to cause the transfer to be includible in the estate of
the decedent. He did not contend that the pre-1931 transfer was taxable because
of the retention of income.

The Supreme Court, however, took advantage of this opportunity to state,
in the Church Estate opinion, that in the light of its decision in Helvering v.
Hallock, 309 U. S. 106 (1940), May v. Heiner, supra, was no longer correct; and
held further that pre-March 3, 1931 transfers with income retained are in-
cludible in the estate of the transferor for Federal estate tax purposes.

The Commissioner has now proposed amendments to the Estate Tax Regula-
tions to conform to the change in the law made by the Church Estate decision.
The proposed regulations state that the rule announced in the Church Estate case
will not be applied retroactively, with respect to decedents who died on or before
January 17, 1949, the date of the Supreme Court's decision.

2. Possibility of Reverter by Operation of Law

On the same day, the Supreme Court handed down its decision in Estate of
Spiegel v. Commissioner, 335 U. S. 701 (1949), a companion case to Commis-
sioner v. Estate of Church, supra. The Court sought to resolve unequivocally all the troublesome questions of the estate tax implications of the remote possibility of reverter by operation of law.

In Helvering v. Hallock, 309 U. S. 106 (1940), the Supreme Court held that a transfer in trust, with the express proviso that the corpus should revert to the grantor in the event he survived the beneficiaries, was includible in the grantor's gross estate at death under the "possession or enjoyment" provision of Sec. 811 (c) of the Code.

Since that decision, the Commissioner has repeatedly sought to extend the Hallock doctrine to include reverters arising, not only by the express language of the trust instrument, but also those which could come into existence only by operation of law. The decisions of the lower courts on this issue were hopelessly in conflict.

The Spiegel case resolved this conflict by holding that all reverters, whether express or by operation of law and irrespective of remoteness, would cause the transfer to be includible in the gross estate under Sec. 811 (c) of the Code.

The Spiegel case demonstrates how remote a possibility of reverter by operation of law can be and yet result in the taxability of the entire trust corpus. There, the decedent transferred property in trust, with the income payable to his three children during his lifetime, or, if they did not survive him, to their surviving children. The corpus was distributable in the same manner. No specific provision was made in the event the decedent outlived his children and grandchildren. Actually, the grantor was survived by his three children and grandchildren. Under local law, the trust corpus would have reverted to the grantor, had he survived his children and their issue.

It is interesting to note, as one of the dissenting opinions points out, the court's decision sustained a tax of $450,000.00 because of a remote possibility of reverter which had an actuarial value of $70.00 at the time of the grantor's death.

On April 15, 1949, the Treasury issued proposed amendments in its Estate Tax Regulations to conform with the Church and Spiegel decisions. They provide that a right to the possession or enjoyment of the property or a right to the income therefrom constitutes a right or interest in the property. This provision reconciles the Regulations with the Church decision.

Another proposed change is in one of the examples under Section 81.17 of the Regulations. An entirely new example is substituted for example 6, which indicates that if the decedent has parted with every right and interest in the property, no part of the property will be includible in the decedent's gross estate.

The effect of the Spiegel case is to be seen in Estate of Merritt J. Corbett, 12 TC-No. 22 (1949). There, the decedent created a trust with the income payable to his wife so long as she remained married to him, and upon his death, the income was to continue to be paid to her for the remainder of her life. In the
event she ceased to be his wife, the income was to be paid to him. Certain remainder interests were also created over which the decedent retained the right to change beneficiaries. There was no doubt that the remainder interests were includible. The question was whether the value of the wife's life estate was also includible. The Tax Court, relying on the rationale of the Spiegel case, held that it was; that the wife's life estate depended on the contingency of her surviving the decedent and the contingency ended only with the decedent's death. Therefore, the life interest did not fully vest in the wife until that time.

Some attempts to circumvent the effect of the Spiegel decision have already been made. Thus, Minnesota enacted a law (Ch. 201 Minn. Laws of 1949) to the effect that no reversionary interest is to be deemed to exist, if the settlor has manifested an intention to divest himself of all interest in the trust. Instead, the trust fund is to be held upon a resulting trust for the benefit of the state, if all the beneficiaries predecease him.

In Pennsylvania, the grantor of a trust which did not provide for the disposition of the fund in the event he survived all the beneficiaries, petitioned the court to reform the trust deed, asserting that this contingency was not covered, through the inadvertence and mistake of the draftsman, and stating that he now wished to provide that in such event the income should pass to a charity. The Pennsylvania Supreme Court returned the case to the lower court for further evidence with instructions that if the lower court finds that the omission was in fact a mistake or inadvertence, the court may permit the requested reformation. Irish v. Irish, 361 Pa. 410 (1949). The final outcome is not yet known.

3. Charitable Remainders as a Deduction

In another estate tax case, the Supreme Court strongly reaffirmed its own prior decision in Merchants National Bank of Boston v. Commissioner, 320 U. S. 256 (1943), with respect to deductions for charitable remainders.

Where a remainder interest is given to a charity, its actuarial value is allowed as a deduction for Federal estate tax purposes. The difficulty arises where invasion of the trust corpus is permitted for the benefit of the life tenant. The courts have held that if the power to invade the corpus can be measured by a clearly defined standard contained in the instrument, the charitable deduction for the remainder interest will be allowed for that portion of the fund which, under all the circumstances, will definitely be devoted to charity. On the other hand, where there is no such standard, the deduction will not be granted.

Thus, in Henslee v. Union Planters National Bank & Trust Company, 335 U. S. 600 (1949), the decedent created a trust providing for the payment of a stipulated amount per month to his mother for life with remainder interests to charities. The trustees were given the discretionary power to expend either income or principal for the "pleasure, comfort and welfare" of the mother, and "in such manner as she may desire". At decedent's death, the mother was 85 years of age
with substantial independent means of her own so that the possibility of corpus invasion was extremely remote. The Supreme Court, nevertheless, held that a deduction for the charitable remainder could not be allowed because the power to invade was not governed by any ascertainable standard. It also commented on the fact that by the terms of the trust instrument, the charitable remainders were subordinated to the decedent's primary concern for his mother. That as a practical matter, the possibility of invasion was unlikely, was immaterial.

4. **Valuation of Remainder Interests**

The valuation of the assets in a decedent's gross estate for Federal estate tax purposes is always fraught with great difficulties. A particularly complex problem arises in valuing remainder interests left to charities. The law is that where life estates are given to specified persons with remainders to charities, the estate is allowed a deduction for the charitable remainder. The difficulty arises in computing the value of the remainder interest where indeterminate factors are present. One of these factors—the power to invade the corpus for the benefit of the life tenant—was previously discussed in connection with the Supreme Court decision in the *Union Planters National Bank & Trust Company* case, *supra*. Another factor—the role of life expectancy tables—is highlighted in two recent Tax Court decisions.

In *Estate of Nellie H. Jennings*, 10 TC 323 (1948), the decedent bequeathed her estate in trust to pay the income to her husband for life with remainder to a designated charity. The husband was 73 years of age at his wife's death. He had been extremely ill the past several years and it was apparent that he would not live as long as the life expectancy table predicted for a man of his age. As a matter of fact, he died within two months. The Commissioner, nevertheless, computed the husband's life interest by reference to the ordinary life expectancy tables. The Court held, however, that actual physical conditions, not life expectancy tables, controlled valuation.

In *Estate of Reinhold H. Forstmann*, 6 TCM 136 (1947), the decedent provided that the income from a trust be paid to his wife for life unless she remarried, remainder to charity. The Court held that the valuation of the wife's life estate should be based on the American Experience Tables designed to reflect the possibilities of a woman at that age remarrying.

c. **Lower Court Decisions**

1. **Estate Tax Implications of Deferred Compensation Arrangements**

The use of deferred compensation arrangements has increased substantially in recent years. Recently, there have been several important decisions dealing with the estate tax implications of such arrangements upon the death of the employee.

In *Estate of William L. Nevin*, 11 TC 59 (1948) (acq.), the decedent was the president of John Wanamaker Philadelphia. To persuade him to resign, the corporation entered into a formal contract with him whereby it agreed to pay him
a stipulated pension for a period of ten years. If he died within ten years, the remaining payments were to be made to his widow, if she survived him. The Tax Court held that upon his death, the value of the remaining payments to be made to his widow was includible in his gross estate under Sec. 811 (c) of the Code. The rationale of the court's decision was that the payments were made under an enforceable contract, supported by valid consideration.

The same result was reached in *Estate of Paul G. Leoni*, 7 TCM 759 (1948).

In *Estate of William J. Higgs*, 12 TC-No. 43 (1949), the decedent under a retirement pension fund paid for by the employer had the right to elect, prior to retirement, to receive either an annuity for his own life or a smaller survivorship annuity for the lives of himself and his wife. He chose the latter. At his death, the Court held that the value of the widow's survivorship rights were includible in his gross estate under Sec. 811 (c).

A dissenting opinion contended that no "transfer" had been made by the decedent, since he exercised his option prior to the time the annuity had vested in him.

On the other hand, where a company voluntarily paid a substantial bonus to an estate of a deceased employee in recognition of his long and faithful services, the Court held that the bonus was not includible in the employee's gross estate, since it was not paid pursuant to any contract. *Jack Messing*, 7 TCM 568 (1948). Similarly, *Estate of Eugene F. Saxton*, 12 TC-No. 74 (1949).

In *Estate of Emil A. Stake*, 11 TC-No. 98 (1948), the decedent employee contributed to an employee's pension fund to which his employer also contributed. He died prior to retirement age (60 years). Under the plan, the employer could either pay a pension to his widow or repay his contributions with interest. The employer elected to pay the pension. The Court held that only the value of the employee's contributions with interest was includible in his gross estate because the decedent, prior to reaching retirement age, had at most an expectancy of a pension for his widow and not a vested right thereto. He had definite rights only to repayment of his contributions with interest.

The rule would appear to be that if the payments to the widow are made pursuant to a contractual obligation, their value will be includible in the decedent's gross estate. On the other hand, if the payments are made voluntarily by the employer, their value will not form part of the decedent's estate.

2. Contemplation of Death

A decedent's age at the time he makes a transfer is of great importance in determining whether the transfer was made in contemplation of death. The factor of advanced years may, however, be overcome by evidence of motives associated with life. In *Estate of Oliver Johnson*, 10 TC 680 (1948), the decedent died at the age of 90. Four years earlier, he had made a substantial transfer of his property.
The Court held that despite his advanced age, the gift was not in contemplation of death. It found that his primary motive was to rid himself of the management of certain properties.

3. **Grantor’s Retained Power to Accumulate or Distribute Income**

A power either to accumulate or distribute the current income of a trust has been held to be a power of alteration or amendment which would cause the trust to be includible in the grantor’s gross estate at death under Sec. 811 (d) of the Code. This is so because the decedent in exercising such a power could favor the remaindermen as against the life tenants. The cases have held, however, that only the interest of the life tenant which could thereby be affected was includible. A recent decision seems to reveal a tendency to include the entire trust, pursuant to the philosophy of the decision in *Estate of Speigel v. Commissioner*, 335 U. S. 651 (1949).

In *Commissioner v. Estate of Hager*, — F. (2d) — (CCA-3, 1949), the decedent had retained the power to accumulate or distribute income; and also the power to treat capital gains resulting from the sale of trust assets either as part of income, in which event they would benefit the life tenants, or as corpus, which would inure to the advantage of the remaindermen. The Court considered these powers to be powers of alteration and amendment and held that the entire trust, not only the life tenant’s interest, was includible in the decedent’s gross estate under Sec. 811 (d).

4. **Power Retained to Remove Trustee as Power to Terminate**

In another recent decision involving Section 811 (d), the decedent created a trust reserving to the trustee the power to terminate the trust. The decedent, as donor, retained the power to remove the trustee and appoint himself successor-trustee. Thus, he would be in a position to exercise the power of termination. The Court held, in *Estate of Paul Loughbridge*, 11 TC-No. 115 (1948), that the trust was includible in the decedent’s gross estate, even though the decedent never became the trustee, so that the power to terminate was not vested in him at the time of his death.

**IV. GIFT TAX**

*a. 1948 Revenue Act*

Prior to the Revenue Act of 1942, residents of community property states enjoyed a distinct Federal gift tax advantage over residents in common law states in respect of the transfer of property by gift.

A gift of community property was taxable as though one-half of the value of the gift were the gift of the husband and one-half the gift of the wife. In common law states, neither spouse had an undivided interest in the property of the other. Therefore, the entire value of the property was taxable as the gift of the donor spouse.
By the Revenue Act of 1942, Congress attempted to equalize this gift tax burden between residents of community property and common law states. It amended the gift tax law with respect to community property by providing that all gifts of community property were to be considered as the gifts of the husband, except gifts of such property which could be shown to have been received as compensation for personal services actually rendered by the wife, or derived from such compensation originally, or from separate property of the wife which were to be considered as gifts of the wife.

The 1948 Revenue Act repealed Sec. 1000 (d) of the Internal Revenue Code relating to gifts of property held as community property except as to gifts made between January 1, 1943, and April 2, 1948, the date of the enactment of the 1948 Revenue Act.

The repeal of the gift tax provisions in respect of community property, restored the pre-1942 gift tax status of such gifts. At the same time, the Congress introduced "gift tax splitting" between spouses resident in common law states, which is similar in its effect to the pattern used for income taxes.

Section 372 of the 1948 Revenue Act amended section 1004 (a) of the Code by adding a new paragraph known as (3) entitled "Gift to Spouse". As in the case of the Federal estate tax, there was introduced into the Federal tax system, for the first time in its history, a marital deduction in computing the net gifts of citizens and residents of the United States. The marital deduction for gift tax purposes is allowed for gifts made after April 2, 1948, the date of the enactment of the 1948 Revenue Act. Gifts of community property, however, are given special treatment.

Under the new law, the marital deduction is an amount equal to one-half the value of any gift of an interest in property made to a donee who, at the time of the gift, is the donor's spouse. It is to be determined with respect to each gift to a spouse without regard to the annual exclusion. Thus, if a donor makes a gift to his spouse of $10,000.00, there will be allowed an annual exclusion of $3,000.00 and a marital deduction of $5,000.00 (one-half of $10,000.00). The net gift will be only $2,000.00.

The marital deduction is allowed for absolute gifts of property. It is, however, disallowed with respect to terminable interests.

The marital deduction may be applied towards an interest transferred in trust by a donor spouse provided that requirements, similar to those set forth in the estate tax amendments, are complied with.

Furthermore, a new subsection (f) was added to section 1000 of the Code by section 374 of the 1948 Revenue Act. A gift made after April 2, 1948, the date of the enactment of the 1948 Revenue Act, by one spouse to any other person than his spouse will be considered as made one-half by him and one-half by his spouse.
The splitting of gifts made by either spouse to third parties is not mandatory. It is permitted only if both spouses consent. A consent signified with respect to any gift made during the calendar year will apply with equal force to all gifts made to third parties during such calendar year; and will apply to property held by the spouses as joint tenants or as tenants by the entireties.

The effect of the marital deduction, under the amendments to the gift tax statute made by the Revenue Act of 1948, is to make possible the transfer by gift between spouses of double the amount of property which could have been so transferred to such spouse free of gift tax prior to the enactment of the new law; and in the case of gifts by husband or wife to a third party to increase the amount of gifts which can be made free of gift tax by virtue of the additional exclusion and the additional specific exemption which will inure in favor of the spouse of the donor.

Amendment to the Gift Tax Regulations reflecting the changes made by the 1948 Revenue Act were published in the Federal Register on May 18, 1949.

b. Court Decisions

Two cases, recently decided, are of interest with respect to the allowance of the annual gift tax exclusion. Since January 1, 1943, a donor is permitted a $3,000.00 annual exclusion for gifts made to each donee. Prior to 1943, the amount allowed was larger. The exclusion, however, does not apply to gifts of future interests. With respect to gifts in trust, the annual exclusion is usually allowed to the extent of the present value of the income beneficiary's right to the income of the trust.

In *Jesse S. Phillips*, 12 TC-No. 32 (1949), the petitioner transferred a life insurance policy in trust, with the direction to pay the net income therefrom to his wife during her life; and if the income was inadequate for her proper support and maintenance, to pay to her so much of the principal as might be necessary for such purpose. The Court held that the annual exclusion could not be applied because the insurance trust was non-income producing. Moreover, no exclusion results from the provision permitting the cash value of the policy to be paid to the beneficiary since such invasion is based upon a contingency which had not occurred at the time of the gift.

In *Kniep v. Commissioner*, —— F. (2d) —— (CCA-8, 1949), the beneficiaries of a trust were to receive the annual income. In addition, the trustees were authorized to pay each beneficiary up to $1,000.00 if necessary for maintenance and support. For purposes of the annual exclusion, the Circuit Court based the value of the present right to receive the income on the commuted value of the income from the trust principal, reduced each year by $1,000.00. It was considered immaterial that the trustees might never dip into the principal to that extent.

As in the *Phillips* decision, *supra*, the Court refused to consider the right to invade the corpus as a gift of a present interest.
These decisions apply only to the annual exclusion. The $30,000.00 specific exemption is available for all gifts, irrespective of whether the gift is of a present or future interest.

1. **Transfers Incident to Divorce**

That the Commissioner’s rulings are not sacrosanct was again illustrated in the case of *Edward B. McLean*, 11 TC 543 (1948) (non-acq.) (appealed to CCA-2 1/4/49). Internal Revenue Bureau’s ruling ET 19, 1946-2 CB 166, provides that transfers of property, pursuant to an agreement incident to divorce, are not for an adequate and full consideration to the extent that they are made in consideration of the release of marital rights other than right of maintenance and support; and hence are to be considered taxable gifts, under Code Section 1002.

In the *McLean* case, *supra* the taxpayer and his wife, after protracted negotiations while a divorce action was pending, entered into a separation agreement whereby the taxpayer undertook to pay specified monthly amounts to his wife and to make lesser payments to her in the event of her remarriage. The Commissioner contended, in the light of ET 19, 1946-2 CB 166, that the payments to be made to the wife after her re-marriage constituted gifts. The Court held otherwise and rejected the Bureau’s ruling. The Court could find no donative intent since the agreed payments to be made to the wife both before and after marriage were the result of bargaining which had as its sole objective the securing of the most advantageous terms.

V. **LOOKING AHEAD**

The impact of Federal taxation on the economic life of the nation in recent years has been tremendous. It has become one of the most important factors affecting the business and social life of the American community. The year 1949 opened with a request by President Truman to the Congress for an increase in Federal taxation to stem the tide of threatened inflation. The continued downward economic course in business since then and the assumption of additional financial responsibilities by the nation has halted this inflationary trend. At the same time, a deficit in the Federal budget of approximately four billion dollars is indicated. The solution to this problem poses the following alternatives—either to increase taxes to meet the deficit or to reduce the budgetary requirements by the necessary amount. Each approach has its advocates. The President stands firm in his demand that Congress increase taxes. A considerable body of responsible leadership prefers to reduce the budget and wishes to avert the increase in taxation, being of the opinion that it might defeat its own purpose by converting the current deflationary trend into a sharp recession.

All indications now point to the fact that there might not be time at this session of the Congress to consider a new revenue bill; but that it will probably become an early order of business at the next session.

*CURRENT TAX DEVELOPMENTS* 247
The Treasury is considering the inclusion of the following items in the new bill:

1. Credit for dividends received by a parent corporation from a foreign subsidiary.

2. Where a corporation receives a dividend in kind, the credit should be limited to 85% of the adjusted basis of the property in the hands of the distributing corporation.

3. A provision different from the present 3% rule on annuities. The Treasury recommends the allowance of an annual exclusion equal to the consideration paid for the annuity divided by the life expectancy of the annuitant at the time the payments commence. This exclusion would be allowable for life.

4. The treatment of a partnership distribution to heirs of a deceased partner as income of the decedent, so there will be no overlapping of income and estate tax.

5. Relaxation of the involuntary conversion provision to allow replacement of the destroyed property prior to receipt of insurance proceeds; and also easing the restrictions concerning the tracing of the proceeds.

6. Some provision which will prevent manipulation of long and short positions in substantially identical securities.

7. A general revamping of the provisions relating to the taxability of income of estates and trusts.

8. A change in the provisions dealing with corporate liquidations to eliminate problems resulting from the Court Holding Company case.

9. The provision in HR 6712 of the 80th Congress relating to stock options is still being considered. The Treasury does not favor it.

10. Other situations which might be treated are mortgage foreclosures, the capital gains structure and net operating losses.