Michigan Law Review

Volume 46 | Issue 8

1948

QUASI-CONTRACTS-TAXATION-RESCISSION OF GIFTS WHERE GIFT FAILS TO ACHIEVE DONOR'S PURPOSE OF MINIMIZING FEDERAL INCOME TAXES

Charles M. Soller S.Ed.
University of Michigan Law School

Edwin F. Uhl S. Ed.
University of Michigan Law School

QUASI-CONTRACTS—TAXATION—RESCISSION OF GIFTS WHERE GIFT FAILS TO ACHIEVE DONOR'S PURPOSE OF MINIMIZING FEDERAL INCOME TAXES—A recent Michigan case, *Stone v. Stone*,[1] presents problems of complexity and far-reaching importance. The plaintiffs, husband and wife, each owned a one-half interest in a family business partnership, and each apparently reported a proportionate share of the partnership earnings for federal income tax purposes. For the purpose of further reducing taxes on the income of the family unit, each parent transferred a one-quarter interest in the partnership to one of their two minor children, and thereafter each parent and child filed separate income tax returns reporting one-fourth of the partnership earnings as individual income. Each parent, under a probate court appointment, acted as guardian for one of the children in accepting the transferred business interests. The United States Supreme Court then announced its decision in *Commissioner v. Tower*,[2] and the Commissioner of Internal Revenue accordingly refunded the income taxes paid by the wife and children and ruled that since the father managed and

[1] 319 Mich. 194, 29 N.W. (2d) 271 (1947).

[2] 327 U.S. 280, 66 S.Ct. 532 (1946). See also the companion case, Lusthaus v. Commissioner, 327 U.S. 293, 66 S.Ct. 539 (1946).

controlled the business without any contribution of services by the wife and children, the entire partnership income for the year was taxable to the father. Because the total business income was then returnable by one person instead of four, the income came within a higher surtax bracket and greatly increased the total tax, all payable by the father, who as an individual received only one-fourth of the total partnership income taxed to him. Conceding the correctness of the commissioner's determination, the plaintiffs brought action to set aside the gifts to the children. In the alternative, the father sought to recover from each guardianship estate the amount of the taxes refunded for the year, plus its pro rata share of the total increased tax.[3] The guardian ad litem, who was a neutral guardian appointed in the instant proceeding, admitted the desirability of relief by way of rescission.[4] The Supreme Court of Michigan affirmed a decree granting rescission of the transfers to the children, basing its decision on the premise that the plaintiffs had made the gifts under a mistake as to their "antecedent and existing private legal rights."[5]

I

When first enunciated, the general rule that relief may be given for mistake of fact but not for mistake of law was based upon the maxim "that every man must be taken to be cognizant of the law."[6] Although the rule and its underlying assumption may have their proper places in cases of tort and crime, the doctrine of refusing relief for mistake of law cannot be dogmatically applied in equity without ignoring historic equity principles. Consequently, where blind adherence to the doctrine would have resulted in undue hardship, the courts have found exceptions to the rule.[7] Professor Williston has asserted that "the only way apparent for the law on the subject to obtain uniformity is by the gradual broadening of these exceptions until they so far coalesce that courts will venture to put mistakes of law and fact upon the same footing."[8]

In the *Stone* case, which involved a mistake of law[9] inducing a gift, the court acknowledged the general rule and then cast about for an appropriate exception. The so-called "antecedent private legal right"

[3] Record on Appeal, pp. 8, 9, and 48.

[4] Id., pp. 23-24.

[5] Principal case at 199.

[6] Biblie v. Lumley, 2 East 469 at 472, 102 Eng. Rep. 448 (1802). For historical discussions of the development of the rule, see RESTITUTION RESTATEMENT 179-181 (1937); and 5 WILLISTON, CONTRACTS, § 1582 (1937).

[7] RESTITUTION RESTATEMENT, §§ 44-45 (1937); 5 WILLISTON, CONTRACTS, §§ 1584-1594 (1937).

[8] 5 WILLISTON, CONTRACTS, § 1581 at p. 4416 (1937).

[9] "A 'mistake of law' means a mistake as to the legal consequences of an assumed state of facts." RESTITUTION RESTATEMENT, § 7 (1937).

exception was regarded by the court as an appropriate rule to support its decree of rescission. The rationale of this exception was expressed by Lord Westbury in *Cooper v. Phibbs* as follows:

> "It is said, '*Ignorantia juris haud excusat*'; but in that maxim the word '*jus*' is used in the sense of denoting general law, the ordinary law of the country. But when the word 'jus' is used in the sense of denoting a private right, that maxim has no application. Private right of ownership is a matter of fact; it may be the result also of a matter of law; but if the parties contract under a mutual mistake and misapprehension as to their relative and respective rights, the result, is, that the agreement is liable to be set aside as having proceeded upon a common mistake."[10]

In the *Stone* case, the parties were said to be in error as to "their own 'antecedent and existing legal rights,'"[11] their "duties . . . in regard to the payment of income taxes under the requirements of Federal law,"[12] and their "power . . . to affect such rights and duties by the transfers in question."[13] Why this particular combination of words should justify relief the court failed to explain. In that respect the Michigan court was doing only what other courts have done, denying relief under the general rule or granting relief under some exception, without any satisfactory analysis of the situation or discussion of the reasons for granting or refusing relief. In its mechanical application of the "antecedent private legal right" exception, did the court reach a desirable result? The answer of course, must depend to a large extent upon a consideration of the policy factors involved.

2

Generally speaking, it would seem that where a mistake as to a basic assumption induces a transaction, rescission should be more readily available where the transaction involves a gift than where it involves a bargain. In bargain transactions, the party resisting rescission is likely to have relied on the transaction, and the consideration given by him for the performance given or promised by the mistaken party is ordinarily sufficient to place the risk of error upon the party committing it. The desirability of finality in commercial transactions dictates a policy of denying relief from a bargained-for performance, even though one of the parties entered the bargain under a misapprehension. Consequently, judicial relief from the consequences of a mistake inducing a

[10] L.R. 2 H.L. 149 at 170 (1867).
[11] Principal case at 199.
[12] Id. at 198.
[13] Ibid.

bargain transaction is ordinarily refused,[14] although under some circumstances moderate relief has been given.[15]

On the other hand, there are usually less compelling reasons for denying relief where the transaction induced by mistake is one of gift and not of bargain. When a donor's generosity is impelled by an innocent mistake of law or fact without which no gift would have been made and which places him in a position of unforeseen hardship when the mistake is discovered, then, if the donee has not changed his position in reliance on the gift, and if a restoration of the parties to their original position would not adversely affect the public interest or vested rights of third parties, rescission of the gift should be allowed. The case for rescission is even stronger if both the donor and the donee are under the same misapprehension. Given these elements, why should not rescission be granted, whether the mistake was one of law or of fact? In the absence of supervening commercial policy or public interest, if the mistake were one of fact, the court would have no trouble finding authorities supporting a decree of rescission.[16] If the mistake were one of law, then even though the court blindly binds itself to the doctrine that relief from mistake of law is not available, there seems to be no objection to resorting to a supposed "exception" in order to give the remedy, so long as relief by way of rescission is really desirable under the circumstances. There is no question of the power of a court of equity to rescind a gift; the only problem lies in the propriety of exercising that power in a given case.

Did the *Stone* case present a situation justifying rescission? The donors acted under an innocent[17] misapprehension of federal tax law, and both the donors and the donee acted under the same misapprehension.[18] The donees did not rely on the gift to their detriment, for

[14] Costello v. Sykes, 143 Minn. 109, 172 N.W. 907 (1919); Bibber v. Carville, 101 Me. 59, 63 A. 303 (1905). But see St. Nicholas Church v. Kropp, 135 Minn. 115, 160 N.W. 500 (1916), for a decision granting rescission where the parties could be restored to substantial status quo. Relief may sometimes be given whether or not the other party had reason to believe that an error had induced the bargain transaction and sought to take advantage of it. Geremia v. Boyarsky, 107 Conn. 387, 140 A. 749 (1928).

[15] Reformation is frequently given where the parties are mistaken concerning the legal effect of words chosen to express in writing a clearly understood antecedent agreement. Pinkham v. Pinkham, 60 Neb. 600, 83 N.W. 837 (1900); Wisconsin Marine & Fire Ins. Co. Bank v. Mann, 100 Wis. 596, 76 N.W. 777 (1898).

[16] Lady Hood of Avalon v. MacKinnon, [1909] 1 Ch. Div. 476; Tuttle v. Doty, 203 Mich. 1, 168 N.W. 990 (1918); Hutson v. Hutson, 168 Md. 182, 177 A. 177 (1935); In re Clark's Estate, 233 App. Div. 487, 253 N.Y.S. 524 (1931). Cf. Pickslay v. Starr, 149 N.Y. 432, 44 N.E. 163 (1896), where the possibility of the donee's detrimental reliance was emphasized in refusing the remedy.

[17] See footnote 20, infra. The donors acted on advice of "competent tax consultants." Principal case at 196.

[18] It could hardly have been otherwise, since each donor acted as legal guardian for the other's donee in receiving the gift.

although they paid taxes on the income from the interests given, the taxes were refunded,[19] and a restoration to their former position would therefore work no inequity. The transaction was purely private, and all the parties to the transaction were parties to the suit. Most important, and the point on which the court principally relied, was the complete failure of the gifts to accomplish their intended purpose.[20] Not only did the gifts fail to achieve an intended income tax saving, but they deprived one of the donors of income with which to pay taxes which were wholly disproportionate to the income individually received.[21] It is not inconceivable that the continuance of such a situation could render the donor insolvent.[22]

3

Since the gifts made in the *Stone* case were so intimately connected with the federal taxing program, an inquiry into the effect of rescission upon that program is necessary before drawing a final conclusion concerning that decision. This is not to say that a state court should consider itself an agency for the enforcement of federal tax laws, but rather that if rescission of a gift made to avoid these laws would adversely affect federal fiscal policy, an element of public interest is injected into the case which must be considered in determining the propriety of granting rescission.[23]

In order to visualize the tax consequences of rescission of gifts of interests in a family partnership, it is first necessary to inquire what

[19] Principal case at 196. Thus, the donees seemingly had the benefit of the income from the property during the period between the gift and the rescission without any liability for taxes during that period.

[20] It was argued that since the purpose of the gifts was to reduce income taxes, the donors came into court with unclean hands. Supplementary Brief for Appellees, pp. 9-10. The court summarily rejected the contention with the short answer that "a taxpayer has the legal right to attempt, by lawful means, to minimize taxes." Principal case at 199. This language paraphrased that of Gregory v. Helvering, 293 U.S. 465 at 469, 55 S.Ct. 266 (1935).

[21] This was true only as to Mr. Stone. Since the commissioner's ruling absolved Mrs. Stone of liability for taxes even on her own interest, her only complaint could be that the purpose of her gift had failed, and not that the mistake had led her as an individual into a position of hardship. Nevertheless, the court granted rescission of the gifts of both donees, without noticing that the effect of rescission was entirely different in the case of Mr. Stone than in the case of Mrs. Stone.

[22] Rescission would not be absolutely necessary to preclude insolvency, however. The court could have decreed that each guardianship estate contribute its share of the total income taxes on the entire business income, as requested by the plaintiffs as alternative relief. Record on Appeal, pp. 8, 9, and 48. Such was the relief given in a substantially comparable situation in Hardy v. Bankers Trust Co. of New York, 137 N.J. Eq. 352, 44 A. (2d) 839 (1945).

[23] Without attempting to analyze the implications, the court in the Stone case simply said that the case involved "no circumstance making restitution . . . inexpedient because opposed to public interests." Principal case at 199.

those consequences would be if rescission were denied. Although a thorough analysis of the taxation of family partnerships is beyond the scope of this comment, a few generalities should be noted.[24] First, it seems clear that where the gift is of an interest in a family partnership controlled and managed by the donor, the donor must pay federal income taxes upon the income derived by the donee from the interest transferred, so long as the donee is a member of the family and makes no substantial contribution of services to the conduct of the business.[25] The gift tax aspect of such a transfer is less clear. The problem is whether a gratuitous transfer can be considered to be a completed gift for gift tax purposes even though for income tax purposes the transfer is not sufficiently complete to relieve the transferor of liability for income taxes on the property transferred. There are two principal Tax Court decisions bearing on the issue. Unfortunately, the inferences to be drawn from these two decisions point in opposite directions. In one case, *James A. Hogle,*[26] the court held that although under the doctrine of *Helvering v. Clifford*[27] the income of an irrevocable trust was taxable to the settlor, the periodic income of the trust did not constitute additional gifts by the settlor for gift tax purposes. Because for gift tax purposes the court considered the trust income as accruing directly to the trust principal, the case seems to imply that the settlor made a completed gift at the time he created the trust, and could be held liable for a gift tax on the value of the original corpus even though he is also liable for income taxes on the trust income. Whether this implication is limited to the *Clifford* trust situation is left to conjecture. In another case, *Ernest Strong,*[28] the commissioner was attempting to collect a gift tax on a husband's transfer of a family partnership interest to his wife, although

[24] On the taxation of family partnerships in general, see 6 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 35.09 (1942); Tuttle and Wilson, "The Confusion of Family Partnerships," 9 GA. B.J. 353 (1947); Mannheimer and Mook, "A Taxwise Evaluation of Family Partnerships," 32 IOWA L. REV. 436 (1947); and Robinson, "The Allocation Theory in Family Partnership Cases," 25 TAXES 963 (1947); and Mandell and Rubinroit, "Rescinding Trusts of Family Partnership Interests," 26 TAXES 11 (1948). On the situation before the Tower and Lusthaus cases, see Barkan, "Family Partnerships Under the Income Tax," 44 MICH. L. REV. 179 (1945); and Paul, "Partnerships in Tax Avoidance," 13 GEO. WASH. L. REV. 121 (1945).

[25] Commissioner v. Tower, 327 U.S. 280, 66 S.Ct. 532 (1946); Lusthaus v. Commissioner, 327 U.S. 293, 66 S.Ct. 539 (1946); I.R.C., §§ 11 and 22 (a).

[26] 7 T.C. 986 (1946).

[27] 309 U.S. 331, 60 S.Ct. 554 (1940), holding that where the settlor of an irrevocable trust retains control over the corpus or income, he can be taxed on the income of the trust under the general income tax provisions of the Internal Revenue Code [§ 22(a)] even though not taxable under the provisions relating specifically to taxation of trust income [§§ 166-167].

[28] 7 T.C. 953 (1946), promulgated 6 days before the James A. Hogle case, but not mentioned in the latter opinion.

he had already won a decision[29] that the donor must return all the income because the original transfer was a sham. The Tax Court held that the income tax case estopped the commissioner by the principle of res judicata to claim that the same transfer was a completed gift for gift tax purposes. The holding would seem to imply that the assumption underlying the continued taxing of partnership income to one individual is so inconsistent with the concept of a completed gift of a partnership interest that the imposition of both income and gift taxes on a single transaction is precluded. Should this view correctly represent the approach of the Tax Court and should it be accepted on review, the problems arising out of the *Stone* case would be greatly simplified. The original transfer would not be taxable and would not become taxable until completed by death or a transaction recognized for income tax purposes. Had a tax been paid it would be recoverable. And it should be immaterial whether rescission of the transfer was obtained.

It is the *Hogle* case and its implications which would create complications deserving inquiry. If the underlying thesis of this case were to be developed and carried over to the field of family partnerships, it seems highly possible that if the donor of the partnership interest cannot rescind under local law he may be held liable not only for income taxes on the interest given, but for gift taxes on the original transfer as well.[30] As for estate taxes, however, it is unlikely that the same property would be considered as a part of his estate.[31]

If rescission of the intended gift is decreed, the tax consequences are considerably altered. First, the donor is, as before rescission, still liable for federal income taxes on the property,[32] but the income is again flowing to him and he is consequently in a better position for making tax payments. Second, the property is clearly brought back into the donor's estate, and will be taxable to him for estate tax purposes if he retains it until death.[33] Again, the gift tax aspect is not settled. If the donor paid no gift tax at the time of the original transfer, and rescinds before such a tax is paid, it would seem that the commissioner would have no claim for gift taxes on the original transfer, but that he might be able to claim that the income received from the property by the donee between the time of the original transfer and the rescission

[29] Grant v. Commissioner, (C.C.A. 10th, 1945) 150 F. (2d) 915.

[30] I.R.C., §§ 1000 (a), 1001, and 1005. Under the 1948 Revenue Act, these provisions subject the donor to gift tax liability on only one-half the value of the gift if the other spouse consents in a specified manner. I.R.C., § 1000 (d).

[31] But it is certainly arguable that where the donor retains full management and control of the business during his lifetime, gifts of interests to members of his family are gifts "intended to take effect in possession or enjoyment at or after his death" and hence are includible in his gross estate under the provisions of I.R.C., § 811 (c).

[32] I.R.C., §§ 11 and 22 (a).

[33] I.R.C., § 811 (a).

constituted gifts taxable to the donor unless on the rescission the donor also recovers that income.[34] Normally, however, where the motive for the gift was tax avoidance, the well-advised taxpayer will have paid a gift tax on the transfer in an effort to convince the authorities of the bona fides of the transaction. If that is the case, and the gift is subsequently rescinded, the donor will naturally desire to recover the amount of the gift tax so paid. If the transfer was made less than three years prior to its rescission a refund of the gift tax paid may be allowable.[35] In this situation, even though the *Hogle* case was right in assuming that a given transfer can constitute a completed gift for gift tax purposes and an incompleted gift for income tax purposes,[36] the rescission of such a transfer by decree of a state court might still support a claim for refund of the gift taxes paid on the theory that the rescission decree put the parties in their original position as if no gift had ever been made and that the commissioner must recognize the decree to that extent.[37] It is conceivable, of course, that some basis could be found for imposing a gift tax on the original donee when the property is transferred back to the original donor by the decree of rescission, since unless the donee actively contests rescission he might well be regarded as making the equivalent of a voluntary transfer. Inasmuch as the transfer is made under at least purported compulsion of a court order, however, the successful imposition of such a tax becomes a matter of considerable doubt.[38]

The validity of a claim for refund of gift taxes paid by the original transferor and the ability to resist an assessment of gift taxes on the transferee on the re-transfer depend to some degree upon the view taken of the effect of the rescission decree, that is, whether the decree avoided the transfer ab initio or whether it merely effected a new transfer as of the date of the decree. In any case, if more than three years

[34] I.R.C., § 1000 (a). The Treasury's view is expressed in I.T. 2145, 1925 INT. REV. BUL. 43. But under the Clifford trust situation, James A. Hogle, 7 T.C. 986 (1946), appears clearly to foreclose such a possibility. The arguments of the court presented in that case might well be carried over to the revoked gift situation.

[35] I.R.C., §§ 1027 (a), and 3770 (a) (1).

[36] In regard to the estate and gift tax laws, it appears that they are no longer interpreted *in pari materia*. See Smith v. Shaughnessy, 318 U.S. 176, 63 S.Ct. 545 (1943).

[37] On the question of binding the commissioner to decisions of state court proceedings to which he is not a party, see 59 HARV. L. REV. 948 (1946); 57 HARV. L. REV. 912 (1944).

[38] The Tax Court's conception of the necessary constituent elements of a taxable gift is illustrated in Adolph Weil, 31 B.T.A. 899 (1934), affd., (C.C.A. 5th, 1936) 82 F. (2d) 561. Where the original donee is a minor or otherwise incapable of making a voluntary gift absolutely binding on himself, the possibility of imposing a gift tax on the transfer back to the original donor in accordance with the decree of rescission is even more remote. Commissioner v. Allen, (C.C.A. 3d, 1939) 108 F. (2d) 961, cert. den., 309 U.S. 680, 60 S.Ct. 718 (1940) would appear to support this observation.

have elapsed since the original transfer, a claim for refund is clearly barred,[39] and the donor must rely on those provisions of the Internal Revenue Code which allow crediting of taxes paid "on a gift" if "thereafter upon the death of the donor any amount in respect of such gift is required to be included in the value of the gross estate of the decedent for the purposes of" the estate tax provisions of the code. Although these credit provisions were designed to prevent dual taxation of property, they do not necessarily afford full relief,[40] and may afford no relief at all unless after the rescission the donor keeps the transferred property identifiable as such.

There is a third situation which might well arise under the circumstances of the *Stone* case. Suppose that the gift was motivated entirely by the mistaken notion that it would result in a tax economy, but the donor, after discovering otherwise, decides not to rescind. It is doubtful that the *Stone* case would support the conclusion that every gift of such an interest is revocable, but assuming that under local law such a gift could be readily rescinded, at what stage would federal transfer taxes take their toll? It is clear that the donor must continue to pay the income taxes whether he rescinds or not. For purposes of estate tax, if the gift is rescindable at will, it is apparent that the enjoyment of the property remains subject to change by the donor, and, unless some effective means of relinquishing this power is devised, the entire value of the property transferred will be included in the donor's estate for tax purposes.[41] It would seem immaterial that the power of rescinding the transfer arose by operation of law, or that the donor had done his best to accomplish an irrevocable transfer and at no time subsequent to the transfer had the slightest intention of seeking judicial relief.[42]

As for the gift tax, if the gift is really rescindable at the will of the donor two recent cases involving voidable transfers[43] seem to indi-

[39] I.R.C., §§ 1027 (b) (1), and 3774 (a); see also §§ 813 (a) (2), and 936 (b).

[40] "For example, the credit does not compensate for any interim loss of interest on the sum paid as gift tax. If the property declines in value between the date of gift and the date of death, the credit is computed upon the basis of the lower value. Moreover, the amount of the credit is limited to the same percentage of the estate tax as the gift property bears to the entire gross estate. The credit for state death taxes is allowed against the tax imposed under the 1926 Act as reduced by the gift tax credit. The latter credit may consume a large portion of the tax which would otherwise be absorbed by the credit for state tax." 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION, § 3.12 at p. 174 (1942).

[41] I.R.C., §§ 811 (d) (1) and 811 (c).

[42] See Howard v. United States, (C.C.A. 5th, 1942) 125 F. (2d) 986 at 989, 990, for such a holding in a similar situation under a Louisiana statute making revocable all donations between husband and wife.

[43] In Estate of Sanford v. Commissioner, 308 U.S. 39, 60 S. Ct. 51 (1939), it was held that liability accrued at the time the settlor relinquished the power to modify

cate that no gift tax liability arose on the original transfer, and hence that the donor could claim a refund of the gift taxes paid even though he does not rescind the gift. A claim for recovery of such gift taxes would seem to be reinforced by the tacit assumption of the *Strong* case, discussed above. It is certainly not clear that this assumption would be followed, however,[44] and the voidable transfer cases referred to above could be sufficiently distinguished[45] to enable the commissioner to resist successfully a claim for refund until after the donor has actually rescinded his gift.

Because rescission for mistake is presumably not a self-help remedy, but requires a judicial decree available only under particular circumstances, it would seem that the donor of such a gift should be treated as having made a completed gift until he actually procures a decree of rescission. In that case, he would, under the implication of the *Hogle* case, be liable for gift taxes on the original transfer, subject to refund or estate tax credit if rescission is later decreed, but he would not be liable for estate taxes until a decree of rescission actually brought the property back into his estate.

4

If the *Strong* case were ignored, it would appear that when rescission is allowed under the circumstances presented in the *Stone* case,

in any way the beneficial interests in a trust. In Commissioner v. Allen, (C.C.A. 3d, 1939) 108 F. (2d) 961 at 962, cert. den., 309 U.S. 680, 60 S.Ct. 718 (1940), a gift by a minor was denoted "inchoate and imperfect" until the expiration of the period for disaffirmance.

[44] In a decision of the Second Circuit Court of Appeals antedating the Ernest A. Strong case, the court said: "At the bottom of respondent's contention is this implied assumption: The same transaction cannot be a completed gift for one purpose and an incomplete gift for another. Of course, that is not true, as the cases cited above make clear. Perhaps to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law." Commissioner v. Estate of Martin Beck, (C.C.A. 2d, 1942) 129 F. (2d) 243 at 246.

[45] In both the Sanford and Allen cases, cited in footnote 43, supra, it was certain that at a particular point in time the transfers would become unassailable, and if the grantor died without having exercised his power the transferred property could properly be included in his gross estate. In the case of an ordinary rescindable gift, however, unless the issue has been litigated during the donor's lifetime, there will be no certain way of determining whether the gift could in fact have been avoided. Hence, there is no absolute correlation between the estate and gift taxes in the latter case, and it may be argued that from the viewpoint of administrative expediency and practical application of the revenue laws the tax should be assessed at the time of transfer, leaving the donor to a claim for refund or estate tax credit if he rescinds at a later time. See 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION, § 16.04 (1942) for a discussion of the Allen case and its bearing upon situations where a donor makes no move to set aside a voidable transfer.

the donor remains liable for federal income taxes on the property given, and although he may be enabled to avoid the full impact of the gift tax he subjects himself to increased estate tax liability. The federal government, then, would receive approximately the same amount of revenue from income taxes whether rescission is granted or withheld, so that in this respect no question of federal policy is raised. But if rescission of gifts in the manner of the *Stone* case is permitted, will taxpayers be unduly encouraged to attempt experiments in tax avoidance? Is it desirable to have each state indirectly determine the federal tax impact upon a given type of transfer? [46] It should be noted that rescission in practical effect gives the taxpayer a declaratory judgment: he is allowed to try a certain device in the belief that it will save taxes, and, if the device fails in that respect, he can complain to the court and by rescission be placed in the same position as before the experiment was tried. The federal tax laws have consistently failed to provide any method of enabling taxpayers to secure a binding declaratory judgment or advisory opinion as to the tax consequences of a transaction which he may be contemplating. Are there strong policy factors making it inappropriate for a state court to afford this type of relief? Although such elements may present no insurmountable obstacle to the efficient functioning of the federal fiscal program, they are at least factors affecting federal fiscal policy which should be kept in mind in appraising the result of the *Stone* case.

But even if it be conceded that there is no objectionable policy to the remedy, the taxpayer should note that rescission may cause him to lose the tax saving inherent in lower gift tax rates, and he would do well to avoid this type of relief assiduously. His decision in that respect, however, must necessarily depend upon his own financial position and the economic feasibility of paying income taxes on the income received by another person.

5

Except for its possible impact on federal fiscal policy, equitable relief in the circumstances presented in the *Stone* case seems singularly appropriate. The donees were minors, and a resort to legal process was consequently necessary. The parties were not attempting to obtain a rescission as a means of avoiding payment of taxes. Where it appears that, in seeking a judicial decree, the parties were practicing tax avoid-

[46] It is interesting to note that a bill recently proposed in Congress would provide that taxation of income from family partnerships was to be governed by the validity of the partnership under the law of the state where the partnership was created and doing business, a question considered totally inapplicable under the Lusthaus and Tower cases. The bill proposes only a limited application, however. H.R. 6086, 80th Cong., 2d sess., April 1, 1948.

ance, a state court might well refuse to allow itself to become a party to the scheme and refuse relief as being "inexpedient because opposed to public interests."[47] Where the donee actively contests the petition the court might be led to a different result. If mixed motives induced the transaction, as where the desire to make a gift was foremost in the donor's mind, but he felt that he was able to do so because he might thereby reduce his income tax, the court might consider that there were circumstances "making restitution inequitable to the donees,"[48] and perhaps limit the relief to apportionment of the tax.[49] If the gifts were made after the Supreme Court decision that gifts of family partnership interests leave the income taxable to the donor, a state court might deny both rescission and apportionment on the supposition that one who makes a mistake under such circumstances deserves no relief.

The rationale of the *Stone* case, extended to its logical extreme, may seem to embrace every transfer induced by an abortive attempt at tax economy. Although the income-splitting provisions of the 1948 Revenue Act[50] make the question of gifts between spouses as a method of saving taxes almost academic, there is still the question of gifts made to persons other than the donor's spouse, as in the *Stone* case, or made to the donor's spouse in ignorance of the new changes in the law, or made to the donor's spouse prior to the effective date of the new act.[51] In these situations, the availability of rescission as a remedy for rectifying mistakes inducing the gift remains a highly important problem.

The doctrine of rescission might also be carried over to the so-called *Clifford* trust, where the settlor, although not coming within the express provisions of the Internal Revenue Code relating to taxation of trust income to the settlor,[52] is nevertheless held to be taxable because of retention of control over the trust corpus or its income.[53] Since "a trust can be rescinded or reformed upon the same grounds as those upon which a transfer of property not in trust can be rescinded or reformed,"[54] a mistake as to the tax consequences of a trust, if it was the element inducing the creation of the trust, might well justify rescission,

[47] Principal case at 199.

[48] Id.

[49] As in Hardy v. Bankers Trust Co. of New York, 137 N.J. Eq. 352, 44 A. (2d) 839 (1945).

[50] I.R.C., § 301.

[51] The act was enacted over Presidential veto on April 2, 1948. The provisions relating to splitting of income are retroactive to January 1, 1948. I.R.C., § 305.

[52] I.R.C., §§ 166-167.

[53] Under I.R.C., § 22 (a). Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554 (1940). The commissioner's regulations under this doctrine are found in INCOME TAX REG., § 29.22(a)-21.

[54] 2 TRUSTS RESTATEMENT, § 333 (1935).

or, as one case has already held,[55] apportionment of the income tax burden. In view of the *James A. Hogle* case, however, discussed above, the possibility of a gift tax refund would seem to be quite remote even if rescission of the transfer were granted.

Although equitable relief in these instances gives to the taxpayer what is practically a determination of the tax consequences of a given transaction without irrevocably binding him to carry out the transaction as originally planned, the remedy is an exceedingly costly process. The *Stone* case suggests one argument for the need of some procedure for determining matters of this nature by way of advisory opinions or declaratory judgments. A method recently proposed by the Treasury Department[56] for alleviating the tax burden is its apportionment by allowing the grantor to obtain reimbursement from the trustee of a fair proportion of the tax which the grantor must pay on income received by the trustee. Unless such a reform is provided, a considerable volume of litigation proceeding upon the theory of the *Stone* case can be expected. Although this is not necessarily undesirable, the courts would do well to proceed advisedly, examining carefully the facts of each case, and remembering that easy rescission may put a premium on attempts at avoidance and interfere with federal fiscal policy to an unnecessary extent.

Charles M. Soller, S. Ed.
Edwin F. Uhl, S. Ed.

---

[55] Hardy v. Bankers Trust Co. of New York, 137 N.J. Eq. 352, 44 A. (2d) 839 (1945).

[56] A joint study by an Advisory Committee to the Treasury Department and by the Office of the Tax Legislative Council with the cooperation of the Division of Tax Research and the Bureau of Internal Revenue, FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX 51 (1947).