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Zoning--When Has One an Existing Use?

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Recent Cases

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

L. Fuhrman Martin

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

[16] Id. at 442.

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

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

the entrance to the proposed subdivision. In addition, a gas line and a water line, which was connected to a water well previously drilled, were laid down to serve the subdivision, and two brick columns and a sign with the name of the subdivision were placed to mark the entrance. Signs were posted on the property indicating that building sites were for sale. While these improvements were being made lots were offered for sale upon the representation that the subdivision would be developed as shown on the plat. However, no lots had in fact been sold by the appellant prior to the adoption of the zoning ordinance.

On April 29, 1955, the zoning ordinance was enacted. By the ordinance the entire city was zoned as a residential district and each lot in any new subdivision was required to be at least 40,000 square feet in area. The ordinance provided that the Board of Adjustment could grant a special exception if certain conditions were found to exist, but in no event could the board grant an exception if the proposed lots in any subdivision contained less than 20,000 square feet.

On his own behalf and on behalf of others to whom he claimed he had sold or to whom he proposed to sell lots, Caruthers made application to the Board of Adjustment for building permits. An order was entered granting Caruthers the right to build on all lots in the new subdivision having an area of 20,000 square feet or more, but denied an exception as to all lots having an area of less than 20,000 square feet. Of the twenty-three building lots, ten were over 20,000 square feet and thirteen under. Caruthers appealed the refusal of the trial court to grant mandamus requiring the board to issue permits to build on the thirteen lots. Upon appeal, judgment affirmed. *J. Caruthers et al.* v. *Board of Adjustment of the City of Bunker Hill Village*, 290 S.W. 2d 340 (Tex. 1956).

Appellant did not contest the constitutionality of the zoning ordinance generally as this question has been judicially laid to rest by numerous court decisions since the historic ruling handed down by the Supreme Court in *Village of Euclid, Ohio* v. *Ambler Realty Co.*[1] Appellant's contention was that the minimum area requirements were invalid and unconstitutional as applied to his property, because, in view of the work done and the expenses incurred in improving the lots, he had at the time of the ordinance an existing use of smaller lot sizes. The issue before the court was whether Caruthers had acquired an existing use which the Court would protect as a property right.[2]

[1] 272 U.S. 365, 71 L. Ed. 303, 47 Sup. Ct. 114, 54 A.L.R. 1016 (1926).

[2] Section 7 of the Bunker Hill Zoning Ordinance, as quoted in the principal case at page 351, provided: "Non-conforming uses:

A. Existing at Time of Enactment of Ordinance:

The use of any building or land existing at the time of enactment

It is clear that "existing use" is a technical term,[3] one which has a separate and distinct meaning from actual physical utilization or alteration of realty. The word "use" in its popular sense would indicate some act or acts of utilization distinguished from mere preparation for use. Thus, the test of whether one has acquired an "existing use" might be thought to be whether he has done an "unequivocal act" which demonstrates that he has gone beyond mere preparation and is actually using the land for his primary purpose. Yet, it is rather obvious from the facts in the principal case and in other cases that, in spite of the all too frequent verbal adherence by the courts to the "unequivocal act" test, an existing use is not determined by deciding whether the party has done an "unequivocal act", nor is it determined by deciding whether the party has a "vested right". These terms—"unequivocal act" and "vested right"—are conclusions (and, in this context, essentially synonymous with "existing use") and not determining factors. What, then, is the test? What are the factors which determine whether a court will protect, as an "existing use", a "use" which does not conform to the comprehensive planning arrangements of the community?

An examination of various cases indicates the controlling importance of at least three factors: economic detriment to the individual;[4] economic gain or loss to the city;[5] and the type of use involved.[6] The Court in the *Caruthers* case did not discuss the factor of economic loss to the city, but it is doubtful that the Court would have denied Caruthers' his right to build on this basis, since to have allowed him to build on the thirteen lots in question probably would not have

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of this ordinance may be continued subject to such regulations as to the maintenance of the premises and conditions of operation as may in the judgment of the Board of Adjustment be reasonably required for the protection of adjacent property."

[3] The difficulties of defining a use can be appreciated by examining some definitions suggested. " 'Use' in this statute [Ky. Rev. Stat. 100.068] means what is customarily or habitually done or the subject of a common practice." Durning v. Summerfield, 314 Ky. 318 at 322, 235 S.W. 2d 761 at 763 (1951); Haller Baking Co.'s Appeal, 295 Pa. 257, 145 A. 77 at 79 (1928) ". . . 'existing use' should mean the utilization of the premises so that they may be known in the neighborhood as being employed for a given purpose."

[4] Ervin Acceptance Co. v. City of Ann Arbor, 322 Mich. 404, 34 N.W. 2d 11 (1948); Application of Rogers, 208 Misc. 785, 144 N.Y.S. 2d 869 (Sup. Ct. 1955); Ritenour v. Township of Dearborn, 326 Mich. 242, 40 N.W. 2d 137 (1949); City of West University Place v. Ellis, 134 Tex. 222, 134 S.W. 2d 1038 (1940); City of Syracuse v. Bronner, 133 N.Y.S. 2d 153 (1953).

[5] Schloemer v. City of Louisville, 298 Ky. 286, 182 S.W. 2d 782 (1944); Neef v. City of Springfield, 380 Ill. 275, 43 N.E. 2d 947 (1942); Michigan-Lake Bldg. Corp. v. Hamilton, 340 Ill. 284, 172 N.E. 710 (1930).

[6] Fairlawn Cemetery Association, Inc. v. Zoning Commissioner of Town of Bethel, 138 Conn. 434, 86 A. 2d 74 (1952); City of Harrisburg v. Pass, 372 Pa. 318, 93 A. 2d 447 (1953).

caused a decrease in value of the neighborhood so as to result in any appreciable net loss in the city's tax base.[7]

With respect to economic detriment to the individual, the decision of the Court was strongly influenced by the fact that even though the effect of the ordinance would be to decrease the *profits* originally contemplated when Caruthers made his substantial investment in buying and improving the property, his *investment* still remained intact. He could redivide the subdivision into lots of the minimum size required by the ordinance and still realize some profit. Having found that Caruthers would not suffer a *net* loss, the Court concluded that the work which Caruthers had done was "preliminary work, albeit substantial . . . [and it] did not constitute an existing use as is contemplated by Section 7 of the ordinance".[8] Thus the Court resolved the problem of "existing use" in terms of economics and, finding Caruthers would suffer no out-of-pocket loss, held that all his expenditures and efforts were inadequate to ripen his contemplated use into a vested one.

The Texas Court specifically distinguished and, by implication, rejected *Darlington* v. *Board of Councilmen of Frankfort*.[9] There the appellant had purchased a building for the purpose of converting it into a florist shop. No valid zoning ordinance existed at the time. However, after appellant commenced some limited excavations on her premises, removed a large tree and actually conducted the business of selling flowers from the premises, a zoning ordinance was passed restricting the property to residential use. The Kentucky Court held that she had acquired an existing use. In its opinion the Court stated:

> [T]he right to utilize one's property . . . becomes 'vested' . . . when, prior to the enactment of such restrictions, the owner has in good faith substantially entered upon the performance of the series of acts necessary to the accomplishment of the end intended.[10]

While both the Texas and Kentucky Courts seem to base their respective opinions on the basis of an "unequivocal act", a more critical analysis may lead to the conclusion that a significant factor in the result of each case was economic detriment to the individual.

[7] See cases cited at note 5. In Schloemer v. City of Louisville, supra, note 5 at 289, 182 S.W. 2d at 784, the court said: "The evidence is to the effect that the erection of a filling station . . . on this lot will decrease the value of other residential property in the neighborhood. This decrease in the value of surrounding property would cause the city a loss in taxes and is directly related to the public welfare."

[8] The language of the Texas ordinance in note 2, supra, is similar to Ky. Rev. Stat. 100.68 and 100.69 (which deals with first class cities) and Ky. Rev. Stat. 100.355 (which deals with second class cities) regarding the use and continuance of nonconforming uses.

[9] 282 Ky. 778, 140 S.W. 2d 392 (1940).

[10] Id. at 785, 140 S.W. at 396.

Despite the language of the Kentucky Court and its explicit rejection of economic detriment as a relevant factor, it is hard to believe that such factor was not, in fact, important.

If the Kentucky Court meant what it said, then the slightest expenditure or preparation would be sufficient to create an "existing use" which the court would protect. The plaintiff in the *Darlington* case had suffered only limited economic detriment—the loss of money for excavating, and the loss, if any, from purchasing the building for the florist shop.[11] The Kentucky decision, if read literally, would mean that any property owner, anticipating a zoning ordinance, could defeat the planning of the legislature by doing some small act, involving little financial expenditure, and thereby take his property from under the zoning scheme. One person should not be allowed to so obstruct the will of the community, unless he can show real, substantial harm to himself, and even then only when the type of use proposed would not substantially harm the character of the neighborhood. In view of this, the probability that the Kentucky Court will protect a person who could not show economic detriment is extremely doubtful.

While economic detriment is a most significant factor it is by no means decisive. Equally significant is the type of use. In the *Caruthers* case, the use which appellant sought to assert—building houses on lots approximately 15,000 square feet—would not have been very harmful in its effect upon the community values. Therefore, the decisive factor in the Court's consideration was that Caruther could show no *actual* loss. In the *Darlington* case, the creation of a florist shop in the neighborhood would have caused only extremely limited depreciation of community values sought to be preserved by the ordinance. While the application of the principal of economic detriment by the Kentucky Court is at best questionable, these cases serve to illustrate the importance of the factor of economic detriment in the determination of those cases in which there is absent the factors of economic loss to the community or harmful use.

[11] The Kentucky court was in error by including the purchase price as a factor of economic detriment, sufficient to show an "unequivocal act" and thereby an "existing use". An "unequivocal act" contemplates economic detriment *after* the purchase of the property, and not the mere act of purchasing. Under the ruling of the court, one who has made a substantial expenditure to purchase in contemplation of future use, would without any further act, be said to have acquired an existing use. The purchase price would be considered substantial economic detriment sufficient to give the purchaser an existing use. Zoning, under this interpretation of economic detriment would be impossible. More properly, the economic detriment adequate to show an existing use should be the *actual loss* sustained in *altering and improving the realty after purchase.* The purchase price is a mere capital expenditure in contemplation of use, not actual use. See West Bros. Brick Co. v. City of Alexandria, 169 Va. 271, 192 S.E. 881 (1937).

The consideration which courts have given to the economic loss factor when the type of use is considered really harmful to the community is illustrated in *Marblehead Land Co.* v. *City of Los Angeles.*[12] There land worth $10,000 per acre was zoned for residential purposes, while the same land would have been worth millions in oil production. The lessee had incurred substantial financial obligations in preparing to prospect for oil. The California Court found that the appellant company had not acquired an existing use.

The Court addressed itself extensively to the problem of whether the type of use in question would cause the atmosphere "to become contaminated with obnoxious fumes and odors" making living conditions there less desirable and causing property values to greatly depreciate. The Court further noticed that it was a matter of common knowledge that oil wells have caused disastrous fires. The Court concluded, therefore, that the city council acted reasonably and justifiably in the exercise of its police power. Finding that the type of use was excessively harmful to community values, the Court gave little weight to the factor of economic detriment in deciding that appellant did not have an existing use.

With the increasing adoption of zoning ordinances in the smaller cities and towns the problem presented in the *Caruthers* case will become a more common one. In seeking to determine what "existing uses" qualify as nonconforming uses (except with regard to structures existing and in use at the time the ordinance was passed) lawyers will be little aided by looking through the facts for an "unequivocal act" of use in contradistinction to mere preparation. An "unequivocal act" indicating an existing use is merely a conclusion a court will come to after an examination of three critical factors: (1) economic detriment to the individual, (2) economic gain or loss to the community and, (3) the nature of the use itself and its effect upon the values sought by the zoning scheme.

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[12] 47 F. 2d 528 (CCA 9 1931).