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BEYOND THE FRUIT TREE: A PROPOSAL FOR THE REVISION OF THE ASSIGNMENT OF INCOME DOCTRINE—*Caruth Corp. v. United States,* 865 F.2d 644 (5th Cir. 1989).

Abstract: The Supreme Court developed the assignment of income doctrine to solve the question of who the proper taxpayer is under section 61 of the Internal Revenue Code. The question arises when individuals transfer income that rightly belongs to them without declaring the income for federal tax purposes. The assignment doctrine attributes income, for tax purposes, to the earner or practical owner of the income notwithstanding that person's assignment of the income. However, the Supreme Court's development of the doctrine has been inadequate, as exemplified by the recent decision of the Fifth Circuit Court of Appeals in *Caruth Corp. v. United States. Caruth* demonstrates the improper focus of the traditional doctrine on form rather than substance. The doctrine should be redefined to attribute assigned income to taxpayers based upon who controls and enjoys that income rather than upon the form of the transaction in which the income was transferred.

The first principle of income taxation is "that income must be taxed to him who earns it."[1] Section 61 of the Internal Revenue Code (Code) defines gross income as "all income from whatever source derived."[2] The Supreme Court has declared that "[t]he broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories" of the taxing statute.[3] The Code, however, assumes that the proper taxpayer will report the income: no provision defines who should assume the tax liability once sums have been identified as income. Therefore, the courts have been called upon to fashion rules for identifying the proper taxpayer.[4]

One such rule is the assignment of income doctrine which holds that one who earns income cannot escape tax upon that income by assigning it to another.[5] The assignment doctrine is designed to prevent taxpayers[6] from shifting income to avoid paying federal income tax on it. But, before one may decide that an individual is attempting to shift income, one must determine that the individual was entitled to that income in the first instance. Thus, the assignment doctrine goes to the heart of the question: who is the proper taxpayer?

1. Commissioner v. Culbertson, 337 U.S. 733, 739–40 (1949).

2. *See* I.R.C. § 61 (1982 & Supp. V 1987) for complete text. The statute defining "gross income" has remained substantially unchanged since the inception of the income tax.

3. Helvering v. Clifford, 309 U.S. 331, 334 (1940).

4. 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 75.4.6. (1986) [hereinafter BITTKER].

5. *See* Lucas v. Earl, 281 U.S. 111 (1930).

6. This Note uses "taxpayer" to refer to all persons who are required to report their income to the Internal Revenue Service (Service).

In *Caruth Corp. v. United States,*[7] the United States Court of Appeals for the Fifth Circuit was presented with the question of who should report a corporate dividend where the stock entitled to the dividend was transferred to a charity after the declaration date but before the record date.[8] The transferor was the controlling stockholder and the transferred shares were noncumulative and callable by the corporation for a fixed price. In a rote application of the assignment doctrine, the *Caruth* court held that since the donor had given up the stock, the dividend income was attributable to the charity.[9] The court failed to look beyond the formal transaction to investigate the practical avenues of control and enjoyment the donor retained.

The outcome of *Caruth* is incompatible with the intent of the assignment doctrine to tax the practical owner of the income.[10] The assignment doctrine should be modified to prevent such a result and to ensure consistency and equality for taxpayers. This Note reviews selected landmark Supreme Court assignment cases, demonstrates how the Fifth Circuit in *Caruth* misapplied the doctrine, and presents a proposal for the modification of the doctrine.[11]

I. THE DEVELOPMENT OF THE ASSIGNMENT OF INCOME DOCTRINE

Supreme Court decisions defining the assignment doctrine can be grouped into three primary areas based on the nature of the transaction: assignments of earnings, assignments of the right to income from property, and assignments of both income-producing property and the income it generates.[12]

7. 865 F.2d 644 (5th Cir. 1989).

8. The "declaration date" is "[t]he day on which directors of a corporation declare a dividend as contrasted with date on which the dividend is actually paid." BLACK'S LAW DICTIONARY 368 (5th ed. 1979). The "record date" is "[t]he date on which a person must be registered as a shareholder on the stock book of a company in order to receive a declared dividend . . . ." *Id.* at 1145.

9. *Caruth,* 865 F.2d at 650.

10. "The dominant purpose of the Revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." Helvering v. Horst, 311 U.S. 112, 119 (1940).

11. This Note analyzes the assignment of income doctrine only as it applies to nonsale transfers.

12. Although these cases are several decades old, they remain the leading cases in this area. *See* BITTKER, *supra* note 4, at ¶ 75.4.6.

A. *Assignments of Earnings*

The assignment doctrine originated in *Lucas v. Earl.*[13] Taxpayer Earl, an attorney, and his wife executed a contract stating that all property they then owned or later acquired was to be owned by them as joint tenants with the right of survivorship. Earl's wife subsequently attempted to report half of her husband's income as her own. The contract notwithstanding, the Commissioner of the Internal Revenue Service (Service) assessed taxes against Earl for the whole of the salary and attorney's fees he earned. Earl objected, arguing that the Code taxed only income "beneficially received."[14]

The Court acknowledged the force of Earl's argument, but stated that the case was not to be decided by such "attenuated subtleties."[15] Rather, the import of the taxing statute was to prevent the earner from avoiding the income tax notwithstanding anticipatory contracts or arrangements that prevented the income from ever vesting in the earner. Justice Holmes wrote that the taxing statute prohibited "arrangement[s] by which the fruits are attributed to a different tree from that on which they grew."[16] This quote, now known as the "fruit-tree" metaphor, has come to embody the assignment doctrine.

The rule laid down in *Earl* stands as a cornerstone of the income tax system.[17] Subsequent earnings cases revolve around what constitutes earnings rather than whether a particular wage-earner may shift earnings income for tax purposes.[18]

B. *Assignments of the Right to Income from Property*

The second grouping involves assignments of income from property that transfer only the right to the income. Here, the primary issue is whether the transferor has retained sufficient control over the use and enjoyment of the transferred income to impose tax liability upon the transferor.

In the same year as *Earl,* the Supreme Court decided *Corliss v. Bowers.*[19] The taxpayer in *Corliss* created a revocable trust designating his wife the life income beneficiary and granting the remainder to his children. He retained the absolute power to destroy or modify the trust.

13. 281 U.S. 111 (1930) (Holmes, J., for a unanimous Court).
14. *Id.* at 114.
15. *Id.*
16. *Id.* at 114–15.
17. United States v. Basye, 410 U.S. 441, 450 (1973).
18. *See, e.g., id.* (Court did not question that *Earl* applied once the sums were identified as earnings).
19. 281 U.S. 376 (1930).

Section 219 of the Revenue Act of 1924 provided that a grantor of a trust should be taxed on the trust income if at any time during the year the grantor could have revested any part of the corpus of the trust. Despite section 219, the taxpayer in *Corliss* argued that he should not be taxed on the trust income because he never held title to the income.[20]

The Court rejected the taxpayer's argument, stating that taxation is not determined by refinements of title.[21] Rather, principles of taxation turn on who had actual command over the property taxed. Income subject to the unlimited control of a person is rightly attributed to that person for tax purposes, no matter how that person sees fit to enjoy the income. The control Corliss retained over the revocable trust made it proper to tax him on the trust's income.[22]

Unlike *Corliss,* which involved a grantor, the later case of *Blair v. Commissioner,*[23] involved the tax liability of a grantee. In *Blair,* a life income beneficiary assigned part of his life estate to his children. Focusing on the fact that the part given was coextensive with the assignor's interest in the trust, the Court held that the assigned income was not taxable to the assignor because he no longer had any claim to the part given. The life interest in the trust corpus was considered a form of "property" of which the assignor completely transferred a part.[24] That the transfer was for the assignor's entire life distinguished this case from the transfer involved in *Corliss.*[25]

In contrast to *Blair* stands *Harrison v. Schaffner.*[26] In *Harrison,* the taxpayer assigned to her children fixed dollar amounts from income to be generated rather than assigning a portion of the trust corpus for

20. *Id.* at 377–78.

21. *Id.* at 378.

22. *Id.* Later, in Helvering v. Clifford, 309 U.S. 331 (1940), the Court reaffirmed its position that the salient question was whether the grantor may still be considered the recipient of the income for tax purposes after the trust was created. The taxpayer in *Clifford* created a five-year trust, naming his wife beneficiary and himself both remainderman and trustee. He retained "absolute discretion" to determine how much, if any, of the trust income was to be paid to his wife and complete control over the disposition of the underlying trust assets. *Id.* at 332–33, 335.

The Court concluded that as Clifford had not surrendered practical ownership, he was the proper taxpayer. *Id.* at 335. "The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the 'victim of despotic power when for the purpose of taxation he is treated as owner altogether.'" *Id.* at 337 (quoting Du Pont v. Commissioner, 289 U.S. 685, 689 (1933)).

23. 300 U.S. 5 (1937).

24. *Id.* at 13–14.

25. *Id.* at 12.

26. 312 U.S. 579 (1941).

life, as in *Blair*. The Court found that the taxpayer parted with nothing save the specified dollar amounts, which were income attributable to her under the assignment doctrine.[27]

Read together, *Blair* and *Harrison* fix the line between transfers of income that shift the associated tax liability and those that do not. A transferor remains liable for the tax on future income so long as the transferor retains control over the income, including the power to decide whether it will be generated and who will receive it.

Like the assignments of earnings cases, the foregoing cases may be cast in terms of the traditional fruit-tree metaphor. The income-producing property is the tree, the income generated is the fruit, and the fruit may not be attributed to a different tree from which it grew.

C. Assignments of Both Income-Producing Property and the Income Generated

Cases involving assignments of both income-producing property and the resultant income required the Court to look beyond the traditional fruit-tree metaphor. The celebrated case of *Helvering v. Horst,*[28] presented the Court with facts under which a mechanical application of the fruit-tree metaphor would not have identified the proper taxpayer. In *Horst,* the taxpayer detached interest coupons from bonds, just prior to their due date, and gave them to his son. Although the son collected the interest at maturity, the Commissioner of the Service determined that these interest payments were income to the father.[29]

The Court held that the father's control and enjoyment of the income sufficed to establish him as the recipient of the income.[30] As holder of the bond and coupons, the father had the legal right to demand payment of the interest at maturity.[31] The Court recognized, as it had in *Corliss,*[32] that the power to command disposal of income was tantamount to enjoyment of that income.[33] The father's ability to

27. *Id.* at 583.
28. 311 U.S. 112 (1940).
29. *Id.* at 114.
30. *Id.* at 117.
31. *Id.* at 115.
32. *See supra* text accompanying note 22.
33. The Court wrote:

> Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.

direct the payment of the interest to his son represented a taxable economic realization to the father.[34] The enjoyment the father derived from bestowing this gift upon his son constituted sufficient economic gain to hold the father taxable on the interest.[35]

The Court in *Horst* could simply have applied the fruit-tree metaphor, treating the coupons—because they were independently negotiable—as the tree and their interest as the fruit.[36] However, applying the fruit-tree metaphor would have produced results inconsistent with the taxing statute's objective to tax income to the person who earns it, or creates and enjoys it.[37] *Horst* represented a step toward transforming the assignment doctrine from its simplistic fruit-tree labels to a doctrine focused on economic realities.

The Supreme Court further refined the assignment doctrine in *Commissioner v. Sunnen*.[38] *Sunnen* involved several licenses between an inventor and the corporation he controlled.[39] The licenses allowed, but did not require, the corporation to manufacture various products for which the inventor held patents. In return, the corporation agreed to pay the inventor royalties of ten percent of gross sales. The licenses were terminable by either party upon notice without liability.[40]

The taxation issue in *Sunnen* arose after the inventor assigned the rights to the royalties and underlying licenses to his wife.[41] The inventor claimed that the royalties should be taxed to his wife because he transferred both the income and the underlying assets to her. The Court, framing the issue as "whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes," held that the inventor was the proper taxpayer.[42]

The *Sunnen* Court reached its conclusion by evaluating the control the inventor retained over the royalties via the licenses.[43] As the controlling shareholder, the inventor could control what royalties, if any,

Horst, 311 U.S. at 116–17.

34. *Id.* at 120.
35. *Id.* at 117.
36. *See id.* at 120 (McReynolds, J., dissenting).
37. *Id.* at 119.
38. 333 U.S. 591 (1948).
39. The inventor owned 89% of the outstanding stock. *Id.* at 593.
40. *Id.* at 594.
41. *Id.* at 595.
42. *Id.* at 604.
43. *Id.* at 608–09.

his wife would receive. The inventor, moreover, would benefit indirectly from the royalty payments made to his wife.[44] As the Court noted, this taxpayer was left with "something more than a memory."[45]

Two distinct principles emerge from a synthesis of the historical development of the assignment doctrine: control and enjoyment. Underlying the analysis in each case is a concern for whether the taxpayer has retained sufficient incidents of ownership to treat that taxpayer as the practical owner.

II. *CARUTH CORPORATION v. UNITED STATES*

A. *Facts and Procedural History*

Taxpayers W. W. and Mabel Caruth[46] were majority shareholders in North Park, Inc. and sole shareholders in another company, the Caruth Corporation.[47] North Park had issued 50 shares of Class A voting common stock, 450 shares of Class B nonvoting common stock, and 1000 shares of nonvoting preferred stock. The preferred stock was noncumulative,[48] and could be called by North Park for $100 per share upon thirty-days notice.[49] Caruth owned seventy-five percent of the Class A and Class B stock and all of the preferred stock. Caruth's nephews owned the remaining twenty-five percent of the Class A and Class B stock.[50]

For a number of reasons, Caruth considered declaring a dividend and winding down North Park in April of 1978.[51] Caruth had previously attempted to buy his nephews' shares in the corporation, but

44. *Id.* at 610.

45. *Id.* at 608.

46. Hereinafter, most references will be to Mr. Caruth (Caruth) alone, as he was the primary actor in the relevant transactions.

47. Caruth Corp. v. United States, 865 F.2d 644, 646–47 (5th Cir. 1989).

48. Preferred stock is often noncumulative; this means that if a dividend is not paid in a particular year, that dividend is gone forever and the corporation has no obligation to pay them when the next dividend is paid. BLACK'S LAW DICTIONARY 949 (5th ed. 1979).

49. The back side of the certificates read, in part:

> The preferred stock is non cumulative, and the holders of the preferred stock shall be entitled only to share pro-rata with the holders of common stock in all dividends, when and as declared and made payable by the board of directors of the corporation. The corporation may at any time at the option of the board of directors, redeem the whole or any part of the outstanding preferred stock on any date after issuance by paying One Hundred Dollars ($100.00) for each share thereof.

Caruth, 865 F.2d at 646–47.

50. *Id.* at 646.

51. Caruth testified at his deposition that he was the one who decided that the corporation would declare a dividend and in what amount. Memorandum of Law at 3, Caruth v. United States, 88-2 U.S. Tax Cas. (CCH) ¶ 9514 (N.D. Tex. 1987) (No. CA-3-84-0877-R).

they had refused to sell. Caruth believed that declaring a large dividend would motivate his nephews to sell so they could realize capital gains instead of ordinary income. Additionally, because Caruth Corporation's activities were increasing, Caruth wanted to use North Park stock to make a capital contribution to the Caruth Corporation. Finally, Caruth knew of, and wished to avoid, a possible imposition of the accumulated earnings tax against North Park.[52]

By letter dated April 14, Caruth advised the Dallas Community Chest Trust Fund (Community Chest) that he was contemplating a substantial gift of North Park stock.[53] On May 5, Caruth began executing his plans by transferring to the Caruth Corporation all Class B shares he held. On May 8, he caused North Park to declare a dividend of $1,500 per share, payable on May 17, to shareholders of record as of May 15. On May 9, the day after the declaration date but before the May 15 record date, he transferred all 1000 preferred shares to the Community Chest.[54] Caruth then deducted $1,600,000 as a charitable deduction from his gross income for federal income tax purposes.[55] He did not report the transferred stock dividends as taxable income.[56]

The Service objected, claiming that the preferred stock dividend was attributable to Caruth under the assignment doctrine.[57] Caruth paid the deficiencies under protest, then sued for a refund in the United States District Court for the Northern District of Texas. The district

52. Caruth Corp. v. United States, 865 F.2d 644, 647 (5th Cir. 1989). The accumulated earnings tax is "[a] special tax imposed on corporations that accumulate (rather than distribute via dividends) their earnings beyond the reasonable needs of the business." BLACK'S LAW DICTIONARY 20 (5th ed. 1979). *See also* I.R.C. §§ 531-37 (1976 & Supp. V 1981) (current version at I.R.C. §§ 531-537 (1982 & Supp. V 1987)). No dividend had ever been declared by North Park and no other dividend was ever declared. *Caruth*, 865 F.2d at 647.

53. *Caruth*, 865 F.2d at 647.

54. *Id.* Caruth informed the Community Chest that these shares should be deposited in the "W.W. Caruth Jr. Fund." Caruth v. United States, 88-2 U.S. Tax Cas. (CCH) ¶ 9514, at 85,513 n.6 (N.D. Tex. 1987).

55. Shortly after the transfer, a bank had valued the preferred shares for the Community Chest at $1,600 per share: $1,500 per share for the dividend plus the call value of $100 per share. *Caruth*, 88-2 U.S. Tax Cas. at 85,514 n.12. Restrictions in the Code forced Caruth to spread out the deductions over four years. Brief for the Appellant at 6, Caruth Corp. v. United States, 865 F.2d 644 (5th Cir. 1989) (No. 88-1015) [hereinafter Appellant's Brief].

56. Thus, out of $2,250,000 in total dividends paid by North Park, Caruth declared only $56,250, while his nephews declared $187,500. Appellant's Brief, *supra* note 55, at 5. The Caruth Corporation received $506,250 in dividends, *id.*, but should have been able to deduct 85% of dividends received pursuant to § 243. *See* I.R.C. § 243 (1976) (current version at I.R.C. § 243 (1982 & Supp. V 1987)). Finally, the bulk of the dividends, $1,500,000, went to the Community Chest and was not taxed. *See* I.R.C. § 501 (1976 & Supp. V 1981) (current version at I.R.C. § 501 (1982 & Supp. V 1987)).

57. Caruth Corp. v. United States, 865 F.2d 644, 648 (5th Cir. 1989).

court held in favor of Caruth[58] and the Service appealed the ruling to the Fifth Circuit Court of Appeals.[59]

B. The Fifth Circuit's Holding in Caruth

Relying on the fruit-tree metaphor, the Fifth Circuit held that because the stock, which represented the tree, had been transferred with its fruit dividend, Caruth did not have to report the dividend income.[60] The Service argued that the dividend income should be attributed to Caruth because this fruit was exceptionally ripe when transferred.[61] The court countered that as long as the entire tree is transplanted before it is harvested, the ripeness of the fruit does not matter.[62] The court viewed the "crucial question" as "whether the asset itself, or merely the income from it, has been transferred."[63]

Caruth timed the transaction so that the transfer of stock to the charity occurred after the declaration date but before the record date. The court dismissed this point in light of the distinction the Service has drawn in the sales context between record dates and declaration dates.[64] Applying this distinction, the court stated that Caruth was never legally entitled to collect the preferred shares dividend under either Texas or federal tax law. However, to reinforce its conclusion that ripeness did not matter, the court noted that after the transfer Caruth could not prevent the dividend from vesting with the Community Chest or another party of its choice.[65] Thus, the court implicitly

58. Caruth v. United States, 88-2 U.S. Tax Cas. (CCH) ¶ 9514 (N.D. Tex. 1987).

59. *Caruth,* 865 F.2d at 648.

60. *Id.* at 650. The court also considered whether the case involved a "sham transaction," an issue largely outside the scope of this Note.

61. *Id.* at 649.

62. *Id.*

63. *Id.* at 648.

64. *Id.* at 649. The court cited Treasury Regulation section 1.61-9(c):

> When stock is *sold* after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, [the record date], the dividend *ordinarily* is income to the seller. When stock is *sold* between the time of declaration and the time of payment of the dividend, and the *sale* takes place at such time that the purchaser becomes entitled to the dividend, the dividend *ordinarily* is income to him.

Treas. Reg. § 1.61-9(c) (1954) (emphasis added).

The court's reliance on this regulation is inappropriate for three reasons. First, the regulation applies only to sales of stock. Presumably, a sales price reflects the combined value of the stock and its impending dividend, indicating that the seller was relinquishing control over both. Second, a seller of stock requires a willing buyer, so the seller cannot completely control the timing of the transaction, unlike a nonsale transferor who has complete control over timing. Third, the regulation is explicitly limited to "ordinary" situations. As recognized by the court, the transaction at issue in *Caruth* was far from "ordinary." *Caruth,* 865 F.2d at 645.

65. *Id.* at 650.

recognized that as of the declaration date, the shareholders had complete control over the disposition of the pending dividend.

Finally, according to the court, Caruth's control over North Park did not "deprive the preferred shares of their status as an income-producing asset."[66] Thus, "the preferred stock was the tree that grew the fruit, rather than merely a crate for conveying the fruit."[67] The extent of the analysis can be summed up as follows: "Caruth gave away the goose that laid the golden eggs, and so lost his entitlement to any later eggs the goose might lay."[68]

III. ASSIGNMENT OF INCOME DOCTRINE: APPLICATION, MISAPPLICATION, AND NEEDED REVISIONS

A. *The Theory Behind the Supreme Court's Assignment of Income Doctrine*

The assignment doctrine focuses on two issues: control and enjoyment. The degrees of control which taxpayers may exercise occupy a continuum. At one end are earnings from work, which are always under the worker's direct control. Earnings accrue solely because of the worker's efforts, so the worker can determine the existence of the earnings income by performing or withholding services.[69]

Cases involving income from assets occupy the middle of the continuum. In these cases, the taxpayer retains the productive asset but transfers the income. By manipulating the underlying asset, the taxpayer may determine the existence and amount of income produced. As with attempted shifts of earnings, the transferor is taxed on the income because the transferor controls the underlying asset.[70]

The middle and direct-control areas of the continuum present relatively few problems for courts and taxpayers. Here, the traditional fruit-tree doctrine can be applied with proper results. Earnings are attributed to the earner, and income from property is attributed to the property owner. In both cases, one can easily identify both the fruit and the tree, and thus can attribute the fruit to the tree upon which it grew. The form of the transaction reveals the factors that are germane

66. *Id.*

67. *Id.*

68. *Id.*

69. *See supra* text accompanying notes 13–16. Taxpayers who simply refuse to accept compensation for future work and who do not designate a beneficiary, however, are generally not taxed on the foregone compensation. *See* Commissioner v. Giannini, 129 F.2d 639 (9th Cir. 1942); Rev. Rul. 66-167, 1966-1 C.B. 20.

70. *See supra* notes 19–27 and accompanying text.

to taxation—control and enjoyment. Courts therefore can determine the proper taxpayer by merely identifying the transaction's form.

Problems arise, however, at the opposite end of the continuum. Cases at the indirect-control end of the continuum involve taxpayers who have given up legal ownership of both the income and the income-producing property, yet who still manage to indirectly control both. *Caruth* illustrates cases found at this end of the continuum. These cases are resolved by focusing on the relationships among the transferor, the transferred asset, and the transferee. If these relationships establish the transferor's practical ownership of the transferred asset, the income will be attributed to the transferor.[71]

In cases such as *Caruth,* control over income from property exists because of the property's intimate association with an intermediary—either other property or an entity the taxpayer controls. The taxpayer's control over the intermediary enables the taxpayer to abandon all legal right to both the income and its parent property and yet to still exercise dominion over them. Such an intimate relationship existed between the bond and the interest coupons in *Horst,* between the licenses and the royalties in *Sunnen,* and between North Park and its preferred shares in *Caruth*. By controlling the bond, the father in *Horst* controlled payment of the interest;[72] by controlling the licenses, the husband in *Sunnen* controlled payment of the royalties;[73] and by controlling North Park, Caruth controlled the preferred shares.[74]

Caruth and similar cases also present the problem of timing. Courts must consider the temporal relationship between when the property was relinquished and when the income from it vested. If the asset is pregnant with income when transferred,[75] the transferor should be taxed on the asset's income because the transferor, by choosing the particular time for disposing of the property, has controlled the anticipated income.

A taxpayer's enjoyment of the income is another indicator of practical ownership presented by cases like *Caruth*. The Supreme Court appears to define "enjoyment" as the ability to procure a satisfaction

71. *See supra* notes 28–45 and accompanying text.

72. Helvering v. Horst, 311 U.S. 112, 115 (1940); *see supra* notes 28–37 and accompanying text.

73. Commissioner v. Sunnen, 333 U.S. 591, 608–09 (1948); *see supra* text accompanying notes 38–45.

74. Caruth Corp. v. United States, 865 F.2d 644, 646–47 (5th Cir. 1989); *see supra* notes 47–50 and accompanying text.

75. Such arrangements often are referred to as "anticipatory assignments of income." United States v. Basye, 410 U.S. 441, 449–50 (1973).

by disposing of the income. Income may be enjoyed directly, by personally spending the money, or indirectly, by disposing of the right to collect the income. Satisfaction occurs when taxpayers use or dispose of their power to receive or control income to procure their wants.[76]

The principles of control and enjoyment developed by the Supreme Court through *Earl* and its successors are in harmony with the basic idea of our income tax.[77] But the Court's case-by-case approach, coupled with its loyalty to the fruit-tree metaphor, has not created an adequate test for identifying the proper taxpayer in difficult cases.[78] Justice Cardozo recognized the folly of the metaphor: they "are to be narrowly watched, for starting as devices to liberate thought, they often end by enslaving it."[79] By clinging to the fruit-tree metaphor, the Court has failed to provide guidance to both lower courts and taxpayers.[80] The *Caruth* decision illustrates the shortcomings of reliance upon the traditional fruit-tree doctrine.

B. Criticism of the Fifth Circuit's Holding in Caruth

In *Caruth,* the court focused on the form of the transaction. By so doing, the court sidestepped the real issue: who is the proper taxpayer? The court held that because Caruth actually parted with the preferred shares by the record date, the dividend income was not attributable to him.[81] The court discussed neither the underlying control retained by Caruth nor the satisfaction he received by donating the shares to a charity. In this way, the court failed to attribute the dividend income to the proper taxpayer.

The *Caruth* decision is flawed for three reasons. First, the Fifth Circuit ignored the theory behind the assignment of income doctrine.

76. *Horst,* 311 U.S. at 116–17.

77. *See supra* note 10.

78. Commentators have criticized courts' use of the fruit-tree metaphor:

> From the beginning, rationality has not been a touchstone for decision of questions concerning the tax consequences of anticipatory assignments of income. Time out of mind, courts have preferred to ground decisions upon the lightening rod of a metaphor once thundered from Olympus by Mr. Justice Holmes: 'The fruit may not be attributed to a tree different from that on which it grew.' . . . Besides being irrational, however, the metaphor has frustrated an orderly evolution of a generic anticipatory assignment principle.

Teschner, *Anticipation of Income,* 41 IND. L.J. 587, 588 (1966) (quoting Lucas v. Earl, 281 U.S. 111, 115 (1930)); *see also* Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes,* 64 YALE L.J. 991 (1955).

79. Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

80. *See* Teschner, *supra* note 78, at 588. "The courts eagerly accepted the invitation that the inquiry they should make in gift assignment cases demands but a determination as to whether the assignor transferred only income fruit or also assigned a capital tree." *Id.* at 592.

81. Caruth Corp. v. United States, 865 F.2d 644, 650 (5th Cir. 1989).

Second, the holding gives taxpayers incentive to devise income-shifting schemes. Third, the decision fosters the appearance of unfairness in the application of the federal tax laws.

1. The Fifth Circuit Ignored the Theory Behind the Assignment of Income Doctrine

The assignment doctrine embodies a theory of taxation: the practical owner of income is the proper taxpayer.[82] While in simple cases the fruit-tree metaphor may offer a convenient shortcut for determining the proper taxpayer, a court should go one step further and test its conclusion against the ultimate goal of taxing the income's practical owner. The *Caruth* court opted to apply the metaphor but missed the theory behind the metaphor.

An outline of the control exercised by Caruth illustrates the problem with the Fifth Circuit's approach. The chain of control over the preferred shares began with North Park, which had absolute control over the stock's continued existence and value. Caruth, as majority shareholder, controlled North Park. This chain of control meant Caruth retained indirect control over the preferred stock even after transferring them to the Community Chest. The Fifth Circuit, however, focused only on Caruth's direct relationship to the preferred shares, which ended at the date of transfer. The court ignored the indirect control retained by Caruth over the preferred stock through his relationship to North Park.

The very nature of the preferred shares evidences Caruth's indirect control. That North Park could call the stock for $100 per share produced two consequences. First, the stock would never appreciate. A rational investor would not buy a share of stock for more than $100 if the issuing corporation could redeem that share for $100 at any time. Second, North Park—and thus Caruth—could repurchase the stock at any time. When coupled with the nonvoting and noncumulative nature of the stock, these consequences rendered the stock valueless to anyone save Caruth. Thus, while in form Caruth gave away the stock, in substance he gave away only the dividend income he had impregnated the stock with just a day before the transfer.

The execution of the preferred stock transfer also establishes Caruth's control and enjoyment. The timing of the transfer enabled Caruth to command payment of a large dividend to the charity of his choice, thus procuring the satisfaction of his wants and enhancing his stature in the community. Caruth caused the corporation to declare a

82. *See supra* text accompanying notes 69–76.

dividend, impregnating the preferred stock, which he then transferred to the W.W. Caruth Jr. Fund. In short, through the timing and the execution of the transaction, Caruth exercised dominion over the dividend.[83]

Both the nature of the stock and the execution of the transfer evidence Caruth's practical ownership of the dividend. His indirect control over the dividend should not have been ignored. Regardless of whether Caruth transferred the fruit with the tree, the control he exercised and retained indicate that the dividend income should have been attributed to him.

2. *Increased Incentive to Shift Income*

The *Caruth* holding gives incentive to other taxpayers to devise schemes by which they too can shift their income for tax purposes while retaining the use and enjoyment of that income. Caruth gave away the preferred shares—the apparent tree—yet he still determined who received the dividend income and when, and retained sufficient control to prevent the shares from bearing fruit again. Caruth had everything to gain by attempting to avoid the tax liability. At worst, he might have been required to pay the taxes. Caruth's success at avoiding his taxes will encourage taxpayers to design mechanisms for shifting their tax liabilities.

As applied by the Fifth Circuit, the assignment doctrine provides taxpayers with a formula for tax evasion, not a prohibition. The court failed to look at the real effect of the transfer, or lack thereof, on the taxpayer's relationship to the income and its parent asset. The court's unthinking reliance upon the fruit-tree metaphor serves to entice taxpayers to concoct disposable property so they can shift their tax liabilities without relinquishing the taxed income. Basing a decision on facts not material to taxpayers' finances encourages taxpayers to tailor their activities to satisfy those technicalities, while retaining practical ownership of the transferred income.

3. *Appearance of Unfairness*

The *Caruth* decision fosters an environment of unfairness. Under the *Caruth* court's approach, taxpayers who have the resources to disguise their incomes may do so; the ordinary taxpayer may not. This can be demonstrated by comparing wage-earners with persons who

83. The Fifth Circuit's failure "to see why the ripeness of the fruit matters, so long as the entire tree is transplanted before the fruit is harvested," *Caruth*, 865 F.2d at 649, suggests a lack of understanding of the assignment doctrine.

earn their income through capital investments. An entrepreneur like Caruth, who impregnates stock with a dividend and then transfers it, avoids the tax liability. A wage-earner who transfers a paycheck, however, remains liable for the taxes.[84]

The Fifth Circuit failed to respond to Caruth's manipulation of the tax laws to achieve his business purpose. Caruth claimed that his purpose in creating a lag-time between the declaration date and the record date was to force his nephews to sell their stock to avoid being taxed on the dividend at ordinary income rates.[85] Essentially, Caruth argued that he should not be taxed in this instance because he intended only to wield the tax laws against his nephews, not the United States Government.

The tax laws should not provide weapons for people to achieve such goals. Personal tax planning should be distinguished from intentional use of the tax laws to interfere with another's tax planning. Rather, the tax laws should be confined to serving the purpose of generating revenue and, at most, to promoting social policies as determined and set forth by Congress. To hold otherwise creates the impression, if not the reality, of unfairness by rewarding persons who hold positions of power.

C. The Assignment of Income Doctrine: Areas Needing Revision

1. The Traditional Doctrine Cannot Keep Pace with the Growing Sophistication of Tax Evasion Schemes

The fruit-tree metaphor is an inadequate, if not harmful, approach to assignment of income cases. The history of the doctrine and its effect on tax avoidance schemes is noteworthy. Over the decades, taxpayers have designed increasingly clever schemes to avoid the assignment doctrine.[86] By responding to the taxpayer's efforts in a way that preserves the integrity of the fruit-tree metaphor, the Supreme Court has prevented the formulation of a coherent assignment principle. The result is that both the IRS and taxpayers are unable to predict the tax consequences of future transfers of income or income-producing property.

84. *See* Lucas v. Earl, 281 U.S. 111 (1930).

85. *Caruth*, 865 F.2d at 647.

86. This trend is played out in the chronology of cases presented above. *See supra* notes 13–45 and accompanying text (discussing assignment doctrine case law). In each successive case, the underlying transaction has become more intricate in form. In substance, though, each transaction has presented the same question: who is the proper taxpayer?

The Service should not have to appeal every assignment case to the Supreme Court to obtain a judgment that reflects an understanding and application of the theory behind the assignment doctrine. Nor should taxpayers be deterred from making valid transfers of income or property for fear that they will later be held liable for taxes on the transferred income. The Supreme Court should devise a doctrine that will force lower courts, the IRS, and taxpayers to adhere to the intent of the taxing statute.

2. *The Traditional Doctrine Does Not Take Into Account the Ease with Which Taxpayers May Hide Their Income*

In one sense the federal income tax is a voluntary tax. By their sheer numbers, taxpayers enjoy an advantage over the Service. Because its resources are limited, the Service fails to detect evasion in all but the most extreme cases. This fact alone encourages attempts to shift income, because the risk of being caught is minimal. Moreover, when detecting problems, the Service begins with information provided by taxpayers themselves. And after the Service suspects a problem, most of the pertinent facts are peculiarly within the control of the taxpayer. In short, the taxpayer is at a distinct advantage.

Judicial reliance on the fruit-tree metaphor merely exacerbates this problem. As taxpayers control the primary evidence, they can tailor their transactions to fit the fruit-tree rhetoric and hide the evidence of their practical ownership. The assignment doctrine should be tailored to reduce the Service's disadvantage, where possible, and force taxpayers to reveal evidence of their practical ownership.

3. *The Traditional Doctrine Violates the Principle of Equal Treatment Under the Tax Laws*

By proceeding ad hoc, the Supreme Court has undermined the notion that the tax laws should treat taxpayers equally.[87] As long as the traditional fruit-tree doctrine admits of manipulation, some taxpayers—particularly wealthy ones—will be able to avoid paying tax on certain income, yet will receive the bounty that the income represents. Ultimately, taxpayers with the resources to restructure and disguise their capital investments will be able to avoid taxes; the average wage-earner will not. The revised assignment doctrine should further "the most significant tax principle of all: the principle of tax equality."[88]

87. Teschner, *supra* note 78, at 588.
88. *Id.*

IV. PROPOSAL

While the Tax Reform Act of 1986 has reduced the incentive to shift income by compressing the former tax brackets,[89] the Act did not totally eliminate the incentive. The present three-rate tax structure offers a potential tax savings of eighteen percent if a high-bracket taxpayer successfully shifts income to a low-bracket taxpayer.[90] Charitable donations remain deductible, subject to certain limitations.[91] Also, by donating certain appreciated assets to a charity, the taxpayer can dispose of income without ever recognizing it for tax purposes. Taxpayers, like Caruth, then may receive a second tax benefit: a charitable deduction for the income transferred tax-free.[92]

So long as there are two or more tax rates, higher-bracket taxpayers will have an incentive to shift income to lower-bracket taxpayers. The greater the disparity between tax rates, the greater the incentive. If either a more progressive tax structure or capital gains rates were reinstituted, the disparity between available tax rates would be increased, as would the incentive to shift income. For these reasons, the assignment of income doctrine is still a fundamental building block of the taxing laws.

Two changes, depending on the type of asset transferred, will rehabilitate the assignment doctrine as it pertains to nonsale transfers. First, when corporate stocks are transferred, contemporaneous dividend income should be attributed to the owner of the shares on the declaration date. Furthermore, persons who exercise control over the issuing corporation,[93] such as controlling shareholders, should be subject to a special rule: a rebuttable presumption of ownership when they transfer their stock during an "expectancy period"—between three and six months—preceeding the declaration of a dividend. Second, in all other nonsale contexts, control and enjoyment should be the determining factors. Taxpayers should bear the burden of proving that

89. *See* I.R.C. § 1 (Supp. V 1987).

90. *Id.*

91. I.R.C. § 170 (1982 & Supp. V 1987).

92. The taxing statute does allow taxpayers to transfer an appreciated asset to a charity, deduct the current market value of the asset rather than their basis in the asset and thus avoid paying the tax on the amount of appreciation. *See* Treas. Reg. § 1.170A-1 (as amended in 1984). That provision should be distinguished from the current discussion for two reasons. First, the appreciated asset deduction is clearly delineated by statute; it represents a policy choice by the legislature. Transfers of income do not enjoy the same status. Second, an appreciated asset represents an indeterminate amount of unrealized income. The appreciation value is not realized until the owner disposes of the property. The assignment of income, however, represents realized income that would be taxed to the owner but for the subsequent transfer.

93. For an analogous rule on controlling persons, see 15 U.S.C. § 77o (1982).

they have relinquished both practical and legal ownership of the income and the income-producing property.

A. Corporate Stock

To avoid future decisions like *Caruth,* the revised assignment doctrine should distinguish between those transfers accomplished by persons who control the issuing corporation and those who do not. When a noncontrolling shareholder transfers stock, dividends should be taxable to the shareholder of record on the declaration date.

This rule would have several benefits. First, it would provide predictability and certainty, both important objectives of tax jurisprudence. To make economically efficient decisions, taxpayers need to know whether they ultimately will be liable for taxes. Furthermore, the rule would help prevent taxpayers from "double-dipping" as Caruth did. Taxpayers transferring income would receive a charitable deduction for the amount contributed but would report the transferred income. Finally, the rule would preserve the equal treatment of taxpayers by making identification of the proper taxpayer turn on facts beyond the taxpayer's control.

The special rule for controlling persons would create a rebuttable presumption that all dividends declared during the expectancy period are attributable to such persons for tax purposes. Taxpayers could rebut this presumption by showing that, at the time of transfer, they had not been involved in the dividend decision and had neither actual knowledge nor any reason to know of the decision. Such a rule would force lower courts to recognize the indirect control that persons in controlling positions can exert over the timing of stock dividends. Application of this rule to the *Caruth* case would have produced the proper result.

B. Other Nonsale Transactions

Since the backbone of the assignment doctrine is control and enjoyment, the Supreme Court should adopt a set of questions to probe those issues. The fundamental question is whether the transferor has relinquished sufficient control over the transferred income and property to have abandoned both legal and practical ownership.

Several questions should be considered to ascertain the proper taxpayer. First, what is the nature of the asset transferred? Courts should look at whether the asset has value beyond the income it generates and whether it is vulnerable to control by someone other than the

legal owner. Second, what was the nature of the transferor's association to the asset before and after the transfer? This question is meant to probe practical ownership through the means available to the transferor to exert indirect control. Third, what relationships, if any, exist between the transferor and the transferee that allow the transferor to continue to control and enjoy the asset? Finally, has the transferor procured the satisfaction of his or her wants by disposing of this income? The focus here is on whether the transferor has enjoyed the income by disposing of it in the time, place, and manner of his or her choice.

The above test is preferable over the traditional fruit-tree doctrine because it focuses the court's attention on the substantive issues rather than on the form of the transaction. Furthermore, the test avoids the problems that the formalistic approach of the fruit-tree metaphor has created. Taxpayers would no longer have an incentive to shift their income because application of the test would require that they forego the income or be held liable for the taxes.

V. CONCLUSION

While the object of the assignment doctrine remains sound, the application of the doctrine needs revision. The recent decision by the Fifth Circuit Court of Appeals in *Caruth Corp. v. United States* illustrates the drawbacks of reliance upon the fruit-tree metaphor. There, the taxpayer was able to shift his tax liabilities while still controlling and enjoying the taxed income. This result is inconsistent with the theory behind the assignment doctrine, gives incentive to other taxpayers to devise tax-avoidance schemes, and violates the notion of tax equality.

The traditional fruit-tree doctrine is satisfactory as an analytical tool in only the most obvious of cases. The doctrine glosses over the issues of control and enjoyment which are the determinative factors in difficult cases, such as *Caruth*. The outcome of *Caruth* taints our federal tax system as an inherently irrational and unfair institution.

The Supreme Court should devise new tests for the assignment doctrine that focus on the theory behind that doctrine. Where possible, courts should adopt rules employing factors specific to the underlying assignments. This would provide consistency and equality for taxpayers. Furthermore, taxpayers would know in advance what the result of a particular transfer would be.

In the area of corporate stock dividends, the proposed rebuttable presumption would identify the proper taxpayer because after the declaration date shareholders have the ability to control and enjoy the pending dividend. Furthermore, as dividends are subject to the control of those who control the corporation, the intent of the assignment doctrine calls for a rule that people who enjoy controlling positions in the issuing corporation presumably own any dividends arising out of shares they owned while enjoying such a position.

With regard to other forms of income-producing property, the court should look to the underlying transaction, without regard to what would have been the fruit or the tree, to see if the transferor retained the ability to either control or enjoy the income or property. By answering the questions proposed, a court would be forced to analyze the substance of the transaction in light of the theory behind the assignment doctrine. If the transferor has retained sufficient control or enjoyment, the transferor should remain liable for the taxes on the income generated.

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