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The Taxation of Capital Gains in the Hands of a Successor in Interest

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TAX COMMENT

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THE TAXATION OF CAPITAL GAINS IN THE HANDS OF A SUCCESSOR IN INTEREST.—In the law of taxation it is frequently reiterated that “statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved most strongly against the government and in favor of the citizen.”¹ Where the statute, however, contains no ambiguity it must be taken literally and given effect according to its language.² But the expounding of a statutory provision strictly according to the letter without regard to the other parts of the act and legislative history would often defeat the object intended to be accomplished.

The Supreme Court of the United States, in *Helvering v. New York Trust Company*,³ recently took cognizance of the effect of such strict construction. To avoid its results the court assiduously carried out the purpose of Congress in including Sections 202(a)(2) and 206(a)(6) in the Revenue Act of 1921.⁴ This case concerns itself with the calculation of an income tax on the gain realized on the sale of property by a trustee. The property in question was 6,000 shares of stock, which was acquired by one Mathiessen in 1906. On December 4, 1921, he transferred the stock to the respondent, New York Trust Company, as trustee, for the benefit of his son, to pay the income to the latter and later to pay the principal to the son at a fixed date. It was provided further, that in the event of the death of the son before the transfer of the stock to him it should go to the settlor's other sons. The stock was acquired in 1906, at a cost to the settlor, as found by the Commissioner and by the court, of \$141,375. On March 1, 1913, it had a value less than cost. The transfer to the trustee took place on December 4, 1921, at which time it had a market value of \$577,500. The trustee sold in 1922 for \$603,385. The tax return for the year included \$87,385 as the gain resulting from the sale.⁵ The trustee then applied a tax rate of 12½

¹ *Gould v. Gould*, 245 U. S. 151, 153, 38 Sup. Ct. 53, 55 (1917); *United States v. Merriam*, 263 U. S. 179, 188, 44 Sup. Ct. 69, 71 (1923); *Reinecke v. Northern Trust Co.*, 278 U. S. 339, 348, 49 Sup. Ct. 123, 125 (1929); *Tyler v. United States*, 281 U. S. 497, 503, 50 Sup. Ct. 356 (1930); Note (1931) 6 *ST. JOHN'S L. REV.* 172, and cases cited therein.

² *Bates Refrigeration Co. v. Sulzberger*, 157 U. S. 1, 37, 15 Sup. Ct. 508 (1895); *Commissioner of Immigration v. Gottlieb*, 265 U. S. 310, 313, 44 Sup. Ct. 528 (1924).

³ 291 U. S. —, 54 Sup. Ct. 806 (1934).

⁴ 42 Stat. 229, 232, 26 U. S. C. 935, 939.

⁵ This figure was reached by subtracting the cost of the shares to the settlor, then claimed to be \$516,000, from the amount the trustee received for them.

per cent as applicable to capital gain. The Commissioner ascertained the gain on the principal adopted in the return, but found the cost to the settlor to be \$141,375. He applied the normal and surtax rates that ordinarily are imposed upon the incomes of individuals, and by the use of these factors arrived at an additional assessment of \$238,275.95.⁶ The Board of Tax Appeals sustained the determination.⁷ The Circuit Court of Appeals held that the gain had been correctly ascertained, but that it was taxable at 12½ per cent rather than at the rates used by the Commissioner.⁸ The Supreme Court of the United States affirmed by a divided bench.

The first question we are concerned with is whether the gain resulting from the trustee's sale is the difference between the price paid by the settlor and that received by the trustee.

The exorbitant rates prior to 1921 supplied the taxpayers with an almost overwhelming incentive to avoid the payment of the heavier levies, and in their attempts so to do, they availed themselves to the full extent of what the law permitted. A convenient escape existed in the tax status of gifts.⁹ By making an outright gift to his family the taxpayer might deprive the government of revenue whenever his property had considerably increased in value. This provided a temptation irresistible to many.¹⁰ In an effort to regain this lucrative channel of revenue and prevent such evasions, Congress included in the Revenue Act of 1921¹¹ a provision requiring the recipient of property acquired after December 31, 1920, by gift *inter vivos* to

⁶ On the basis of the return made, the tax was \$14,391.71. On the construction of §202 (a) (2), for which the trustee contends, the tax would be \$7,714.

⁷ *New York Trust Co., Trustee*, 27 B. T. A. 1127 (1932).

⁸ *New York Trust Co. v. Commissioner*, 68 F. (2d) 19 (C. C. A. 2d, 1933).

⁹ KLEIN, *FEDERAL INCOME TAXATION* (1929) 847, 848. The effectiveness of the gift device is illustrated in the following example set forth in the above volume: Mr. Doe was offered, in 1918, \$1,000,000 in cash for property which had a tax basis of \$300,000. Assuming that his income in that year was over \$1,000,000, had Mr. Doe sold the property in 1918 he would have been subject to a tax of 77% (12% income tax plus 65% surtax) on a profit of \$700,000—a tax of \$539,000 on the transaction. Suppose that Mr. Doe first made a *bona fide* gift of the property in question to his wife. Under the 1918 Act and earlier acts her basis was the fair market value of the property at the time she acquired it—presumably the amount of the offer, or \$1,000,000. If immediately thereafter she disposed of the property for \$1,000,000, she realized neither a gain or loss and no income tax could be collected on the amount realized, which represented the appreciation in the value of the assets sold.

¹⁰ *Ibid.* See Report of the Senate Finance Committee, 1921 Act, Report No. 275, 67th Congress, 1st Session, p. 10. As a result Congress discussed seriously the question of preventing such tax evasion. It refused to adopt the method employed under the New York State Income Tax Laws, which sought to tax the donor on the amount of appreciation at the time the gift was made. See *People ex rel. Brewster v. Wendall*, 196 App. Div. 613, 188 N. Y. Supp. 510 (3d Dept. 1921) where the levy was held unlawful. *Wilson v. Wendall*, 196 App. Div. 596, 188 N. Y. Supp. 273 (3d Dept. 1921).

¹¹ §202 (a) (2). 42 Stat. 229, 26 U. S. C. 935.

take as his basis upon the sale of such property, the basis for the donor or the last preceding owner by whom it was not acquired by gift.¹² Notwithstanding the objection¹³ to taxing the donee on the entire difference between the cost to the donor and the selling price when the increase in value accrued in part before the gift was made, the Supreme Court has upheld such a tax¹⁴ even when the donation and sale accrued prior to the enactment of the taxing statutes.¹⁵

In the instant case the settlor irrevocably disposed of the shares by a gift.¹⁶ "He gave the trustee legal title temporarily to be held to enable it to conserve, administer and transfer the property for the use and benefit of his son to whom he gave the beneficial interest. It may rightly be said that the trustee and beneficiary 'acquired by gift' within the meaning of Section 202(a).¹⁷ If the broad definition in Section 2(9)¹⁸ stood alone, either might be regarded as the taxpayer, but it is qualified by the rule that the trustee must pay the tax. It follows that the trustee properly may be regarded as the taxpayer and, for the purpose of calculating the gain, as having assumed the place of the trustor."¹⁹ In truth the stock represented a single investment of capital, that made by the settlor. It was said in the *Taft* case,²⁰ that the donee accepted with knowledge of the statute and voluntarily assumed the position of the donor. "When she sold, she got the original amount invested plus the entire appreciation and out of the latter was called upon to pay only the tax demanded." Congress did not act arbitrarily in requiring the donee

¹² This provision continued unchanged in later acts. §204 (a) (2), Rev. Acts of 1924 and 1926; §113 (a) (2), Rev. Acts of 1928, 1932 and 1934.

¹³ See Swan, J., dissenting in *Bowers v. Taft*, 20 F. (2d) 561, 564 (C. C. A. 2d, 1927); Note (1927) 27 Col. L. Rev. 287, 289.

¹⁴ *Taft v. Bowers*, 278 U. S. 470, 49 Sup. Ct. 199 (1929). The power of Congress to require a succeeding owner, in respect to taxation to assume the place of his predecessor is pointed out in *United States v. Phellis*, 257 U. S. 156, 171, 42 Sup. Ct. 63 (1921): " * * * He simply stepped into the shoes of the stockholders whose shares he acquired and preferably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of the company profits constitutes income of a stockholder is not affected by antecedent transfers of the stock from hand to hand."

¹⁵ *Cooper v. United States*, 280 U. S. 409, 50 Sup. Ct. 164 (1930); *cf. Heineman v. United States*, 52 F. (2d) 1035 (Ct. Cl. 1931).

¹⁶ *Burnet v. Guggenheim*, 288 U. S. 280, 53 Sup. Ct. 369 (1933).

¹⁷ *Supra* note 11; *Neilson v. Lagow*, 19 U. S. 46, 13 L. ed. 909 (1851); *Executors of McDonogh v. Murdoch*, 20 U. S. 564, 14 L. ed. 732 (1853); *Croxall v. Shererd*, 72 U. S. 268, 281, 18 L. ed. 572 (1866); *Doe, Lessee of Poor v. Considine*, 73 U. S. 458, 471, 18 L. ed. 869 (1867); *Bowen v. Chase*, 94 U. S. 812, 817, 818-819, 24 L. ed. 182 (1876); *Young v. Bradley*, 101 U. S. 782, 787, 25 L. ed. 1044 (1879); *Macguire v. Trefry*, 253 U. S. 12, 16, 40 Sup. Ct. 417 (1920); *Anderson v. Wilson*, 289 U. S. 20, 24-25, 53 Sup. Ct. 417 (1933).

¹⁸ Rev. Act of 1921, 42 Stat. 227, 26 U. S. C. —. This section defines a taxpayer to include any person, trust or estate subject to a tax imposed by the Act.

¹⁹ *Helvering v. New York Trust Co.*, *supra* note 3, 54 Sup. Ct. at 807-808.

²⁰ *Supra* note 14, at 482.

to take the donor's position. It would seem that the same result must be reached in the use of the trust for the same purpose. The same reasoning applies. Transfers to trustees may be used to avoid burdens intended to be imposed quite as effectively as may gifts that are directly made. By requiring the trustee, who was the recipient of the entire increase, to pay a part into the public treasury, Congress deprived him of no right and subjected him to no hardship.²¹ The gain in the case at bar was correctly ascertained.²²

The second and final question to be considered is whether the gain derived from the trustee's sale is taxable at 12½ per cent. This optional flat rate is applicable to net gains resulting from profitable transactions in so-called "capital assets." This latter term is often not what the business man or economist supposes.²³ The Revenue Act of 1921,²⁴ the statute applicable in the case under discussion, defines it to be "property acquired and held by the taxpayer for profit or investment for more than two years."²⁵

We notice in the instant case that the time between the creation of the trust and the sale was less than the specified period and, if the words alone are to be looked to, the shares were not held by the taxpayer for more than two years.²⁶ If a strict construction is to be given Section 206(a) (6) the result will lead to inconsistencies. The court will be treating the trustee for the purpose of computing the income, as holding the property during the period of the settlor's tenure; but for the purpose of finding the rate at which that very income is to be taxed, as holding it only from the time when he gets it. He will be the recipient of all the burdens and none of the benefits.²⁷ It is well settled however, that, in interpreting a statute, "the

²¹ *Ibid.*

²² The difference between the cost to the settlor in 1906 and the amount for which the trustee sold in 1922 was rightly taken as taxable income of the trust.

²³ *Supra* note 9, at 961.

²⁴ §206 (a) (6), 42 Stat. 232, 26 U. S. C. 939.

²⁵ *Italics* own. Revenue Acts of 1924 and 1926 §208 (a) (8) and Revenue Acts of 1928 and 1932 §101 (C) (8) define "capital assets" to be "property held by the taxpayer for profit or investment for more than two years." We note that the 1921 Act was less liberal in that it restricted the term to property "acquired and held by the taxpayer * * *."

²⁶ Prior to the decision in the New York Trust Company case, *supra* note 3, two circuits ruled that property transferred to a trustee, for purposes and upon terms and conditions analogous to those expressed in the indenture of the instant case, which remained in his hands less than two years, was not "capital assets," and that the resulting gain was not taxable at the 12½ per cent rate. *Johnson v. Commissioner*, 52 F. (2d) 726 (C. C. A. 3d, 1931); *Shoenberg v. Burnet*, 55 F. (2d) 543 (App. D. C. 1931).

²⁷ *Supra* note 3, at 809. Justice Butler said: "Here the taxable gain was ascertained by putting together the periods in which the shares were held by the trustor and the trustee respectively. The taxable gain was the same as if the former held continuously from the time of the purchase in 1906 until the sale in 1922. But to ascertain the applicable rate the Commissioner broke the continuity. If the trustor had held until the sale, the 12½ per cent rate would have been applicable and the tax would have been substantially less than one-

court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute, or statutes on the same subject, and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the legislature, as thus ascertained, according to its true intent and meaning."²⁸ It has been noted²⁹ that though the trustee has not literally "held" the property for two years, he is treated as though he had; his acceptance of the gift is regarded as a vicarious substitution of himself for the settlor. In this manner alone can he become subject to a tax upon the whole appreciation "realized" by his sale, part of which is otherwise wholly foreign to him. By following the rule set forth in the *Brown* case,³⁰ that substitution may be carried over into Section 206(a)(6),³¹ and as a result the purpose of Congress, which was to avoid "freezing" of property because of high surtaxes,³² is made comprehensive. As the majority opinion in the *New York Trust Company* case states,³³ per Butler, J.:

"Sections 202(a)(2) and 206(a)(6) are included in the same act and are applicable respectively to different elements of the same or like transaction and are not to be regarded as wholly unrelated. While undoubtedly legally possible and within the power of Congress, the methods adopted and results attained by the Commissioner are so lacking in harmony as to suggest that the continuity required to be used to get the base was also intended for use in finding the rate. No valid

fourth of the amount assessed against the trustee who, for the purpose of calculating the gain, was substituted for the trustor." The deficiency assessed, \$238,275.91, plus the original assessment, \$14,391.71, makes the total \$252,667.66. The taxpayer's calculation indicates that, if the 12½ per cent rate were applied, the total tax would be \$58,921.51.

²⁸ Taney, C. J., in *Brown v. Duchesne*, 60 U. S. 183, 194, 15 L. ed. 595 (1856). In *Ozawa v. United States*, 260 U. S. 178, 194, 43 Sup. Ct. 65 (1922), the Supreme Court said: "It is the duty of this court to give effect to the intent of Congress. Primarily the intent is ascertained by giving the words their natural significance, but if this leads to an unreasonable result plainly at variance with the policy of the legislation as a whole, we must examine the matter further. We may then look to the reason of the enactment and inquire into its antecedent history and give it effect in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose may not fail." See *Barrett v. Van Pelt*, 268 U. S. 85, 45 Sup. Ct. 437 (1925), wherein it was stated, in substance, that a thing which is within the intention of the makers of a statute is as much within the statute as if it were within the letter, and a thing which is within the letter of a statute is not within the statute unless it is within the intention of the makers.

²⁹ *Supra* note 11.

³⁰ *Supra* note 28.

³¹ *Supra* note 24.

³² See Reports of Ways and Means Committee, 67th Congress, 1st Session, House Report No. 350, p. 10. Also Senate Report No. 275, p. 12.

³³ *Supra* note 3, at 810.

ground has been suggested for requiring tenures to be added for one purpose and forbidding combination for the other.”³⁴

It is submitted that the holding of the majority in the *New York Trust Company* case³⁵ is correct, not only in purview of the present language of the section applicable,³⁶ where Congress expressly stated that its intent was to consider the taxpayer as assuming the position of his predecessor for the purpose of determining the period for which he has held the property, as well as for the purpose of determining the gain or loss from the sale or exchange of said property; but also from the standpoint of its practicability and economical sense of justice. It could not have been the intent of Congress to put upon the shoulders of the taxpayer all the burdens, with no benefits attached thereto. To lessen the hindrance caused by the high normal and surtaxes there should be no distinction between the gains derived from a sale made by an owner who has held the property for more than two years and those resulting from one by a donee whose tenure plus that of the donor exceeds that period. To this effect Congress clarified the definition of “capital assets” in the Revenue Act of 1926.³⁷ It was not new law, as the dissenting opinion thought,³⁸ but “a more explicit expression of the purpose of the prior law.”³⁹

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³⁴ The substance of the dissenting opinion, per Justice Roberts, is that the courts must not make law, but only declare it; that by reading §§202 (a) (2) and 206 (a) (6) together the majority opinion is stepping beyond its bounds. Judge Hand, in the Circuit Court decision, answers this argument thusly: “* * * but there is no *vade mecum* to guide us between a sterile literalism which loses sight of the forest for the trees, and a proper scruple against imputing meanings for which the words give no warrant. * * * here we find no sufficient obstacle in the language used; rather we think the generative purpose can infuse it.” *Supra* note 8, at 20.

³⁵ *Supra* note 3. The gain derived from the trustee's sale is correctly taxable at 12½ per cent.

³⁶ §101 (C) (8) (b), REV. ACT OF 1932, 47 Stat. 191, 26 U. S. C. 3101 (c) (8) (b): “In determining the period for which the taxpayer has held property, however acquired, there shall be included the period for which such property was held by another person, if under the provisions of section 113, such property has, for the purpose of determining the gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.”

³⁷ §208 (a) (8), 44 Stat. 19, 26 U. S. C. 939. Similar provisions are included in the Revenue Act of 1932 in §101 (c) (8). 47 Stat. 191, 26 U. S. C. 3101.

³⁸ *Supra* note 3, at 812.

³⁹ *Jordan v. Roche*, 228 U. S. 436, 445, 33 Sup. Ct. 573, 576 (1913); *Merle-Smith v. Commissioner of Internal Revenue*, 42 F. (2d) 837, 842 (C. C. A. 2d, 1930); *McCauley v. Commissioner of Internal Revenue*, 44 F. (2d) 919, 920 (C. C. A. 5th, 1930).