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NOTES

Spendthrift Trusts

ATTACHABILITY OF A BENEFICIARY'S INTEREST IN SATISFACTION OF A TORT CLAIM

Wealthy persons are often the parents of extravagant children. While the parents live they can maintain control over their children and keep them from actual want. But after they have passed away they will no longer be able to personally protect or restrain their offspring against their own improvidence. The solution for such people is the spendthrift trust.¹ A spendthrift trust is one in which the beneficiary is entitled to the income from the trust property for life, or for a term of years, and which provides that his interest shall not be transferable by him, and shall not be subject to the claims of his creditors — a trust in which there is a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary.²

A distinction should be made between the "spendthrift trust," the "trust for support" and the "discretionary trust." In all three instances the interest of the beneficiary is immune to the claims of the creditors, but for different reasons. In the case of the spendthrift trust, immunity is the result of an express provision in the instrument which prevents alienation; the beneficiary's interest in a trust for support is, by its nature, incapable of being subjected to creditors' claims; while under the discretionary trust the creditor cannot compel the trustees to pay anything to him because the beneficiary could not compel payment to himself.³

Even though the terms of the trust or a statute provide that creditors of a beneficiary shall not be allowed to attach the beneficiary's interest in the trust, certain classes of creditors have been permitted to reach his interest.⁴ The problem with which we are here concerned is whether or not a tort claimant falls within such a class of creditors. Where the beneficiary of a spendthrift trust commits a tort against a third person, can such third person satisfy his claim out of the beneficiary's interest in the spendthrift trust?

¹ In states in which restraints on the alienation of the interest of a beneficiary are upheld, it is immaterial that the beneficiary is in fact a fully competent person. See *Wagner v. Wagner*, 244 Ill. 101, 91 N.E. 66 (1910).

² See *RESTATEMENT, TRUSTS* § 152 (1935).

³ For a detailed discussion of these distinctions see *RESTATEMENT, TRUSTS* §§ 152, 154, 155 (1935).

⁴ 1 *SCOTT, TRUSTS* §§ 157 - 157.5 (1939); 1A *BOGERT, TRUSTS & TRUSTEES* § 223 (1951).

Case authority on the point is practically negligible. An early Pennsylvania case⁵ contained dictum to the effect that no distinction should be drawn between a tort creditor and any other creditor. The court said, "Whether the judgment be for a breach of contract or for a tort, matters not."⁶

In a later decision⁷ in one of the lower Pennsylvania courts it was held that a beneficiary's interest in a spendthrift trust was not subject to attachment for an unsatisfied judgment rendered in the court of a sister state for damages for tort. In this case the spendthrift trust expressly provided that the income of the trust was to be paid as it accrued and was not to be paid by way of anticipation and that the beneficiary's interest was not to be subject to his "debts, contracts, or engagements." The plaintiff argued that the word "debts," used by the settlor should have been interpreted in a strict technical sense and with a limited meaning so as to exclude all liabilities originating in tort. The court refused to follow the plaintiff's argument. It stated that the general policy of the Pennsylvania courts was to uphold spendthrift trusts, not out of any regard for the beneficiary, or desire to aid him in escaping payment of his just obligations, but solely to protect the donor's right of property. The court conceded that an unliquidated liability for tort was not technically a debt but stated that a debt arose when the liability became liquidated and was reduced to judgment. The court said that upon reduction to judgment, it became a "debt of record" which was a contract of the highest nature.

The Pennsylvania court in the above case held, in effect, that the tort claimant, by reducing his claim to judgment, became an ordinary creditor. Even though it is usually held that a tort claim merges with the judgment, this would seem to be giving undue weight to form.

The above view would probably be disapproved in view of recent Pennsylvania cases. In one case⁸ the court stated that spendthrift trusts were against public policy in Pennsylvania in so far as they might defeat the claims of a wife for support and maintenance. Wives are entitled to recover against the beneficial interest of their husbands as though no spendthrift clause was contained in the will or deed creating the trust. The court held that a wife suing on a judgement for support rendered by a Florida court would be allowed to recover. The court said that she did not lose her claim against the trust simply because she had obtained a judgment.

⁵ *Thackara v. Mintzer*, 100 Pa. 151 (1882).

⁶ *Id.* at 154-155.

⁷ *Davies v. Harrison, Jr.*, 3 Pa. D. & C. 481 (C.P. 1923). See also *Blakemore v. Jones*, 303 Mass. 557, 22 N.E.(2d) 112 (1939) in which a trustee-beneficiary of a spendthrift trust committed a breach of trust. Held, that his interest as beneficiary could not be reached to satisfy the damage claim.

⁸ *In re Stewart's Estate*, 334 Pa. 365, 5 A.(2d) 910 (1939). Also see *Lippincott v. Lippincott*, 28 Pa. D. & C. 28 (C.P. 1936).

Before proceeding further in the discussion of whether or not a tort claimant may satisfy his claim out of the interest of a beneficiary in a spendthrift trust, it would probably be wise to discuss the status of spendthrift trusts in the United States generally.

In the majority of states today spendthrift trusts are recognized as being valid.⁹ They are allowed either without qualification, or subject to statutory restrictions. Jurisdictions holding spendthrift trusts valid may be divided into the following classes:¹⁰ (a) those jurisdictions which have upheld the spendthrift trust without any limitation as to the size of the income or the needs of the beneficiary; (b) those states having statutes similar to New York statutes which allow spendthrift trusts to an extent necessary to support and educate the *cestui* in the manner of life to which he has been accustomed;¹¹ and (c) those states in which the spendthrift trust is limited as to size of corpus or purpose of the trust.¹²

There is a small group of states which follows the English view that spendthrift trusts are invalid in so far as they restrain the voluntary and involuntary transfer of the interest of the beneficiary.¹³ In these states the beneficiary's interest is freely alienable by himself and attachable by his creditors.

In the leading case of *Broadway National Bank v. Adams*,¹⁴ the court admitted that a provision made by the donor of a *legal* interest that it should not be alienated was invalid, but held that this was not so in regard to the *equitable* interest created under a trust.¹⁵ The court stated that the creator of the trust was the absolute owner of the property and that his directions should be followed unless they were contrary to public policy. The court thought that there was nothing against public policy in giving the beneficiary such a qualified interest

⁹ For a collection of cases see Note, 119 A.L.R. 19 (1939) supplemented in 138 A.L.R. 1319 (1942).

¹⁰ 1A BOGERT, TRUSTS & TRUSTEES § 222 (1951).

¹¹ CAL. CIV. CODE § 859 (1949); MICH. STAT. ANN. § 26:63 (1937); MINN. STAT. § 501:14 (1949); MONT. REV. CODES ANN. § 86:106 (1947); N.Y. REAL PROP. LAW § 98; N.D. REV. CODE § 59:0310 (1943); OKLA. STAT. tit. 60, § 140 (1951); S.D. CODE § 59:0306 (1939); WIS. STAT. § 231:13 (1951).

¹² ALA. CODE tit. 58, § 1 (1940); ARIZ. CODE ANN. § 41:112 (1939); CONN. GEN. STAT. § 8034 (1949); LA. REV. STAT. ANN. § 9:1923 (1950); N.C. GEN. STAT. § 41:9 (1950); OKLA. STAT. tit. 60, § 175:25 (1951); VA. CODE § 55:19 (1950).

¹³ Cecil's Trustee v. Robertson & Bro., 32 Ky. L. R. 357, 105 S.W. 926 (1907); Brahme v. Rollins, 87 N.H. 290, 179 Atl. 186 (1935); Tillinghast v. Bradford, 5 R.I. 205 (1858).

¹⁴ 133 Mass. 170, 173, 43 Am. Rep. 504 (1882).

¹⁵ In Brahme v. Rollins, 87 N.H. 290, 179 Atl. 186 (1935) it was argued that the common law rule of property invalidating direct restraints upon alienation applies with equal force to equitable interests, but in *Broadway National Bank v. Adams*, *supra*, it was held that the beneficiary's interest is a creature of equity, existing in spite of the rules of property and that equity can determine its nature.

in the income, unless the effect was to defraud creditors. The court pointed out that the creditors were not defrauded since they could have learned of the restriction if they were diligent. In substance the argument of the court was that the owner of property should be able to dispose of it in any way he chooses so long as no third person is injured thereby. The restraint on alienation imposed on the beneficiary is no injury to his creditors, since, if it were not for the disposition, they could not have reached the property anyway, and if they were deceived into extending credit in reliance upon the beneficiary's interest in the trust, they had only themselves to blame, for they would not have been deceived if they had examined the record.¹⁶

A Pennsylvania court stated its argument in upholding a spendthrift trust as follows:¹⁷

The law rests its protection of what is known as a spendthrift trust fundamentally on the principle of *cujus est dare, cujus est desponere*.^[18] It allows the donor to condition his bounty as suits himself so long as he violates no law in so doing. When a trust of this kind has been created, the law holds that the donor has an individual right of property in the execution of the trust; and to deprive him of it would be a fraud on his generosity. For the law to appropriate a gift to a person not intended would be an invasion of the donor's private dominion. . . . It is always to be remembered that consideration for the beneficiary does not even in the remotest way enter into the policy of the law. It has regard solely to the rights of the donor. Spendthrift trusts can have no other justification than is to be found in consideration affecting the donor alone. They allow the donor to so control his bounty, through the creation of the trust, . . . not because the law is concerned to keep the donee from wasting it, but because it is concerned to protect the donor's right of property.

Where the settlor provides that the interest of a beneficiary shall not be alienable by him or attachable by his creditors, the only substantial question in regard to the validity of the provision, according to Professor Scott, is whether it is against public policy to give effect to it.¹⁹

Law, it would seem, is simply the crystallization of public policies which attempt to promote the orderly conduct of society. Often, these policies are in direct conflict. Thus, to uphold the spendthrift provisions in a trust gives support to the basic policy that a donor has a right to

¹⁶ In *Nichols v. Eaton*, 91 U.S. 716, 23 L. Ed. 254, 257 (1875) it was stated; "Why a parent or one who loves another, and wishes to use his own property in securing the object of his affection, as far as property can do it, from the ills of life, the vicissitudes of fortune and even his own improvidence or incapacity for self-protection, should not be permitted to do so, is not readily perceived." (Dictum). Similar statements appear in *Canfield v. Security-First Nat. Bank*, 13 Cal.(2d) 1, 87 P.(2d) 830, 835 (1939); *Frensley v. Frensley*, 177 Okla. 221, 58 P.(2d) 307, 315 (1936); *Adams v. Williams*, 112 Tex. 469, 248 S.W. 673 (1923); *Huestis v. Manley*, 110 Vt. 413, 8 A.(2d) 644 (1939).

¹⁷ *In re Morgan's Estate*, 223 Pa. 228, 72 Atl. 498, 499 (1909).

¹⁸ "Whose it is to give, his it is to dispose," or "The bestower of a gift has a right to regulate its disposal."

¹⁹ 1 SCOTT, TRUSTS § 152 (1939).

dispose of his property as he so desires. However, upholding spendthrift trusts runs against the general policy of the law that a creditor has a right to secure satisfaction from his debtor's property. The majority of courts have given spendthrift trusts their blessing, leaving the policy protecting creditors a poor runner-up.

Even though a spendthrift trust will be upheld in most jurisdictions it would seem to be well within the power of the court of equity to give relief to certain creditors with peculiarly powerful claims on the sympathy of the court. Ordinarily, contract creditors cannot reach the beneficiary's interest because, as stated above, they have only themselves to blame if they extend credit to him without first ascertaining the amount of his resources which are available for the discharge of his debts. It does not appear unfair to place upon such a creditor the burden of checking the credit risk, and placing the risk of loss upon him for his failure to do so. But this line of reasoning is not applicable to certain classes of creditors who did not voluntarily extend credit to the beneficiary. To leave involuntary creditors who had no opportunity to check resources, or who were forced into this relationship with the spendthrift, in the same position is more suggestive of injustice or unfairness.

A number of courts have realized that certain claimants are on a different footing from normal creditors and have allowed the claimants to reach the interest of the beneficiary.²⁰ The interest of the beneficiary has been reached (a) by the wife or child of the beneficiary for support, or by the wife for alimony, and (b) by the United States or a state or subdivision thereof to satisfy a claim against the beneficiary. Also creditors who have rendered necessary services or furnished necessary supplies to the beneficiary have been placed in a different position from ordinary contract creditors and have been allowed to recover.

There is a conflict of authority on the question of the right of dependents of the beneficiary of a spendthrift trust to reach his interest. There have been cases which have allowed the wife or child to recover on the ground that the settlor intended that they should be supported by the husband and father out of the funds paid to him.²¹ Other decisions have been based on the ground that it is against public policy to permit the beneficiary to have the enjoyment of the income from the trust while he refused to provide for dependents whom he had a duty to support.²² A Pennsylvania court in holding that the public policy of

²⁰ See RESTATEMENT, TRUSTS § 157 (1935) for a list of particular classes of claimants which are allowed to reach a spendthrift's interest.

²¹ *England v. England*, 223 Ill. App. 549 (1922); *Marsh v. Scott*, 2 N.J. Super. 240, 63 A.(2d) 275 (1949); *Obendorf v. Farmers' Loan & Trust Co.*, 208 N.Y. 367, 102 N.E. 534 (1913); *In re Morehead's Estate*, 289 Pa. 542, 137 Atl. 802 (1927); *Thomas v. Thomas*, 112 Pa. Super. 578, 172 Atl. 36 (1934).

²² *Safe Deposit & Trust Co. of Baltimore v. Robertson*, 19 Md. 653, 65 A.(2d) 292 (1949); *Lippincott v. Lippincott*, 349 Pa. 501, 37 A.(2d) 741 (1944). *Contra*:

requiring support for wives and children was stronger than the policy behind spendthrift trusts said:²³

The Commonwealth has a vital interest in the maintenance of marriage, because it is the foundation of society. . . . "the Commonwealth is vitally interested not only in the moral and social factors involved but also in preventing deserted wives from becoming public charges."

The public policy of permitting dependents of the beneficiary of a spendthrift trust to reach his interest has been codified in some states. There are now statutes to this effect in Louisiana,²⁴ Missouri,²⁵ Oklahoma,²⁶ and Pennsylvania.²⁷

Statutes enabling creditors of any class to reach the surplus income not needed for the care and education of the beneficiary furnish a means in some states for at least a limited satisfaction of the claims of a wife or children to support or alimony.²⁸

It has been held that government claims against the beneficiary of a spendthrift trust for unpaid taxes can be satisfied out of the beneficiary's interest. It makes no difference whether the claim is related to income received under the trust, or whether it is a claim for a tax due from the beneficiary with respect to other property owned by him.²⁹ In *In re Rosenberg's Will*,³⁰ the court stated that no policy of the state protecting spendthrift trusts from creditors could interfere with the power of Congress to levy and collect taxes on income, and that Section 98 of the

Schwager v. Schwager, 109 F.(2d) 754 (7th Cir. 1940); *In re Bucklin's Estate*, 51 N.W.(2d) 412 (Iowa 1952); *Erickson v. Erickson*, 197 Minn. 71, 266 N.W. 161 (1936). In 266 N.W. at 164, the court stated: "If alimony or support money is to be an exception to the protection offered by spendthrift provisions it must be by some justifiable interpretation of the donor's language by which such implied exception may be fairly construed into the instrument of trust. It cannot logically arise out of the character of the obligation (though some cases so hold)."

²³ *Lippincott v. Lippincott*, 349 Pa. 501, 37 A.(2d) 741, 743 (1944).

²⁴ LA. REV. STAT. § 9:1923 (1950).

²⁵ MO. REV. STAT. § 456:080 (1949). "All restraints upon the right of the *cestui que* trust to alienate or anticipate the income of any trust estate in the form of a spendthrift trust, or otherwise, and all attempts to withdraw said income of any trust estate from the claims of creditors of the *cestui que* trust, whether said restraints be by will or by deed, now existing or in force, or, which may be hereafter executed in this state, be and the same are hereby declared null and void and of no effect, as against the claims of any wife, child or children, or said *cestui que* trust for support and maintenance, or, as against the claim of any said wife for alimony."

²⁶ OKLA. STAT. ANN. tit. 60, § 175:25 (1951).

²⁷ PA. STAT. ANN. tit. 20, § 301:12 provides that, "Income of a trust subject to spendthrift or similar provisions shall nevertheless be liable for the support of anyone whom the income beneficiary shall be under a legal duty to support." See also PA. STAT. ANN. tit. 18, § 4733 (1945); PA. STAT. ANN. tit. 48, § 136 (1930).

²⁸ *Fink v. Fink*, 139 Misc. 630, 248 N.Y.Supp. 129 (Sup. Ct. 1931); *Wetmore v. Wetmore*, 149 N.Y. 520, 44 N.E. 169 (1896).

²⁹ *United States v. Mercantile Trust Co. of Baltimore*, 62 F. Supp. 837 (D. Md. 1945); *Mercantile Trust Co. v. Hofferbert*, 58 F. Supp. 701 (D. Md. 1944).

³⁰ 269 N.Y. 247, 199 N.E. 206 (1935).

Civil Practice Act of New York restricting creditors to ten percent of the income did not apply to the federal government.

It has been held in a number of cases that a person who furnishes necessaries to the beneficiary of a spendthrift trust can reach his interest in such trust.³¹ A physician or a hospital which has rendered necessary medical services has been allowed to recover out of a spendthrift trust.³² Where, however, the necessaries were furnished without the knowledge of the trustee, who was not neglecting to support the beneficiary, a recovery has been denied.³³

The apparently total lack of case authority in point on whether a tort claimant may recover damages out of a spendthrift's trust interest renders a positive statement on the question impossible at this time. However, there seems to be no sound reason for placing the tort claimant in the same class with ordinary contract creditors. As regards opportunity to investigate assets, which appears to be the main consideration in denying contract creditors recovery, there is no similarity. As has been stated by Professor Scott:³⁴

A man who is about to be knocked down by an automobile has no opportunity to investigate the credit of the driver of the automobile, and has no opportunity to avoid being injured no matter what the resources of the driver may be.

A sense of justice suggests that the tort claimant belongs more properly in the class of other special claimants just mentioned who have been permitted to recover their debts out of his interest in the trust.

The view that the primary concern of the courts in the field of spendthrift trusts is not to protect the spendthrift beneficiary but rather to uphold the settlor's right to dispose of property as he sees fit has been seriously discredited. In addition to numerous statutes and decisions which have detracted considerably from the idea of absolute immunity, the view has also been sharply attacked by legal scholars.³⁵

The argument that the victim of a tort is actually in no worse position than if the tortfeasor were penniless may be true in certain instances; nevertheless it is obviously unjust to allow the beneficiary to continue enjoying his property while the injured tort claimant remains uncompensated.

³¹ *Cooper v. Carter*, 145 Mo. App. 387, 129 S.W. 224 (1910); *In re Mayer's Will*, 59 N.Y.S.(2d) 561 (Surr. Ct. 1945).

³² *Sherman v. Skuse*, 166 N.Y. 345, 59 N.E. 990 (1901); *In re Berrien's Estate*, 147 Misc. 788, 264 N.Y. Supp. 593 (Surr. Ct. 1933).

³³ *Charles, Inc. v. Mellor*, 20 Pa. D. & C. 464 (C. P. 1934).

³⁴ 1 SCOTT, TRUSTS § 157.5 (1939).

³⁵ Griswold, *Reaching the Interest of the Beneficiary of A Spendthrift Trust*, 43 HARV. L. REV. 63 (1929); Costigan, *Those Protective Trusts Which are Miscalled "Spendthrift Trusts" Reexamined*, 22 CAL. L. REV. 471, 483 *et seq* (1934).

In a number of states there are statutes like Section 98 of New York Real Property Law, which provides that creditors may reach the surplus income accruing to the beneficiary of a trust, "beyond the sum necessary for the education and support of the beneficiary." Such provisions are in effect in California, Michigan, Minnesota, Montana, North Dakota, Oklahoma, South Dakota and Wisconsin.³⁶

In New York the statute does not specify what sum shall be regarded as necessary for the education and support of the beneficiary. The courts of New York have decided this question by applying what is known as the "station in life" rule. Thus, the amount necessary for a beneficiary's education and support varies with his "station in life." The rule has been severely criticized for its undue regard to the lavish propensities of a spendthrift who has accustomed himself to a life which leaves little or no surplus for his creditors.

Section 684 of New York Civil Practice Act provides that any interest in a spendthrift trust which pays the beneficiary thirty dollars or more per week, in a city with a population of over two hundred and fifty thousand — twenty-five dollars per week in all other areas — shall be subject to the attachment of judgment creditors in an amount not to exceed ten percent of the value of such interest during any one period. The statute also provides that the levy shall be a continuing levy until the judgment creditor's execution is satisfied, and where several executions are issued against the same debtor they are to be satisfied in the order of priority.³⁷ However, this section does not aid the creditor until he has obtained judgment.³⁸

It has been held that where a creditor has obtained an order garnishing ten percent of the beneficiary's income under Section 684 of New York Civil Practice Act, he can also, under Section 98 of New York Real Property Law, reach the surplus income not necessary for the beneficiary's support and education, since these statutory remedies are cumulative.³⁹ These statutes attempt to give some relief to all types of creditors.

There are statutes in Oklahoma⁴⁰ and Louisiana,⁴¹ patterned upon a model statute suggested by Dean Griswold of the Harvard Law School⁴²

³⁶ See note 11 *supra*.

³⁷ An almost identical statute was enacted in Indiana, IND. STAT. ANN. § 2:4501 (Burns 1933), but was held unconstitutional as violating the Due Process Clause and the Equal Protection Clause of the U.S. Constitution, Amend. XIV, and the Indiana Constitution Art. I, § 23 guaranteeing equal privileges and immunities. *Galesburg Coulter Disc Co. v. Hunter*, 208 Ind. 330, 196 N.E. 94 (1935).

³⁸ *Judis v. Martin*, 218 App. Div. 402, 218 N.Y.Supp. 423 (1st. Dep't 1926).

³⁹ *In re Brown's Estate*, 35 N.Y.S.(2d) 646 (Sup. Ct. 1941), *aff'd. mem.*, 264 App. Div. 824, 35 N.Y.S.(2d) 738 (4th Dep't 1942).

⁴⁰ OKLA. STAT. tit. 60, § 175:25 (1951).

⁴¹ LA. REV. STAT. ANN. § 9:1923 (1950).

⁴² GRISWOLD, SPENDTHRIFT TRUSTS 477 (1st. ed. 1936).

which provide that all income in excess of five thousand dollars per annum accruing from a spendthrift trust shall be subject to attachment by creditors of the beneficiary. The Louisiana statute provides, in addition, for garnishment of ten percent of all income from spendthrift trusts in excess of twelve dollars per week. Both statutes contain express provisions empowering the courts of the state to order the payment of any or all of the income accruing to the beneficiary in satisfaction of claims for (a) support of a husband, wife, or child of the beneficiary, (b) necessary services rendered or necessary supplies furnished to the beneficiary, or (c) a judgment based on any such claim under (a) or (b). The Louisiana statute, in addition, provides that the beneficiary's interest shall be fully subject to claims arising out of a tort or a judgment based thereon.⁴³ These special-claimants provisions are in addition to the other remedies provided under the statute.⁴⁴

Conclusion

Both judicial decisions and legislative enactments of the past twenty-five years have evidenced a steady trend toward limiting the inaccessibility of spendthrift trusts where special classes of claimants are concerned. The spirit of nineteenth century individualism which originally validated these trusts has been gradually replaced by a growing sense of social justice which, while it recognizes and approves the desirable elements inherent in spendthrift provisions, has increasingly attempted to qualify their application according to principles of fairness and justice.

Although it is not unreasonable for the settlor, in creating a trust, to protect the beneficiary against his own improvidence by provisions against alienation, there seems to be little justice in extending such a provision to the claims of involuntary creditors. Few, if any of the arguments supporting the spendthrift trust as against a voluntary creditor have any application to a man injured through a tort by the beneficiary. There appears to be no equity whatever, and little if any justice, in permitting the tort-feasor to enjoy the comparative luxury of his trust income while the tort claimant receives no recompense for the injury suffered at his hands.

The solution to the problem would appear to lie in the establishment or the recognition of a public policy in the states, permitting involuntary creditors to recover out of the spendthrift's interest. While such recognition might just as easily stem from the courts as from the legislatures, in the interests of uniformity and certainty, it is the belief of this writer

⁴³ The Louisiana statute expressly provides that the court may make such order as is just in connection with claims for torts or judgments for torts. The Oklahoma statute did not include the provision of the model statute as to torts.

⁴⁴ The other remedies are the \$5000.00 per annum provision, and the provision concerning the garnishing of ten percent of all income over \$12.00 per week.

that the policy should be expressed through positive enactments by the legislatures. The adoption of the model statute on spendthrift trusts advocated by Dean Griswold of the Harvard Law School should go far toward eliminating most of the evils which accompany such trusts while still retaining their desirable elements.

William N. Antonis

Taxation

TAX IMPLICATIONS OF A GIFT TO A CHILD OF
INCOME PRODUCING PROPERTY

Introduction

Basic to the solution of the problem of successful intra-family wealth distribution so as to minimize taxes is the gift; and when the gift can take the form of a gift of income producing property it is potent indeed to stave off the inroads of the tax collector into the family wealth.

Such a gift has, most obviously, estate tax implications, in that it reduces the donor's estate at death. In addition, and perhaps more important, a gift of income producing property has income tax consequences. Finally, a gift of this character, in view of the fact that minor children may be involved, has important gift tax problems which must be considered. The aim of this article will be to deal with problems in making these distributions effective from the point of view of the Federal Income Tax and the Federal Gift Tax. Specifically involved will be two problems: (1) Securing attribution of income to property donated; and (2) Securing, if feasible, the benefit of the annual exclusion under the gift tax. Estate tax considerations will be treated only incidentally. Particular attention will be directed to a gift of a partnership interest, creating a family partnership, the "litigation-breeder" which recently received what has been characterized as "off-hand" legislative treatment.¹

"Estate planning" is a current term for an ancient prudence. It has never been defined as a mere series of tax reducing formulae. But taxes are one factor, perhaps an unfortunately large one, influencing the direction of property and the arrangement of affairs.²

Gifts to children have long played an important role in estate planning. Tax considerations alone cannot be blamed for this fact. There are

¹ Lifton, *The Family Partnership: Here We Go Again*, 7 TAX L. REV. 461, 480 (1952). Whether or not this phrase properly characterizes the congressional measure, there is no doubt of one aspect it suggests: there remains more than ample room for litigation.

² Twentieth Century Fund, *Taxation as an Instrument of Social Control in FACING THE TAX PROBLEM* 129 (1937).

several other weighty reasons why an individual with a fairly large estate would desire to utilize inter vivos gifts to his children as an important element in the distribution of his property:

A gift may have the effect of aiding a dear one at the time he needs it most, instead of forcing him to anticipate the death of his ancestor.

A gift may enable the donor to achieve the satisfaction of seeing the objects of his bounty in enjoyment of some of his property prior to his death.

A gift may test the capacity of a donee to deal with property, and be a gauge for future testamentary disposition. A gift may condition expectant heirs for what is planned in the future.

Moreover, a gift may establish the independence of donees prior to the date of the donor's death. If timely made, it may secure the donees against financial risks to which the affairs of the donor may expose him, and within certain limitations, remove property from the potential grasp of creditors.³

Suffice it to say that donative disposition of property will always be and has always been of considerable utility in estate planning, even apart from tax considerations. But taxation has had its role in recent years. Apart from the very disturbed individual who might make a senseless disposition of property in order to reduce government's participation in his wealth, even the hypothetical man spoken of by the economists would very likely alter his estate distribution plans when a tax saving exceeded the marginal measure of desirability of some former disposition.

The by-product of progressive rates in taxation has been the endeavor to shift wealth to other members of the family. Such shifting, if carefully done, can save large amounts of tax; but few problems have occasioned more litigation and difficulty in the formation and administration of the tax laws.

The split concept of marital property, embodied in the Revenue Act of 1948⁴ which cuts across the lines of estate and gift as well as income taxation, whether in the interest of a more just tax incidence or not, has mitigated the problem in the area of husband and wife transactions.

The problem with respect to the remainder of the family circle looms larger. Highlighted in this area is the problem of the tax-inspired transaction with one's child. And the partnership provisions in the Revenue Act of 1951⁵ have increased the expectancies of the taxpayer as to what he can do along these lines.⁶

³ See *e.g.*, UNIFORM FRAUDULENT CONVEYANCE ACT §§ 5, 6, 9A UNIFORM LAWS ANN. 90-92 (1951).

⁴ INT. REV. CODE § 12(d). See Surrey, *Federal Taxation of the Family — The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1103 *et seq.* (1948).

⁵ INT. REV. CODE § 191.

⁶ For an illustration of surtax savings available through this device, see Packel, *The Next Inning of Family Partnerships*, 100 U. OF PA. L. REV. 153 (1951).

The problems involved in these transactions, such as retained control, completeness of disposition, simultaneous enjoyment, substance versus form, and other tests used to overturn tax avoiding schemes are sufficiently complicated when individuals *sui juris* are involved. Minority itself, with its consequent natural and legal disability adds to these difficulties.⁷ And many of the most desirable tax transactions, particularly at the present, involve youngsters.

There is, and has been, a persistent social force impelling the increased recognition of the individuality under the law of the constituent members of the family unit, wives and children alike.⁸ The fact remains, nevertheless, that within a closely knit family organization there is a considerable degree of mutual and simultaneous enjoyment of wealth. Even under the present arrangement, the tax law must in many instances ignore state laws regarding the rights of parents to their children's income when it taxes that income to the child himself. But even with the child as a separate taxpayer, the courts and legal writers refuse, in the interests of fairly distributing the national burden, to completely ignore what are often fused economic interests.⁹

Attribution

Economists ascribe income to labor, capital and profit, the economist's profit, or pure profit, being that remaining after a reasonable allocation has been made to the other two income producing factors.¹⁰ It makes no difference to the economist that these salaries, including salaries for proprietary services, and the interest on capital, including invested capital, has not actually been paid or incurred.¹¹ Traditionally the accountant, however, has declined to recognize any reduction of profits by costs not actually incurred; proprietary salaries or an allowance for interest on invested capital would be unacceptable, and would be regarded as a hypothetical cost in the accounts.¹²

⁷ Discussion of the difficulties which minority adds to an already difficult tax area can be found in Fleming, *Gifts for the Benefit of Minors*, 49 MICH. L. REV. 529 (1951); Rogers, *Some Practical Considerations in Gifts to Minors*, 20 FORD. L. REV. 233 (1951); Shattuck, *A Practical Consideration of Some of the Legal and Tax Problems Inherent in Gifts to Minors*, 31 B. U. L. REV. 451 (1951). Many of these difficulties will be discussed in the course of this paper.

⁸ The policy finds its most obvious expression in the Married Woman's Property Acts, and other legislation increasing the social, economic and political status of women. Further recognition of it is to be found in the assault being made on the common law rule precluding tort actions by a child against his parent. Details concerning this policy are beyond the scope of this paper.

⁹ For a suggestion that the family be taxed as a unit, see Bruton, *The Taxation of Family Income*, 41 YALE L.J. 1172, 1191 (1932). For a critique of family taxation, see Ryan, *Federal Tax Treatment of the Family*, 32 MARQ. L. REV. 244 (1949); Surrey, *supra* note 4.

¹⁰ 12 ENCYC. SOC. SCI., *Profit* 481 (1933).

¹¹ *Id.* at 482.

¹² 1 ENCYC. SOC. SCI., *Accounting* 412 (1933).

So too, the tax structure, in the matter of income determination, has declined to accept the economists' definition of profit. Deductions are allowed solely on the basis of incurred rather than hypothetical costs,¹³ and income has not been treated any differently because economically it may be ascribed to one factor rather than another.

In the area of income attribution, however, where the problem is not the determination of the amount of income but the determination of who should be taxed on it, the courts have been forced to these considerations.¹⁴ To employ Justice Holmes' oft quoted metaphor, the courts seek to ascribe the fruit to the tree that bore it.¹⁵

Two basic precepts have developed: Income from labor is to be ascribed to the one whose services produced it; income from capital should be taxed to the owner of the capital.¹⁶ The economists' pure profit, presumably, goes to capital.

Unfortunately for theory at least, these standards are not inexorable, even apart from any practical difficulties they may present in actual application. They do present, however, the working premises for the solution of any assignment of income problem. There is no explicit statement of them in the Internal Revenue Code; they have been recognized indirectly in the partnership provisions above referred to¹⁷ and have been read into Section 22(a) of the Code by the courts.¹⁸

*Lucas v. Earl*¹⁹ involved an assignment of future income by an attorney-husband through a contract with his wife providing that she should be entitled to one-half of all he should acquire. Being thus

¹³ A controversial exception exists in the case of percentage depletion allowed on certain mineral property. INT. REV. CODE § 114(b) (3-4).

¹⁴ *E.g.*, Justice Frankfurter concurring in *Commissioner v. Culbertson*, 337 U.S. 733 (1949): "The word 'income' has none but an economic significance, and so the application of § 22(a) is properly a matter of economic analysis."

¹⁵ *Lucas v. Earl*, 281 U.S. 111, 115 (1930). This analogy, the famed "horticultural allusion," has been very frequently used in this area. But consider the following from *Doyle v. Commissioner*, 147 F.(2d) 769, 771 (4th Cir. 1945): "But, in the instant case, we do not find that the tree-and-fruit metaphor, despite its figurative charm, is of great assistance in solving our problem. . . . Yet, here, as we view the situation with all the dispassionate calm at our command, the tree appears, by some subtle economic alchemy, to have been virtually transmuted into the fruit." See also, Eisenstein, *Some Iconoclastic Reflections on Tax Administration*, 58 HARV. L. REV. 477, 494 (1945): "But it is not always a simple matter to distinguish the 'tree' from 'the fruits' and the metaphor may easily be expanded to include such additional refinements as 'the seed' and 'the branch.'" Soll, *Intra-Family Assignments: Attribution and Realization of Income*, 6 TAX L. REV. 435, 443-44 (1951).

¹⁶ INCOME TAX STATUTE A. L. I. 8 (Tent. Draft No. 1, 1949).

¹⁷ See note 1 *supra* and accompanying text.

¹⁸ *Lucas v. Earl*, 281 U.S. 111 (1930), is clearly at the foundation of this attribution. Most of the other important limitations on the ability to secure reallocation of income have also been engrafted on Section 22(a) of the Internal Revenue Code.

¹⁹ 281 U.S. 111 (1930).

entitled to half (under a contract apparently untouched by any tax motives when made) the taxpayer argued that his wife should be taxed on that half and the earner taxed only on his half. But all was taxed to the assignor. The court said: ²⁰

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Motive in this connection thus became completely immaterial. Control by the husband over the income thus assigned was considered by some, however, to be at the basis of the decision.²¹ It was believed that the material factor was not as much the fact that the husband earned the income as that he controlled it, if only in the negative way that he could discontinue his services and thus cut off the flow of income.²² Thus it was believed that where the income antedated the assignment, the income shifting would stand.

Helvering v. Eubank,²³ in 1940, settled this matter. There an insurance agent attempted to assign his renewal commissions on insurance business previously obtained. No future services were necessary to perfect the right to receive the income; it was contingent merely upon the renewal by policy holders of their policies. No vestige of control could be found. But the choice of the taxable person in this area was not made to rest upon control, but on the simple fact that the assignor earned the income.

The principle that income from services should be taxable to the earner without regard to the question of control is further borne out by the taxation of income to the earner despite the fact that he assigns it to a charity over which he has no control,²⁴ or where he simply refuses to accept it,²⁵ or where it goes directly to a trustee in bankruptcy for the benefit of creditors.²⁶

²⁰ *Id.* at 114-15.

²¹ See Soll, *supra* note 15, at 438 citing Magill, *Taxable Income* 257 (1936) and others. See also Commissioner v. Bateman, 127 F.(2d) 266, 272-73 (1st Cir. 1942); *Matchette v. Helvering*, 81 F.(2d) 73, 74-5 (2d Cir. 1936).

²² *Matchette v. Helvering*, 81 F.(2d) 73, 74-5 (2d Cir. 1936).

²³ 311 U.S. 122 (1940).

²⁴ U.S. Treas. Reg. 111, § 29.22(a)-2(b) (1943). *Contra*: Commissioner v. Giannini, 129 F.(2d) 628 (9th Cir. 1942); Commissioner v. Bateman, 127 F.(2d) 266 (1st Cir. 1942).

²⁵ *Hedrick v. Commissioner*, 154 F.(2d) 90 (2d Cir. 1946).

²⁶ *Parkford v. Commissioner*, 133 F.(2d) 249, 251 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943).

A close question may arise, however, as to whether income is truly the result of mere services or of capital.²⁷ Where the former predominates, taxation of the donor may be expected.²⁸ Thus, in *Hogle v. Commissioner*,²⁹ a father, whose business was that of broker, created a trust for his children consisting of a trading account, which the father operated in connection with his other operations. The funds remained in the father's possession. When profits resulted from trading, the income was taxed to the father rather than to the trust, the court stating that: "In substance, he [Hogle] gave to the trust in each of those years the profits derived from a designated portion of his individual efforts."³⁰ With respect to non-trading gains, however, the trust was taxable, these being attributed to the property rather than to the services.

Several recent cases dealing with income resulting from farm stock suggest a different conclusion in the case of an activity of that character,³¹ but it is submitted that those cases do not cut the rationale of the *Hogle* case, and may be of doubtful value.

Further discussion of the attributability of income as to either services or capital, and the problem of apportionment as between them is reserved until later as is a discussion of both the attribution and the realization problem suggested by the farm cases.

While the principle that income from services will be ascribed to the person who performs the services, irrespective of control or other extraneous factors, needs little qualification; the principle that income from capital will be ascribed to the owner of the capital does not weather the test of the decisions so well.

At the outset, it might be well to consider whether it should. Assume family A has an income of fifty thousand dollars derived entirely from the father's personal services. Compare it with family B which has an income of the same amount derived entirely from the father's investments. It appears that in no instance could family A reallocate its income so as to minimize surtaxes. But since ownership of property is readily transferable, family B has definite possibilities of such reallocation.

Nor will the principle that income from capital is to be ascribed to the owner of the capital stand too invulnerably if we qualify it by saying that "legal" ownership does not necessarily mean the same thing as "tax"

²⁷ This question is dealt with in connection with earnings from a partnership, *infra*.

²⁸ Thus, there can be no assignment of income from a business or profession, the income of which is derived from fees, commissions, or other payments or gains from services.

²⁹ 132 F.(2d) 66 (10th Cir. 1942).

³⁰ *Id.* at 71.

³¹ *Visintainer v. Commissioner*, 187 F.(2d) 519 (10th Cir. 1951) (where a rancher branded cattle for his children and raised them with the rest of his stock); *Alexander v. Commissioner*, 194 F.(2d) 921 (5th Cir. 1952) (same).

ownership. But it helps. A strange tax concept of what is property for these purposes enters the picture as well; retained control, and a retained reversionary interest after a relatively short grant also take on a significance which a bland recitation of the principle will hardly accord them.

First as to the problem of ownership. It is clear that in order to escape taxation on the income from capital one must part with ownership of it. Bare legal title, however, lost its magic at a very early date as tax dates go, and we find the constantly recurring theme in the income attribution cases that taxes are not concerned with the refinements of legal title.³²

Ownership involves the possession of various rights in respect of property, most important of which are a *jus disponendi*, control, and rights to present enjoyment and possession of property.³³ Any retention of control militates against a contention that the ownership of property has in substance been transferred, and the issue of ownership and the issue of retained control in the tax cases are closely related. But the rights in respect of property can be split and dealt with in a multitude of patterns, particularly in the trust arrangement. Moreover, control can be achieved indirectly by strong moral influence where no legal right may exist. A strong-willed father can perhaps control property of the son to some extent even where the property was acquired by the son's own efforts; how much more can he do so when he has previously given the property to his son!

What has been termed the "ownership test" has, accordingly been the primary tool for judicial attack upon the intra-family assignment of property.³⁴ And when, as in the typical family circle, retention of a measure of control is coupled with a pre-existent degree of mutual enjoyment of property, the situation is frequently said to invite careful scrutiny.³⁵

Here, therefore, is an area which is characterized by cautious planning, careful drafting, and carefully observing rituals and rights bestowed on a donee, for which the donee himself may care little at times.³⁶

When a family transfer purports to be outright, a typical nontrust transfer, the ownership and control issues are chiefly issues of fact,³⁷ and the courts will try to find underlying realities which belie appearances. A wide variety of circumstances has been looked into in this regard.³⁸

³² *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

³³ RESTATEMENT, PROPERTY § 10, comment b (1936).

³⁴ *Soll*, *supra* note 15, at 440.

³⁵ See, e.g. H.R.REP. No. 586, 82d Cong., 1st Sess. 33 (1951); *Helvering v. Clifford*, 309 U.S. 331, 335 (1940).

³⁶ For cautions in this area, particularly in connection with trusts, see *Lourie, Marital Settlements and Family Gifts*, 30 TAXES 522, 523-26 (1952).

³⁷ See Paul, *Restatement of the Law of Tax Avoidance* in STUDIES IN FEDERAL TAXATION 150-1 (1937).

With respect to transfers in trust the issue will often be the extent of retained control, to be determined by a reading of the trust instrument, giving the broadest possible interpretation to any powers which the grantor has retained.³⁹ This rule of law, besides being well defined judicially, has received legislative sanction.⁴⁰

*Blair v. Commissioner*⁴¹ involved a life beneficiary of the income of a trust who assigned this income to his children for the duration of his life. Previously, the Illinois Appellate Court had held that the trust of which Blair was beneficiary was not a spendthrift trust and that his assignment of his beneficial interest therein was valid. The Supreme Court held that the assignment was valid for income tax purposes as well, and that the income was taxable to the assignees. The Court pointed out that the interest under the trust which Blair possessed made him equitable owner of property which he could transfer in whole or in part, and added:⁴²

The assignment of the beneficial interest is not the assignment of a chose in action but of the "right, title, and estate in and to property." . . .

We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income, and that as to these interests they and not the petitioner were taxable. . . .

Accepting the doctrine at the base of this decision — that a beneficiary's interest in a trust is in equity an ownership of the trust res — the *Blair* case might well be cited for the proposition that assignment of an interest in property is effective of itself to change the taxable person. However, severe limitations on this case remain to be discussed. And it has been suggested⁴³ that the *Blair* case has no applicability to assign-

³⁸ The list set forth in *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949) (quoted at length on page *infra*), although dealing with a partnership, is typical of all property thus transferred.

³⁹ For a good example of such construction see *Commissioner v. Newman*, 159 F.(2d) 848 (2d Cir.) *cert. denied*, 331 U.S. 859 (1947), showing the breadth the courts will give such powers or possible powers in an intra-family situation.

⁴⁰ INT. REV. CODE §§ 166, 167.

⁴¹ 300 U.S. 5 (1937).

⁴² *Id.* at 13-14.

⁴³ Soll, *supra* note 15, at 454. Mr. Soll's contention is that the "transmutation of a pure income right into an independent property should be limited to those situations where the congressional alchemists have distilled a rule." The property concept — that the interest of a beneficiary under a trust is in equity ownership *secundum quid* of the assets of which the trust has been declared—has hardly been of congressional distillation. The writer feels that when the assignment involves any rights of substantial duration and importance, the rights themselves are property. On principle, the writer does not feel that the so-called "res test" is of any value in the attribution area than as an inverse view of the "control" or "ownership" test. In other words, in a situation where the grantor has retained so much control over the property which produces the income that he has failed to pass a sufficient "res," the income should justly be taxed to him. There is no real limitation placed by the "res test" which the "ownership test" does not already impose. Beyond that, the issue is a mere economic determination of whether income really arises from

ments of property generally, but rather should be limited to trust situations. The writer disagrees. On principle, there seems to be no reason for distinguishing the grantor's ownership in a situation where he owns the property directly as compared with the situation where his ownership is "strained" through the medium of a trustee.

A severe limitation was imposed upon the rule of the *Blair* case a short time later in *Helvering v. Horst*.⁴⁴ In that case the owner of bonds detached negotiable interest coupons from them shortly before their due date and delivered them as a gift to his son. The bonds themselves were retained. The donor was taxed on the income when it was received by the son. The rationale of the decision was indeed broad: the assignor, by assigning the coupons, had enjoyed the income, and, without receiving money, had received money's worth in satisfaction. The decision embodied a refusal to treat the coupons as property in their own right, and a failure to distinguish interest which had accrued prior to the transfer from that which accrued while the donee was owner. (The latter amount was apparently insignificant). To be noted is the short duration of any interest which the donation of the coupons gave the son in the underlying property, the bonds themselves.

*Harrison v. Schaffner*⁴⁵ further cuts the *Blair* recognition of the ability of a parent to shift income taxes by shifting interests in property to members of his family. The taxpayer in that case, beneficiary of a testamentary trust, assigned portions of the income from that trust for the following year, and that year only, to certain of her children. Again, the choice of the taxable person was involved. The assignor was taxed. The disposition was held, for income tax purposes, not a gift of property, but merely a gift of income. A single year's equitable interest in the trust res was not sufficient to be recognized as any measure of ownership in the underlying property. Said the Court:⁴⁶

But we think it quite another matter to say that the beneficiary of a trust who makes a single gift of a sum of money payable out of the income of the trust does not realize income when the gift is effectuated by payment, or that he escapes the tax by attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income, where that is its obvious purpose and effect.

Drawing the line between a *Blair* transfer and a *Harrison v. Schaffner* transfer, the court quite frankly admitted, might pose difficulties:⁴⁷

the rights parted with, or from some other source. Nor has anyone doubted that the *Clifford* doctrine, also arising from a trust situation, is equally applicable in a non-trust situation. See *Hawaiian Trust Co. v. Kanne*, 172 F.(2d) 74 (9th Cir. 1949).

⁴⁴ 311 U.S. 112 (1940).

⁴⁵ 312 U.S. 579 (1941).

⁴⁶ *Id.* at 582.

⁴⁷ *Id.* at 583.

It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor.

"Property" as a concept throughout the law has retained the perhaps fortunate characteristic of being a "nomen generalissimum," a broad term which means different things for different purposes.⁴⁸ A bond coupon in the *Horst* case, and a single year's equitable estate in a trust in the *Schaffner* case, were not property of such character as to warrant attribution of income to them. And where the property consists of merely a right in gross to receive income, it has no standing in an attribution case. Obviously the property in connection with the interest in *Horst* was the bond itself; and even though a single's equitable estate in a trust may in equity, when a trust or property problem is posed, be property, it was not a sufficient property in the assets of the trust to warrant the attribution of income to it. In either the *Horst* or the *Schaffner* case no substantial measure of the underlying income-producing property was transferred to the child. Of even further significance is the brevity of the period involved.

Additional light is shed upon this latter aspect by the doctrine arising from the case of *Helvering v. Clifford*,⁴⁹ wherein a husband declared for his wife's benefit a short term trust (five years) of securities owned by himself. The husband was trustee and in that capacity had complete administrative control over the trust. The income was payable to the wife to the extent that the husband, as trustee, in his absolute discretion might determine, and the reversionary interest remained with the husband.

The husband was taxed under Section 22(a) of the Internal Revenue Code. Three factors were controlling: (1) a reversionary interest after a short-term grant; (2) the power to control the beneficial enjoyment of the income or corpus; and (3) broad administrative control. Any one factor, said the Court,⁵⁰ would not normally be decisive. But the Clifford Regulations⁵¹ which followed as an aftermath of this decision would use any one of these on a dogmatic basis. Thus, ten years, or fifteen where the beneficiary is not an exempt organization, was set up as the limit before which attribution would not be changed. The United States Court of Appeals for the Seventh Circuit, however, has very recently quashed

⁴⁸ 12 ENCYC. SOC. SCI., *Property* 528 (1937). See also *Schuster v. Helvering*, 121 F.(2d) 643, 645 (2d Cir. 1941).

⁴⁹ 309 U. S. 331 (1940).

⁵⁰ *Id.* at 336.

⁵¹ U.S. Treas. Reg. 111, § 29.22(a)-21 (1945). See Pavenstedt, *The Treasury Legislates: The Distortion of the Clifford Rule*, 2 TAX L. REV. 7 (1946), and compare Eisenstein, *The Clifford Regulations and the Heavenly City of Legislative Intention*, 2 TAX L. REV. 327 (1947).

any such hope on the part of the Treasury for certainty and administrative convenience by calling such limitation unconstitutional.⁵²

Even though a conclusive period, if this decision is adhered to, cannot be used, it nevertheless remains true that time is a vital factor. On principle, it would seem that the mere factor of time, standing alone, should not change the attribution of income, but rather should be suggestive, along with other factors, of too much retention of control to permit taxation to the grantee as the owner.

A myriad of cases have applied the principles of the *Clifford* decision.⁵³ Generally, each case has been dealt with on its facts by the Tax Court, and generalizations beyond the broad doctrine are difficult to make. Reference will, however, be made to some of these cases in subsequent sections of this article.

The impact of the above cases has been to center litigation around Internal Revenue Code Section 22(a), the general definition of income, under which these cases arose. Several remaining principles of attribution, less difficult in theory, but of at least equal importance for present purposes remain for discussion.

Even before the present Section 166 of the Internal Revenue Code was enacted, it was established that a power of revocation with respect to the corpus rendered the settlor taxable on any property thus incompletely transferred.⁵⁴ Under Section 166 a power to revest the corpus, held either by the grantor alone, the grantor and another person, or another person alone, provided that the other person does not have a substantial adverse interest,⁵⁵ renders the grantor taxable on the income from the trust. No limitation of time within which this power may be exercised is stipulated. A power to revest the corpus at the end of five years has been held to be within the rule.⁵⁶ Even though the wording of the present Regulations would suggest that a contingent power is within the rule, the cases have held to the contrary.⁵⁷

It is interesting to observe the potential difference in result where the interest of the beneficiary is limited by an express power to revoke after the expiration of a stipulated period of time, as compared with a grant for the certain period with a reversion retained in the grantor. Only the *Clifford* doctrine's operation will tax the grantor in connection with his

⁵² Commissioner v. Clark, 202 F.(2d) 94 (7th Cir. 1953).

⁵³ For some of the more important, see Roberts, *Recent Decisions Involving Attribution of Income for Tax Purposes*, 25 N.Y.U.L. REV. 810 (1950).

⁵⁴ Corliss v. Bowers, 281 U.S. 376 (1930).

⁵⁵ For a discussion of the concept, see Brunner, *Substantial Adverse Interests*, 21 TAXES 385 (1943).

⁵⁶ Helvering v. Dunning, 118 F.(2d) 341 (4th Cir. 1941).

⁵⁷ Commissioner v. Betts, 123 F.(2d) 534 (7th Cir. 1941); Commissioner v. O'Keeffe, 118 F.(2d) 639, 642 (1st. Cir. 1941); Corning v. Commissioner, 104 F.(2d) 329, 332 (6th Cir. 1939).

retained reversion, whereas if the same operative effect is achieved with respect to the duration of the beneficiary's interest by a retained power to revoke at the end of a stipulated period, it is very possible that the grantor will be taxed without any reference to any of the *Clifford* tests. The Supreme Court has held, moreover, in a case which was companion to the *Clifford* case, that Section 166 is inapplicable in situations involving a retained reversion.⁵⁸

*Douglas v. Willcuts*⁵⁹ established the proposition that income, even though not actually received by the grantor or in fact used to discharge his obligations, but instead actually received by the beneficiary whose interest was subject to this contingency, was nevertheless taxable to the grantor. The holding in this case has been codified in Section 167,⁶⁰ which provides that if the grantor has the power to divert income to himself, he will be taxed on the income. A contingent possibility of diversion to the grantor is sufficient.⁶¹ Accumulation of income which may, upon the happening of some contingency, be paid or used for the benefit of the grantor is thus taxable to him. It makes no difference that the income was not actually so used, if it could have been. It has been held, however, that where the contingency is too remote, the grantor will not be taxed.⁶²

Of particular moment is Section 167(c). Without 167(c), as was the case when *Helvering v. Stuart*⁶³ was decided, the rules in Section 167(a) (1) and (2) would tax the grantor where the trust income could be used, even by trustees other than the grantor himself, for the support and maintenance of the grantor's minor children. This was so because such use would inure to the grantor's benefit, being the discharge of one of his obligations, and applied even though no income was actually so used. Section 167(c) limits this taxability in situations where the power exists in a trustee (but not in the grantor in his individual capacity) to the extent that the income was in fact used in satisfaction of the grantor's obligation to support. Thus saved is a common and salutary provision in trusts drafted for the benefit of children.

It is to be noted, however, that Section 167(c) is limited to income which can be used to discharge support obligations. Income which can be otherwise used for the grantor's benefit remains taxable.

⁵⁸ *Helvering v. Wood*, 309 U.S. 344 (1940).

⁵⁹ 296 U.S. 1 (1935).

⁶⁰ Note that Section 166 above discussed relates to powers retained with respect to corpus.

⁶¹ *Helvering v. Evans*, 126 F.(2d) 270 (3rd Cir. 1942) (if needed for support); *Altaier v. Commissioner*, 116 F.(2d) 162 (6th Cir. 1940) (contingency of surviving wife).

⁶² *Baker v. Commissioner*, 43 B.T.A. 1029 (1941).

⁶³ 317 U.S. 154 (1942).

Realization

In the cases and statutory provisions in the area of attribution dealt with thus far, the writer has attempted to define the areas in which a gift can be used to secure a reallocation of income. Before a consideration of particular classes of property is undertaken, however, it seems advisable to deal with the problem of realization in its bearing upon the problem of attribution. This interjection is made at this point because of the materiality of this consideration in the partnership and personal service product cases.

With respect to donated property, the present statutory scheme is designed to tax the donee of property on both pre-gift and post-gift appreciation. Thus Internal Revenue Code Section 113(a)(2) provides that the basis of property acquired by gift after December 31, 1920, shall have the same basis in the hands of the donee as it had in the donor's hands.

Realization is the "judicial proclamation of a taxable event."⁶⁴ Thus, even though there has been an increment in the value of property, that gain is not to be recognized until it has been "realized" — until some "closed transaction" establishes the gain in the form, normally, of cash or property of a different character.⁶⁵

Section 113(a)(2) has resulted generally in a nonrecognition of the donative disposition of property as an occasion for the realization of income, and this is true whether the property involved was a capital asset or a non-capital asset.⁶⁶

However, realization, like attribution, is an area primarily of judicial rather than statutory doctrine. Thus, realization is nowhere specifically defined in the Code. Realization, normally taking the form of a sale, may take the form of some "other disposition." It is conceivable that "other disposition" could be construed broadly enough to include gifts,⁶⁷ but thus far it has been limited generally to a taxable trade.⁶⁸

There is to be discerned, however, a movement in the cases toward recognition of the gift itself as an occasion for the realization of such income as accrued up to the date of the gift.⁶⁹ This movement, although

⁶⁴ See Soll, *Intra-Family Assignments: Attribution and Realization of Income* (second installment), 7 TAX L. REV. 68 (1951).

⁶⁵ Or such gain might be accrued and more or less incontrovertible right to receive cash or other property. See *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932).

⁶⁶ The realization cases make no distinction between capital assets and non-capital assets realizations. Thus, *Burnet v. Logan*, 283 U.S. 404 (1931), dealing with a capital asset, freely employed non-capital asset cases.

⁶⁷ Soll, *supra* note 64, at 77.

⁶⁸ *Id.* at 78.

⁶⁹ See Note, *Gratuitous Disposition of Property as Realization of Income*, 62 HARV. L. REV. 1181 (1949).

it finds no clear rejection, also finds no recognition in the Supreme Court cases, unless in isolated statements.⁷⁰

The relation of the doctrine of realization to that of attribution is nowhere better pointed out than in the problem posed in I. T. 3932.⁷¹ There, a father, who was in the business of raising cattle, made a complete and bona fide gift to his son of some half-grown cattle. At the time of the gift to his son there had been a considerable increment in their value. The son kept them for an additional period, increasing their value, and they were finally sold. The basis of the cattle in the father's hands was zero. On traditional attribution and basis rules, unless *Horst* stands for as broad a proposition as the Commissioner there contended,⁷² the father should be taxed on nothing, and the cattle should have a zero basis in the son's hands. The income, then, upon sale, would be taxed entirely to the son — possibly even as a capital gain, if the son was not himself in the business of raising cattle.⁷³

On the other hand, if there was some defect in the transfer of economic ownership or an inordinate retention of control, a bland application of the doctrine thus far advanced would suggest that the father be taxed on the entire amount.

The position of I.T. 3932 is that the income should be taxed to the donor up to the date of transfer, and thereafter taxed to the son. It is submitted that the position of I.T. 3932 is the sound solution to harmony in the attribution doctrine. A distinction between income already accrued and income to accrue after the transfer is consistent with the economics underlying the entire judicial doctrine in this area. As has been suggested⁷⁴ a statutory provision seems appropriate to implement the doctrine as it now stands.

It will be noted, however, that a change in the realization concept on the gift of property would bring about a change, unless specific exception were made, to the very interesting results which may be achieved in the instance of a gift of appreciated property to charity.⁷⁵ Whether this exception should be made as an additional inducement to aid private charity is a discussion beyond the scope of this paper.

⁷⁰ *Helvering v. Horst*, 311 U.S. 112, 117 (1940): "Even though he never receives the money, he derives money's worth from the disposition of the coupons. . . ."

⁷¹ 1948-2 CUM. BULL. 7. See also I.T. 3910, 1948-1 CUM. BULL. 15.

⁷² The contention as to the *Horst* case made in I.T. 3932 refers to the Commissioner's position in I.T. 3910. The contention in both is that the case stands for realization by giving.

⁷³ INT. REV. CODE § 117(a). Capital assets are all property held by the taxpayer with the exception of merchandise, land and depreciable property used in trade or business, and other exceptions not material here.

⁷⁴ Soll, *supra* note 64, at 81.

⁷⁵ See Clark, *How to Get the Most Out of the Deduction for Charitable Contributions by Individuals and Business*, 6 N.Y.U. INSR. 1015 (1948).

The Problems of the Partnership Interest

There have been, perhaps, no muddier waters in the entire field of tax litigation than the family partnership controversies. The number of such controversies is, or soon will be, legion.

The history of this litigation, and the present congressional solution is significant for two reasons: First of all, the gift of a partnership interest is one of the most tax-desirable gifts of income producing property that can be made, and is thus important in itself; secondly, the pattern of this litigation and legislation is significant in bearing upon the solution of allied problems involving income producing property. To this writer, there seems a movement to be discerned toward the greater attribution of income to the transferees of property transferred within the family group, even when property other than a partnership interest is involved. The *Blair*⁷⁶ decision, in short, still has unsuspected vitality.

In the typical family partnership arrangement, one finds emphasized in bold relief the most perplexing difficulties in intra-family assignments. The business involved is frequently one which a father has established or in which he has been a dominant factor. After the gift, he is prone to remain in about the same position with respect to the whole business. Formerly, the new family partner attempted to perform "vital services" and serve a real "business purpose."⁷⁷ We shall consider to what extent these things — often reduced to mere sham⁷⁸ — remain necessary.

Perhaps the earliest attack on the family partnership is embodied in *Burnet v. Leininger*⁷⁹ in which the taxpayer, who owned a one-half interest in a partnership, agreed with his wife that she should be an "equal partner" in that interest. The taxpayer was nevertheless taxed upon his full distributive share and the wife was not regarded as being a partner in any sense. The Court followed the *Earl*⁸⁰ decision very closely in arriving at this result.

The cases of *Lusthaus v. Commissioner*⁸¹ and *Commissioner v. Tower*,⁸² decided in the Supreme Court in 1946, shed important light on the problem. The *Tower* case involved a transfer to a wife of shares of stock in a controlled corporation with the understanding that she would place the assets in a partnership to be formed. The partnership was formed, but held to be invalid for tax purposes. The test which was seized upon from this decision for the solution of partnership problems was:⁸³

⁷⁶ *Blair v. Commissioner*, 300 U.S. 5 (1937).

⁷⁷ *Dierberger, Income Splitting and Family Partnerships*, 30 TAXES 515, 516-7 (1952).

⁷⁸ *Id.* at 517. Note several amusing instances cited.

⁷⁹ 285 U.S. 136 (1932).

⁸⁰ *Lucas v. Earl*, 281 U.S. 111 (1930).

⁸¹ 327 U.S. 293 (1946).

⁸² 327 U.S. 280 (1946).

⁸³ *Id.* at 290.

If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner. . . .

The converse became the test: no original capital and no vital services yielded no income reallocation. Housewives were hard pressed to perform those vital services periodically and tracing partnership capital to the wife originally was often an impossible task.⁸⁴ Partnerships with children were virtually impossible because of the requirement of original capital contributions.

*Commissioner v. Culbertson*⁸⁵ rather unexpectedly⁸⁶ opened a new chapter in 1949. In that case a rancher had accepted his sons as partners on the basis of their promissory notes. Several of these sons had little connection with the operation of the ranch at the time, but there seemed to be intentions of a future close connection. The issue to be decided was whether an intention to contribute capital and services in the future would validate a partnership of this kind for tax purposes.

The Court, however, went beyond the bare issue of the case, and in view of the harsh results which followed the application of the standards gleaned by the lower courts from the *Tower* case, undertook to clarify its position. A “clarified” test of family partnership existence was set forth:⁸⁷

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, *considering all the facts* — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties *in good faith* and acting with a *business purpose* intended to join together in the present conduct of the enterprise. [Italics mine]

The requirements of original capital as essential to recognition of the partnership was directly attacked, and it was concluded that its absence was “not conclusive” although its absence had the effect of “placing a heavy burden on the taxpayers to show the bona fide intent of the parties to join together as partners.”⁸⁸

It was clear that no simple solution had emerged from the *Culbertson* decision by the subsequent developments in that very case. Remanded to the Tax Court, the same result as had been originally obtained was

⁸⁴ Dierberger, *supra* note 77, at 516-17; Lifton, *supra* note 1, at 465.

⁸⁵ 337 U.S. 733 (1949).

⁸⁶ It was expected that the Court would merely clarify the existing “tests” in the area of a future intention to contribute capital.

⁸⁷ *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

⁸⁸ *Id.* at 744.

reached⁸⁹ — that the Culbertson partnership was not a partnership for income tax purposes. The United States Court of Appeals for the Fifth Circuit again reversed the Tax Court.⁹⁰

Cases subsequent to the *Culbertson* case further indicate that the air had not been completely cleared of pre-*Culbertson* doctrine. Varying weight was given to the original capital and the services⁹¹ aspects. The law became more fluid, and the cases were clothed in language of intent⁹² and business purpose⁹³ as well as on the basis of ownership criterion.⁹⁴

Section 340 of the Revenue Act of 1951⁹⁵ amended the Internal Revenue Code with respect to partnerships in two places. Section 3797 (a) (2) contains the definition of a partner. Added to this definition was a statement providing that a person is to be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such capital interest was acquired by purchase or gift from any other person.

Secondly, Supplement F, the partnership supplement, was amended by the addition of the present Section 191.⁹⁶

The purpose of these provisions, the Committee Report said,⁹⁷ was "to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business." The principles of attribution of income are to be applied to family partnerships irrespective of the business benefit or lack of it to the particular partnership involved. Immediately one thinks of the sug-

⁸⁹ William O. Culbertson, Sr., P-H 1950 TC MEM. DEC. ¶50,187 (1950).

⁹⁰ *Culbertson v. Commissioner*, 194 F.(2d) 581 (5th Cir. 1952).

⁹¹ An analysis of post-*Culbertson* cases can be found in Packel, *supra* note 6, at 155-57.

⁹² *E.g.* W. F. Harmon, 13 T.C. 373 (1949).

⁹³ *Greenberger v. Commissioner*, 177 F.(2d) 990 (7th Cir. 1949).

⁹⁴ *E.g.* *McPhillips v. United States*, 85 F. Supp. 922 (S.D.Ala. 1949).

⁹⁵ 65 STAT. 511 (1951).

⁹⁶ The provisions of this section were aptly paraphrased by Dierberger, *supra* note 77, at 518:

"(1) In the case of any partnership interest created by gift, the allocable share of the income of the donee under the partnership agreement is to be recognized as the donee's income except

(a) When the shares are allocated without the allowance of reasonable compensation for services rendered by the donor to the partnership and except

(b) to the extent that the allocation to the donated capital is proportionately greater than that allocated to the donor's capital.

"(2) The distributive share of a partner in the earnings will not be diminished because of absence due to military service.

"(3) Any interest purchased by one member of a family from another is treated as a gift from the seller and as donated capital in the amount of its fair value. For this purpose the family of an individual includes his spouse, ancestors, lineal descendants and any trust for the primary benefit of such persons."

⁹⁷ H.R. REP. No. 586, 82d Cong., 1st Sess. 34 (1951).

gestion in the *Culbertson* case that a testing of motives be made, and of the remaining applicability of the *Gregory* doctrine⁹⁸ in this area.

The statute enunciates no really new principles of income attribution. The Committee Report makes it clear that it was not intended to, but rather was presented to clear some of the post-*Culbertson* confusion. More specifically, the provisions were aimed at family partnerships in which the interest of one or more of the members was acquired by gift. It reaffirms the proposition that if the transferee really owns the interest — the income-producing property — income shall be attributed to it.

Capital must be a material income-producing factor in the business. This is no more than to say that the property, the partnership interest, must be income producing before income can be attributed to it. An interest in a purely service business is therefore excluded.

It is hoping too much to expect that these provisions will alleviate to any great extent the amount of litigation in the family partnership area. As has been pointed out, there are gaps for judicial speculation.⁹⁹ The attack on any partnership interest on the basis of the "ownership test" remains open. The donor must make a fairly clean transfer. Good faith is still necessary, as always. And the matter of retained control, and the incidence of the *Clifford* doctrine in this area, are clearly to be expected as limitations.

Besides controversy in the preliminary analysis as to whether the ownership has truly been transferred for tax purposes, which will undoubtedly follow the *Clifford* approach, the lack of standards for determining when capital is a material income-producing factor will occasion difficulty.¹⁰⁰ This is, however, primarily a matter of economic analysis of the business involved, and to expect precise statutory standards on this subject would probably be to expect magic. Several pre-1951 cases, however, suggest a caveat.¹⁰¹ The precedent value of these cases is doubtful, of course, both because of their pre-1951 vintage, and also because of the failure of the courts to attempt allocation either in the attribution cases or in the partnership cases.¹⁰²

In view of our analysis thus far, both with respect to income-producing property generally, and specifically a partnership interest, there seems to be no reason why a child cannot be owner, even an outright owner, of

⁹⁸ The business purpose doctrine as based on the decision in *Gregory v. Helvering*, 293 U.S. 465 (1935).

⁹⁹ Lipton stresses these "gaps." Lipton, *supra* note 1, at 471, 476.

¹⁰⁰ See Smith, *Shifting Income Within the Family Group*, 30 TAXES 995, 998 (1952).

¹⁰¹ See notes 24-29 *supra* and accompanying text. See also Lyman A. Stanton, 14 T.C. 217 (1950).

¹⁰² See Robinson, *The Allocation Theory in Family Partnership Cases*, 25 TAXES 963 (1947), discussing the difficulty with which any allocation attempts have met. See also Lipton, *supra* note 1, at 473.

such property for tax purposes. On principle, it should make no difference whether the property is owned directly, owned by a beneficiary under a trust, or by a ward under a guardianship arrangement.

As a practical matter, however, where material amounts are involved, in view of the severe tests as to ownership and control to which such transfers are subjected, it may be very desirable to attempt these dispositions through a trust or, if appropriate, a guardianship device. Particularly is this true where the donee is a minor child who cannot be shown competent to manage property and participate in ownership activities. It is not thought that the fact of legal disability will preclude treatment of the child as owner. His natural limitations are perhaps more material. A parent who would profess to have given property to a child which he nevertheless manages and deals with as veritable owner, even if he considers himself as a sort of trustee and acts only in the child's interests, may nevertheless find himself with an insurmountable burden of proof in the Tax Court.

If the advisable solution, where the amounts involved justify the expense, is to have a third person manage the income producing property on a fiduciary basis for the child, a problem arises when a partnership interest is the property sought to be transferred.

Can a partnership interest be placed in trust for a child? At first blush, several objections appear. At common law, a trustee is severely limited as to his capacity to contract. Clearly nowhere could a trustee contract in such a way as to make beneficiaries liable as general partners. Moreover, the traditional definition of a partnership as well as that under the Uniform Partnership Act,¹⁰³ does not seem broad enough to contemplate a trust as a partner.

As to the capacity of the trustee to contract, the unlimited liability of general partners is not an insurmountable difficulty. While the trustee could not contract so as to bind the beneficiaries to unlimited liability, the trustee himself may be willing to undertake this liability in consideration of fees to be received for his risks and services.¹⁰⁴ Or an indemnity agreement might be worked out to save the trustee harmless in the event of the insolvency of the partnership. And most practical of all, there is the device of the limited partnership, which is available in most states.

Whether a trust may undertake this relationship is basically an issue for state law to resolve, but there seems to be no reason in principle why a trustee, given sufficient power in the trust instrument, cannot be a person within the meaning of that term under the Uniform Partnership Act.¹⁰⁵

¹⁰³ UNIFORM PARTNERSHIP ACT § 6(1): "A partnership is an association of two or more persons to carry on as co-owners a business for profit."

¹⁰⁴ As he would have to if he attempted to contract so broadly with respect to the trust estate. See 2 SCOTT, TRUSTS § 262(1939).

For tax purposes, it is to be noted that the definition of a partnership,¹⁰⁶ like that of a corporation,¹⁰⁷ is broader than traditional "legal" definitions.

The issue of whether a trust can be a partner has received considerable attention in the Tax Court and the lower federal courts in recent months. In the Tax Court, the trust has generally been accepted, at least to the extent that the bare fact that the partner is a trust is not sufficient to preclude its treatment as a partner for tax purposes. The *Stern* case¹⁰⁸ so held in 1950; two 1952 cases, *Sultan*¹⁰⁹ and *Brodhead*,¹¹⁰ are in accord. A 1953 case, the *Shainberg* case¹¹¹ even had implications for a professional business in that regard.

However, *Hanson v. Birmingham*,¹¹² a case in an Iowa Federal District Court, reached an opposite result, stressing the character of a partnership at common law and its apparent inconsistency with a trust relationship. In 1953, the Ninth Circuit apparently reached the same result in *Toor v. Westover*,¹¹³ but whether this is really so is doubtful, since the court in that case probably based its decision more on the bundle of rights the taxpayer retained,¹¹⁴ than on the mere fact that a trust relationship was involved, even though the court added that it was not impressed by the tax court's reasoning in *Sultan* and *Brodhead*.¹¹⁵

It seems probable that in the near future a definitive ruling that a trust may be a partner will appear on the scene. *Mim. 6767*, for example, states:¹¹⁶

The bureau does not adhere to the view that a trustee cannot in any circumstances become a partner for tax purposes, regardless of some judicial expressions of such a rule.

So too, the amendments proposed to conform the Regulations to the 1951 partnership provisions (to be discussed in detail later) definitely contemplate a trust relationship as a partner.

United States Treasury Regulations 114 § 29.191-1 *et seq.*¹¹⁷ warrant special attention both as implementing the statutory provisions previous-

¹⁰⁵ UNIFORM PARTNERSHIP ACT § 2: "Person includes individuals, partnerships, corporations, and other associations."

¹⁰⁶ INT. REV. CODE § 3797(a)(2).

¹⁰⁷ *Id.* § 3797(a)(3).

¹⁰⁸ Theodore D. Stern, 15 T.C. 521 (1950) (five judges dissenting).

¹⁰⁹ Edward D. Sultan, 18 T.C. No. 86, P-H 1952 TC REP. DEC. ¶ 18.86 (1952).

¹¹⁰ Thomas H. Brodhead, 18 T.C. No. 87, P-H 1952 TC REP. DEC. ¶ 18.87 (1952).

¹¹¹ Herbert Shainberg, P-H 1953 TC MEM. DEC. ¶ 53,068 (1953).

¹¹² 92 F. Supp. 33 (N.D. Iowa 1950), *appeal dismissed*, 190 F.(2d) 206 (8th Cir. 1951).

¹¹³ 200 F.(2d) 713, 716-17 (9th Cir. 1952).

¹¹⁴ *Id.* at 715-17.

¹¹⁵ *Id.* at 717.

¹¹⁶ 1952-1 CUM. BULL. 111, 118.

¹¹⁷ Promulgated in 17 FED. REG. 11663 (1952).

ly dealt with, and as indicating the Treasury Department's position on the meaning and implications of these provisions.

Section 29.191-1(a)(3) requires that the transaction be bona fide, and not mere sham if a partnership is to be created by one member of a family for another. It is also stated, however, that motive and business purpose, generally speaking, are immaterial.¹¹⁸ The suggestion of the importance of these things in the *Culbertson* decision¹¹⁹ is therefore rejected. It is hoping too much, perhaps, to expect these considerations to be completely removed from the judicial analysis of a transaction as being either real or sham. At least, it seems quite doubtful that an extension of the *Gregory* doctrine will ever find its way into the family partnership decisions.

As to the question of what sort of a partnership interest can be one in which capital is a material income-producing factor, the Regulations give but little help. A mere right in gross to receive a share of profits is not such an interest as will be recognized.¹²⁰ Underlying this right must be an ownership of an undivided interest in business assets to which some portion of a given business' profit can economically be ascribed. The Regulations suggest that where the income of a business consists principally of fees, commissions, or other compensation for personal services, no such interest exists.¹²¹ Where, however, substantial inventories or investment in plant, machinery, or equipment are involved, the capital will be regarded as income producing property.¹²² Application of this standard to particular businesses may pose some difficulties¹²³ but the scheme seems quite clear on principle.

As anticipated, the Regulations expressly reserve the issue of whether the ownership has in truth and in fact been transferred, and suggest only that it will be determined in the light of all the facts and circumstances of the case.¹²⁴ So, too, the issue of retention of control, direct or indirect, comes in for distinct comment. Indirect control is at least as dangerous as direct control, and the burden of proof on such an issue may be even more difficult to sustain. It will normally be evidenced by conduct acquiesced in by the purported donee.¹²⁵ That a tax counsel must give careful advice to a client contemplating a family partnership arrangement in respect to this particular problem is at once obvious.

Several significant examples of directly retained control are mentioned in the Regulations¹²⁶ and warrant special mention. None of these, it is

¹¹⁸ U.S. Treas. Reg. 111, § 29.191-1(b)(10) (1952).

¹¹⁹ *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

¹²⁰ *Accord*, *Helvering v. Horst*, 311 U.S. 112 (1940).

¹²¹ U.S. Treas. Reg. 111, § 29.191-1(a)(4) (1952).

¹²² *Ibid.*

¹²³ See note 100 *supra* and accompanying text.

¹²⁴ U.S. Treas. Reg. 111, § 29.191-1(b)(1) (1952).

¹²⁵ *Id.* § 29.191-1(b)(3).

¹²⁶ *Id.* § 29.191-1(b)(2).

said, is alone conclusive. Control over the distribution of income is first mentioned. To avoid question on the basis of such a retention of control, it seems wise to incorporate into the partnership agreement a precise formula for the division of profits, and leave the right of withdrawal fairly unfettered.

Secondly, a retained control restricting the right of the donee to withdraw and sell his interest is mentioned.¹²⁷ Also cited as an example of retained power inconsistent with a proper family partnership arrangement is the retention of ownership by the donor of certain assets essential to the business.¹²⁸ It is quite obvious that retention of the ownership of certain vital assets of a business could render effectively revocable a partnership which on its face seem quite solid.

Finally, the retention of managerial powers is cited.¹²⁹ Managerial powers, to some extent, can be retained. But where these powers are inconsistent with normal relations among partners, the partnership will probably fall under the attack of the Bureau.

It is specifically mentioned that a trustee may be a partner under the new provisions.¹³⁰ He may not, however, be so subjected to the will of the grantor as to limit his exercise of control to a mere reflection of the grantor's wishes. Limited partnerships in this regard, as in a non-trust family partnership arrangement, will be recognized if they are valid under state law.¹³¹

Section 29.191-1(b)(8) is perhaps most significant of all. It sets forth in express terms what tax advisers have probably suspected for some time in dealing with the interests of minor children. It is here expressly provided that except where it is shown that a minor child is competent (presumably in terms of natural rather than legal ability) to manage property and participate in activity in respect of property befitting an owner, the minor's interest will not be recognized unless the enjoyment of such interest is exercised by another as fiduciary for the sole benefit of the child. Use of the income from the partnership to support the child, in conformance with Internal Revenue Code Section 167, is use for the parent's rather than the child's benefit.

A theoretical argument against such a position may be made. A parent may be able to establish and maintain an impartiality in his relationship with his child in this connection such as would become a trustee. *Visintainer v. Commissioner*,¹³² for example, might be cited to show situations in which the courts have not required a third person in the relationship

¹²⁷ *Id.* § 29.191-1(b)(2)(ii).

¹²⁸ *Id.* § 29.191-1(b)(2)(iii).

¹²⁹ *Id.* § 29.191-1(b)(2)(iv).

¹³⁰ *Id.* § 29.191-1(b)(7).

¹³¹ *Id.* § 29.191-1(b)(9).

¹³² 187 F.(2d) 519 (10th Cir. 1951).

to sustain it. It might even be submitted that this position will not be inflexibly sustained any more than the *Clifford* Regulations have been followed as absolute rules.¹³³

Administrative convenience, however, strongly suggests the above rule, and the tax counsel is much less apt to find himself faced with a most difficult burden of proof in an unprofitable tax controversy if he follows it.

The Products of Personal Services

Where property assigned within a family group is property which is specifically the product of the personal efforts of the assignor, very difficult problems of income attribution arise. The tentative draft of the American Law Institute¹³⁴ regards an assignment of such property as ineffectual to change the taxable person.

The producer of a patent, a copyright, or a franchise may assign such property to a child, or a trustee for a child, and the child or trustee may in turn license its use for stipulated royalties. Shall the income thus received be taxable to the producer of the property on the theory that ultimately, he earned it, or shall it be taxable to the assignee on the theory that the ownership of the property was adequately transferred, without the retention of control, and the property itself produced the income? Stated in another form, shall the approach be that the assignment involved merely an assignment of the right to receive income, demanding a *Eubank*¹³⁵ analysis and solution, or shall the assignment be regarded as one of income producing property, requiring attribution to the assignee? Strains of either approach are to be found in the cases. And even under the latter approach, the Commissioner may attack the reality of the transfer on the basis of retention of control.

Outstanding in this area is *Commissioner v. Sunnen*¹³⁶ where the inventor had assigned to his wife certain license contracts relating to the patents he had produced. The licensee under these contracts, however, was a corporation over which the transferor had substantial control. Moreover, the corporation had a power to cancel the contracts, and the ultimate power to control the amount of the royalty. In addition, the license contracts were not exclusive. Under these circumstances, the Court did not find it necessary to meet the taxpayer's contention that the right assigned was property itself capable of producing income. The Court merely invoked the ownership and retention of control tests, and found such retention through the medium of the corporate device as to preclude treating the assignee as owner.

¹³³ See *Commissioner v. Clark*, 202 F.(2d) 94 (7th Cir. 1953).

¹³⁴ INCOME TAX STATUTE A.L.I. 8 (Tent. Draft No. 1, 1949).

¹³⁵ *Helvering v. Eubank*, 311 U.S. 122 (1940). See note 23 *supra* and accompanying text.

¹³⁶ 333 U.S. 591 (1948).

In *Straus v. Commissioner*,¹³⁷ the taxpayer, as a result of his personal services, had received a right to receive a percentage of royalties paid for the use of certain processes produced in part by him. The taxpayer assigned this interest to his wife. Nevertheless he was taxed on the royalties. The *Eubank* approach was utilized. The interest of the taxpayer in the process was never more than a contract right to be paid a certain sum in exchange for past services, and this contract right could not be property capable in its own right of producing income.¹³⁸

Some created rights, however, can be property. Recognition of this fact is to be found in the Code itself.¹³⁹ The copyright decisions, whether for the taxpayer or against him, have generally utilized the property approach, and in testing the propriety of attribution to one other than the producer have looked to the completeness of the transfer.

*Lewis v. Rothensies*¹⁴⁰ involved an assignment of royalties by an author to his children. The court explicitly worked on the premise that the royalties were the fruit of an income producing property, rather than a mere return for the personal services of the author:¹⁴¹

When an author writes a book the literary ideas embodied in the manuscript are property. When he sells it in exchange for royalties his interest in the contract by which the royalties are paid is property. Of course, the book came into being by his personal service (a term by no means restricted to services rendered by virtue of an employer-employee relationship), but so do many other kinds of income-producing property. For example, a man may build, entirely by his own labor, a boat or a wagon or a barn. If he did so and rented what he had to others, it would hardly be contended that the income was income derived from compensation for personal service.

Nonetheless, the author and not his children paid the taxes on the royalties.

The cases of *Wodenhouse v. Commissioner*, wherein two circuits reached opposite results based on assignments by the same author of manuscripts produced by him, both, nevertheless, embody a property approach to the attribution problem. In the Second Circuit,¹⁴² the court held that the assignment would stand for tax purposes, the court stating that although the husband created the story, the wife's right to receive royalties was not created by him. The Fourth Circuit,¹⁴³ in reaching a contrary result, based its decision with respect to the manuscript assignment on the retention of control by the author.

¹³⁷ 168 F.(2d) 441 (2d Cir.), *cert. denied*, 335 U.S. 858 (1948).

¹³⁸ For a good analytical discussion, see Soll, *supra* note 15, at 456-57.

¹³⁹ E.g. INT. REV. CODE § 117(a)(1)(c).

¹⁴⁰ 61 F. Supp. 862 (E.D. Pa. 1944), *aff'd per curiam*, 150 F.(2d) 959 (3rd Cir. 1945).

¹⁴¹ *Ibid.*

¹⁴² 177 F.(2d) 881, 884 (2d Cir. 1949).

¹⁴³ 178 F.(2d) 987 (4th Cir. 1949).

The cases in this area have not sufficiently crystallized the law. The theoretical difficulty is in the realization, not in the attribution area. If "A" assigns to his child the product of his personal services (or to the trustee for his benefit) and the child or his trustee then deal with the property very wisely, on economic principles it is clear that both father and child have income in the total transaction. There should be a cut-off at the time of the transfer to the child. The father should be taxed on the fair value of the product at the time of his transfer to the child, that being income from his personal services. The son should be taxed on the income which is the fair return for the use of property which is now his, as well as any gains resulting from dealing with the property as owner.

As above indicated, this approach is not fully incorporated into the tax law as yet.¹⁴⁴ There is a movement in that direction, however,¹⁴⁵ which to this writer seems to harmonize the attribution principles when, as here income results from both services and property.

Summation

The above pages have dealt with the problems of what interests may be transferred to a child to secure attribution of income to the child rather than the father, and in what manner this transfer must be effectuated in order to make it a complete and valid transfer.

The former matter is largely a matter of the economic determination of the source of income; the latter largely a question of reality. We have seen the incidence of the *Clifford* doctrine and must conclude that three vital factors limit the manner in which a transfer can be made so as to secure the benefit of income re-allocation: The duration of the interest must be substantial; control over the administration of the property must be yielded; finally, there must be no control over the beneficial enjoyment of the property.

Few occasions have arisen to make explicit distinctions between trust transfers and non-trust transfers. The *Clifford* doctrine, of course, arose in the trust area. On principle, there should be no difference in its incidence on non-trust transfers, and the courts have occasionally found its use appropriate in connection with non-trust cases.¹⁴⁶ It is submitted that it will find its way into transfers of a partnership interest even where no trust is involved. But normally, unless a trust is involved in a transfer, there is no way in which the transferor can limit the interests of the transferee, and a question merely of reality arises. Retained control is of equal significance in this area. Seldom could the question of limited duration arise apart from a trust, unless in a grant of land, or an unusual deed gift of personal property.

¹⁴⁴ See Heading "*Realization*" *supra*, at page

¹⁴⁵ See Note, *Gratuitous Disposition of Property as Realization of Income*, 62 HARV. L. REV. 1181 (1949).

¹⁴⁶ *E.g.* Hawaiian Trust Co. v. Kanne, 172 F.(2d) 74, 75-76 (9th Cir. 1949).

With respect to the former question, the attributability of income to the interest or right transferred, it should make no difference who the transferee is. As to the latter question, the manner in which the transfer must be affected, the nature of the transferee is of great practical importance.

Where a child is involved, the only safe transfer, if the child is under, say seventeen or eighteen, is one in trust or one to a guardian for administration for the child's benefit. Such transfers and such administration, however, are expensive. And if the property is such as to lend itself well to the child's custody, or unique or clearly identifiable as the child's, such administration may probably be dispensed with. With respect to a partnership interest, or property with which administrative action is necessary (like stocks in a corporation), the use of a third person as fiduciary, however, is clearly indicated.

Beyond the principles enunciated, the problems as to the actual transfer are problems for the advice of an attorney having knowledge of the particular character of the property involved and of the particular situation of the donee.

The Gift Tax Annual Exclusion

The remainder of this article will be devoted to the problem of securing the benefit of an annual exclusion in the case of a gift to a child.

In addition to the life-time exemption which a donor has under the Federal Gift Tax, Internal Revenue Code Section 1003 (b)(3) allows each donor an exclusion in each year after 1943 of the first three thousand dollars in gifts "(other than gifts of future interests in property)" to any person. By use of the split gift provision¹⁴⁷ in a family situation this amount may be effectively doubled.

Since a tax-wise donor may desire to spread his gifts to his children over a period of years, the availability of this exclusion in the case of gifts to minors is very material in determining the tax consequences of his plan.

The purpose of excluding gifts of future interest was Congressional apprehension of the administrative difficulty of determining "the number of eventual donees and the value of their respective gifts."¹⁴⁸

The term "future interest" is not defined in the statute. The Regulations state that the term is a legal one¹⁴⁹ and one case¹⁵⁰ says it is a term "that every man on the street knows of." By the more important

¹⁴⁷ INT. REV. CODE § 1000(f).

¹⁴⁸ H.R.REP. No. 708, 72d Cong., 1st Sess. 29 (1932).

¹⁴⁹ U.S. Treas. Reg. 108, § 86.11 (1943).

¹⁵⁰ *Rheinstrom v. Commissioner*, 105 F.(2d) 642, 649 (8th Cir. 1939).

case law on the subject, however, it is a term *sui generis*, and not the same as its predecessor in property law.¹⁵¹

Whether an interest is future does not depend upon state law or the vested or contingent nature of a given interest.¹⁵² Moreover, every right in property has present existence as a right.¹⁵³ The determination of whether an interest is future rests rather upon the issue of whether there is bestowed a present right of enjoyment in the donee.¹⁵⁴ Thus the Regulations define future interests as: “. . . interests . . . whether vested or contingent . . . which are limited to commence in use, possession, or enjoyment at some future date or time.” Present interest requires “substantial present economic benefit.”¹⁵⁵

There is no doubt that an interest of a life beneficiary under a trust may be a present interest within the meaning of this term under the gift tax, provided the beneficiary's enjoyment of income is present. The trustee must have a duty to pay all or a stipulated portion of the income, and this duty must be unconditional. Where the trustee is to accumulate income for a certain period of time or it is discretionary with the trustee whether to pay or to accumulate, there is no present interest.¹⁵⁶ This is so even though no accumulation is actually made.

However, a present interest under a trust can be shown where the beneficiary has a right subject to some demonstrably definite standard which will require present payments.¹⁵⁷

In the case of a child, however, there is considerable question as to whether the interest beyond an amount which is capable of being immediately consumed by him, can qualify as a present interest even though such additional amount may be theoretically available to him at the present time through the medium of his parent or guardian. The same doubt exists in the case of outright transfers, although, perhaps, to a lesser extent.

Almost all of the decisions dealing with the availability of an annual exclusion have dealt with transfers in trust. In some of these is to be found express or implied assent to the proposition that a transfer without any trust control retained cannot be a gift of future interest.¹⁵⁸ In

¹⁵¹ *Fondern v. Commissioner*, 324 U.S. 18, 20 (1945); *United States v. Pelzer*, 312 U.S. 399 (1941).

¹⁵² *United States v. Pelzer*, 312 U.S. 399, 403 (1941).

¹⁵³ RESTATEMENT, PROPERTY § 153, comment e (1936).

¹⁵⁴ *Commissioner v. Disston*, 325 U.S. 442, 447-49 (1945); *Fondern v. Commissioner*, 324 U.S. 18 (1945).

¹⁵⁵ *Commissioner v. Estate of Holmes*, 326 U.S. 480, 486 (1946).

¹⁵⁶ Cases cited note 154 *supra*.

¹⁵⁷ *Commissioner v. Disston*, 325 U.S. 442, 449 (1945). See also *Hessenbruch v. Commissioner*, 178 F.(2d) 785, 787 (3d Cir. 1950).

¹⁵⁸ *Kieckhefer v. Commissioner*, 189 F.(2d) 118 (7th Cir. 1951); *John E. Daniels, P-H 1951 TC MEM. DEC. ¶ 51,044* (1951).

the *Daniels* case a transfer in trust was regarded as an "essential ingredient" of a future interest, and it was stated that: "If it should be determined that petitioner made outright gifts to the grandchildren, then respondent Government's position cannot be sustained."¹⁵⁹

Clearly, this position is too broad. The nature of the interest transferred, even apart from any trust restriction, may preclude present enjoyment. It is clear, for instance, that an outright deed giving a remainder in real property would not bestow a present interest.¹⁶⁰ Neither would an assignment of a life insurance policy, or similar interest, where there are restrictions on the rights of the assignee under the policy.¹⁶¹

The absence of a trust is certainly not conclusive where property is involved which, of its very nature, involves restrictions on present enjoyment. But what of non-trust transfers where there are no limitations inherent in the property itself, and the only factor preventing the child's immediate ability to exhaust or otherwise use the property are his lack of present needs for the property (since his support, maintenance, comfort and education are adequately supplied from other quarters), and his present incapacity to deal with the property as owner?

Under the present state of the law, the question is left unanswered, at least conclusively.

Presumably, say several of the cases,¹⁶² Congress did not intend to discriminate against gifts to minors. And no case has gone so far as to say that the disabilities of minority should preclude in his case an exclusion which would be available were some older person involved. Some cases expressly disavow this situation, and from others its disavowal may be inferred.¹⁶³

Certain statements of the Supreme Court in the *Fondern* and *Disston* cases — cases which on their facts involved trusts — nevertheless suggest that this discrimination does exist. The applicability of these cases to a non-trust transfer may well be questioned,¹⁶⁴ but the statements themselves were not so limited. Thus, in the *Fondern* case:¹⁶⁵

Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of future interest. . . .

¹⁵⁹ John E. Daniels, *supra* note 158.

¹⁶⁰ Rosa A. Howze, 2 T.C. 1254 (1943).

¹⁶¹ Spyros P. Skouras, 14 T.C. 523 (1950). See also Dora Roberts, 2 T.C. 679 (1943) *aff'd*, 143 F.(2d) 657 (5th Cir.), *cert. denied*, 324 U.S. 841 (1945); Commissioner v. Boeing, 123 F.(2d) 86 (9th Cir. 1941).

¹⁶² E.g. *Fondern v. Commissioner*, 324 U.S. 18, 29 (1945).

¹⁶³ *Kieckhefer v. Commissioner*, 189 F.(2d) 118, 122 (7th Cir. 1951); John E. Daniels, P-H 1951 TC MEM. DEC. ¶ 51,044 (1951).

¹⁶⁴ See Rogers, *Outright Gifts to Minors and the Gift Tax Exclusion*, 7 TAX L. REV. 84 (1951).

¹⁶⁵ 324 U.S. 18, 20 (1945).

Note the use of the words "whatever" and "or donee." Can it be said that "whatever" refers merely to trust limitations, and "or donee" refers only to beneficiaries under a trust and not to other donees, particularly in view of the fact that "beneficiary" was used just before the conjunctive? If not, do not the disabilities of a minor represent such a barrier to his immediate enjoyment of such of the property as is not required for his immediate needs? ¹⁶⁶ And note the *Disston* limitation upon a present interest in the case of a trust — the amount that will be needed for maintenance, education, and support of the minor determines the extent to which an interest in that income is "present."¹⁶⁷

As above indicated, no case has dealt with the availability of an exclusion in the case of an outright transfer to a child. To pursue analysis any further even in this area, we must again look to cases involving trusts.

Relying, perhaps, on a policy of non-discrimination toward minors, trust drafters have frequently inserted in instruments, in order to make the beneficiary-child's interest present, a provision enabling the child (usually through his guardian) to call for the entire res or income.

In the case of *Kieckhefer v. Commissioner*,¹⁶⁸ the Seventh Circuit recognized such a provision as sufficient to take the gift out of the "future interest" class, but the Tax Court and the Second Circuit, relying on the *Fondern* and *Disston* cases, disagree with *Kieckhefer* and reach a conclusion completely at variance with it.¹⁶⁹ For, while the facts may be distinguishable in the case of *Stifel v. Commissioner*, the rationale is clearly opposed.¹⁷⁰

Mere availability of the property is not sufficient under the *Stifel* rule. There must be someone who can effectively make the property available; that someone must be in existence, and be free of control by the grantor. But if, under the *Stifel* rule, there must be some third person to impartially see to the minor's enjoyment of the property, it might still be doubted on principle whether even an outright gift to a child will qualify for an exclusion, in the instance where he is incapable of making an effective consumption of the property.

Beyond this, the law is speculation. The writer, however, finds it difficult to believe that the courts, faced with an outright transfer of property to a child would deny an exclusion. And it seems quite clear that if the

¹⁶⁶ See the view of Fleming that they do. Fleming, *Gifts for the Benefit of Minors*, 49 MICH. L. REV. 529 (1951); also, Fleming, *A Different View of Outright Gifts to Minors*, 7 TAX L. REV. 89 (1951).

¹⁶⁷ 325 U.S. 442, 448-49 (1945).

¹⁶⁸ 189 F.(2d) 118 (7th Cir. 1951).

¹⁶⁹ *Stifel v. Commissioner*, 197 F.(2d) 107 (2d Cir. 1952), affirming 17 T.C. 647 (1951).

¹⁷⁰ Rogers, *Stifel Stifles Kieckhefer*, 7 TAX L. REV. 500 (1952); Diamond, *Tops and Dolls — or Gifts to Minors*, 30 TAXES 987 (1952).

property is transferred to the child by way of a guardian who is uncontrolled by the donor, most courts would see fit to distinguish the broad language of the *Fondern* and *Disston* cases and avoid the discrimination toward minor's gifts which denial of an exclusion would embody. It should be clear that under the present state of the law, in order to secure the benefit of an annual exclusion, a rather narrow line must be walked in the case of minor children as donees. All writers agree¹⁷¹ that it would be most improvident to distort a scheme of distribution to obtain this end under the present state of the law.

Provisions making it mandatory upon the trustee to pay over the accrued income will normally make an annual exclusion available to the extent of the value of the income paid out. As indicated previously, there is some doubt where the income to be paid over exceeds the needs or possible uses of the minor. What has been said with respect to outright gifts beyond this extent seems equally applicable in the case of trusts.

In two District Court cases, *Strekalowsky v. Delaney*,¹⁷² and *Cannon v. Robertson*,¹⁷³ however, an annual exclusion was sustained without any reference to the actual needs of the beneficiaries. To the extent that the *Stifel* case requires some showing of the probability that the contingency set up for payment will occur, these cases are inconsistent.

The demands of the *Stifel* case, it seems, clearly prejudice dispositions to minors with respect to the annual exclusion. If it is desired to make a disposition of property to take advantage of the exclusion, and to use a trust arrangement, not only must a right of termination be given, but it must be given to someone who may effectively exercise it on behalf of the child. Further, *Stifel* suggests that the third party be free of the influence of the family in exercising his power. And finally, *Stifel*, *Fondern* and *Disston* leave considerable doubt as to whether even this will succeed except to the extent that a probability of an occasion arising for the exercise of this power can be shown.

There is in existence a suggested form for a very convenient and inexpensive "baby trust" currently used to assume this risk.¹⁷⁴

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¹⁷¹ E.g. Diamond, *supra* note 170, at 994-5.

¹⁷² 78 F.Supp. 556 (D.Mass. 1948).

¹⁷³ 98 F.Supp. 331 (W.D.N.C. 1951).

¹⁷⁴ This form is set forth in SURREY AND WARREN, CASES AND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION 493 (1952). It is discussed in Rogers, *Some Practical Considerations in Gifts to Minors*, 20 FORD. L. REV. 233, 253 (1951); Note, 53 COL. L. REV. 530, 538 (1953).