

Chapter 6: Attribution of Income

A. Introduction

Once it is determined that some accession to wealth constitutes taxable income, it then remains to be determined who must report the income. Because we have always had progressive tax rates, it matters to the government whether a certain item of income is taxable to one taxpayer or to another, at least when they are in different marginal tax brackets. Taxpayers often attempt to shift the attribution of income to lower bracket taxpayers. Recall the basis rule in §1015 applicable to transfers by gift: appreciation in the gifted property is not taxed to the donor but ultimately will be taxed to the donee, and the donee often is in a lower tax bracket than the donor.

B. Transfers Between Spouses and Ex-Spouses

Spouses are permitted to file a joint return combining their income onto a single tax return, although they are not required to do so. The decision can be made annually, with the election made by submitting a joint return.¹ One might conclude from this possibility that spouses cannot engage in a taxable transaction with one another, but that is not true. For example, one spouse can pay a salary to the other, and both the salary and the business deduction (if payment of the salary generates a business deduction) are taken into account separately and are reported on their joint return.²

However, §1041(a) provides that no disposition of property between spouses can be treated as a taxable transaction. Instead, any transfer of property between spouses is treated as a gift to the recipient spouse, §1041(b)(1), with basis determined not under §1015 but rather always treated as carryover from the transferor spouse, §1041(b)(2). Note that if one spouse purchases property from the other spouse, the two transfers are each treated as separate gifts. Finally, note that §1041 applies whether the marital couple files jointly or separately.

These rules in §1041 also apply to a transfer between ex-spouses so long as the transfer is “incident to divorce,” §1041(c), where “incident to divorce” means the transfer takes place within one year of the end of the marriage or, if later, is “related” to the cessation of the marriage.³ Note, though, that §1041 does not apply to transfers between prospective spouses in anticipation of marriage so that, for example, the transfer of appreciated property as part of the execution of a pre-nuptial agreement will be a taxable event to the transferor.⁴

¹ See §6013.

² Reg. §1.1041-1T (A-4).

³ See Reg. §1.1041-1T(A-7).

⁴ *United States v. Davis*, 370 U.S. 65 (1962).

Question

Q-1. H and W, husband and wife, are contemplating divorce. They have only a single asset, their personal residence worth \$500,000 and with an adjusted basis in the hands of W of \$100,000. In order to equally divide the value of their asset, W borrows \$250,000 from a bank with the loan secured by the house. W then deeds the house, subject to the debt, to H. W retains the loan proceeds of \$250,000. Does this transaction represent a fair division of their asset?

C. Attribution of Income from Labor

Lucas v. Earl

281 U.S. 111 (1930)

MR. JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the circuit court of appeals, 30 F.2d 898. A writ of certiorari was granted by this Court.

By the contract, made in 1901, Earl and his wife agreed

"that any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship."

The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 approved February 24, 1919, c. 18, §§ 210, 211, 212(a), 213(a), imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid," § 213(a). The provisions of the Revenue Act of 1921, in sections bearing the same numbers are similar to those of the above. A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that, taking the question more technically, the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because, however the matter might stand between husband and wife, he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to

say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. 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.

Judgment reversed.

Questions

Q-2. Why was any revenue at stake?

Q-3. Did the Supreme Court ignore the contract between Mr. and Mrs. Earl?

Q-4. We know that the contract was not made as a tax-avoidance device. Why, then, was Mrs. Earl not taxed on her half of the income?

Q-5. Suppose an entertainer offers a public performance with all proceeds paid directly to a charitable organization. How should the analysis proceed? Note that Reg. §1.61-2(c) provides that if services are provided directly to an organization described in §170, no income need be imputed to the service provider. But if services are rendered to a third party with payment made to such an organization, income *is* imputed to the entertainer. What is the government's basis for such a rule? Section 170 defines organizations as to which contributions are deductible – subject to certain dollar limitations -- by the contributor.

Poe v. Seaborne

281 U.S. 191 (1930)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Seaborn and his wife, citizens and residents of the State of Washington, made for the year 1927 separate income tax returns as permitted by the Revenue Act of 1926.

During and prior to 1927, they accumulated property comprising real estate, stocks, bonds and other personal property. While the real estate stood in his name alone, it is undisputed that all of the property, real and personal, constituted community property, and that neither owned any separate property or had any separate income.

The income comprised Seaborn's salary, interest on bank deposits and on bonds, dividends, and profits on sales of real and personal property. He and his wife each returned one-half the total community income as gross income, and each deducted one-half of the community expenses to arrive at the net income returned.

The Commissioner of Internal Revenue determined that all of the income should have been reported in the husband's return, and made an additional assessment against

him. Seaborn paid under protest, claimed a refund, and, on its rejection, brought this suit.

The district court rendered judgment for the plaintiff (32 F.2d 916); the Collector appealed, and the circuit court of appeals certified to us the question whether the husband was bound to report for income tax the entire income, or whether the spouses were entitled each to return one-half thereof. This Court ordered the whole record to be sent up.

The case requires us to construe §§ 210(a) and 211(a) of the Revenue Act of 1926 and apply them, as construed, to the interests of husband and wife in community property under the law of Washington. These sections lay a tax upon the net income of every individual. The Act goes no farther, and furnishes no other standard or definition of what constitutes an individual's income. The use of the word "of" denotes ownership. It would be a strained construction, which, in the absence of further definition by Congress, should impute a broader significance to the phrase.

The Commissioner concedes that the answer question involved in the cause must be found in the provisions of the law of the state as to a wife's ownership of or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor?

The answer is found in the statutes of the state and the decisions interpreting them.

These statutes provide that, save for property acquired by gift, bequest, devise, or inheritance, all property however acquired after marriage by either husband or wife or by both is community property. On the death of either spouse, his or her interest is subject to testamentary disposition, and, failing that, it passes to the issue of the decedent, and not to the surviving spouse. While the husband has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co-owner. The wife may borrow for community purposes and bind the community property. *Fielding v. Ketler*, 86 Wash.194, 149 P. 667. Since the husband may not discharge his separate obligation out of community property, she may, suing alone, enjoin collection of his separate debt out of community property. *Fidelity & Deposit Co. v. Clark*, 144 Wash. 520, 258 P. 35. She may prevent his making substantial gifts out of community property without her consent. *Parker v. Parker*, 121 Wash. 24, 207 P. 1062. The community property is not liable for the husband's torts not committed in carrying on the business of the community. *Schramm v. Steele*, 97 Wash. 309, 166 P. 634.

....

Without further extending this opinion, it must suffice to say that it is clear the wife has, in Washington, a vested property right in the community property equal with that of her husband, and in the income of the community, including salaries or wages of either husband or wife, or both. . . .

In the *Earl* case, a husband and wife contracted that any property they had or might thereafter acquire in any way, either by earnings (including salaries, fees, etc.) or any rights by contract or otherwise, "shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants. . . ." We held that assuming the validity of the contract under local law, it still remained true that the husband's professional fees, earned in years subsequent to the date of the contract, were his individual income, "derived from salaries, wages, or compensation for personal service" under § 210, 211, 212(a) and 213 of the Revenue Act of 1918. The very assignment in that case was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which it could operate. That case presents quite a different question from this, because here, by law, the earnings are never the property of the husband, but that of the community.

....

The district court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective incomes, and its judgment is

Affirmed.

Questions

Q-6. The Supreme Court said that the husband's income should be taxable equally to each spouse because "the use of the word "of" [in §61] denotes ownership." Cannot the same reasoning be applied to the Earls? If so, why did the cases come out differently?

Q-7. Unlike in *Earl*, this case did not involve consensual income splitting. Does that mean it offers less opportunity for tax manipulation? In fact, after *Poe v. Seaborn*, several states adopted community property laws, allowing their citizens to exploit the opportunity offered by *Seaborn*. In 1948, Congress eliminated the need for such statutory manipulation by enacting the marital joint return.

Notes

1. *The Marriage Penalty*. How should a marital community be taxed? Initially, the marital community's taxable income reported on a joint return was divided in two, the applicable tax rate was applied to that amount, and then the total tax liability was set equal to twice that amount (i.e., twice the tax on half the amount). This had the advantages that (1) a marital community was taxed the same regardless of the division of income among the spouses, and (2) a marital community never paid more after marriage than the two members of the community paid separately prior to the marriage. Do you see why?

Starting in 2018, the tax rates applicable to married couples filing a joint return are as described above other than when their combined income is greater than \$500,000. Compare §1(j)(2)(A) with §1(j)(2)(C). Note that for married couples filing separately, the brackets are exactly half of the married filing jointly brackets for all income levels.

Congress has largely eliminated any tax increase arising from marriage. But as a result, there can be a significant tax increase occasioned by divorce. Consider, for example, a marital community in which one spouse generates \$400,000 of income and the other generates no income. While married, this couple will owe a tax liability of \$91,379; once divorced, their combined tax liability will equal \$115,689. If it is true that two can live (almost) as cheaply as one, what is the effect of this divorce penalty? Note that if a marital community's income is to be taxed uniformly regardless of the division of taxable income among the spouses, then there must be a marriage penalty or a divorce penalty (or both) if their combined income exceeds the lowest bracket.

2. *Attribution inconsistent with applicable law.* In *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972), a bank holding company created an insurance subsidiary to provide credit life insurance to customers of the bank that took out loans. The lending banks generated the insurance policies, and it was industry standard for an insurance company to remit a significant fraction of the initial policy payment to whomever generated the policy. However, applicable federal law precluded a national bank from being compensated for insurance generation, and so the insurance subsidiary did not pay any commission to the lending banks. Because the insurance subsidiary had a lower average tax rate than the lending bank, the failure to pay commissions reduced the group's combined tax liability. The Commissioner argued that the lending bank should be imputed a commission despite the legal inability to receive it, but the Court held for the taxpayer, refusing to attribute income to a taxpayer who was legally precluded from receiving it.

Questions

Q-8. Suppose US athletes participating in Olympic Games must agree that during the period of the Games, autographs to fans will be offered for \$20 payable to the USOC. Who is taxable on the autograph fees?

Q-9. A US multinational corporation owns a foreign subsidiary that extracts oil and sells it to its US parent for refining and eventual sale. Assume the cost of extraction is \$10 per unit, the cost of refining is \$55 per unit, and the eventual sale price is \$100 per unit for a net profit of \$35 per unit. Assuming the income tax on profits earned off-shore is less than the income tax on profits earned in the US, presumably the foreign subsidiary will sell the crude oil to its parent for something around \$99. How should the IRS respond? What if the government of the country where the oil is extracted imposes a minimum sale price on extracted oil of \$99: can the IRS reallocate the profits despite such a law?⁵

⁵ See *Exxon Corp. v. Commissioner*, T.C. Memo 1993-616 and §482.

D. Attribution of Income from Capital

Blair v. Commissioner

300 U.S. 5 (1937)

Mr. Chief Justice Hughes delivered the opinion of the Court.

This case presents the question of the liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the tax years and which the trustees had paid to them accordingly.

The trust was created by the will of William Blair, a resident of Illinois who died in 1899, and was of property located in that State. One-half of the net income was to be paid to the donor's widow during her life. His son, the petitioner Edward Tyler Blair, was to receive the other one-half and, after the death of the widow, the whole of the net income during his life. In 1923, after the widow's death, petitioner assigned to his daughter, Lucy Blair Linn, an interest amounting to \$6,000 for the remainder of that calendar year, and to \$9,000 in each calendar year thereafter, in the net income which the petitioner was then or might thereafter be entitled to receive during his life. At about the same time, he made like assignments of interests, amounting to \$9,000 in each calendar year, in the net income of the trust to his daughter Edith Blair and to his son, Edward Seymour Blair, respectively. In later years, by similar instruments, he assigned to these children additional interests, and to his son William McCormick Blair other specified interests, in the net income. The trustees accepted the assignments and distributed the income directly to the assignees.

....

Third. The question remains whether, treating the assignments as valid, the assignor was still taxable upon the income under the federal income tax act. That is a federal question.

... In the *Lucas [v. Earl]* case, the question was whether an attorney was taxable for the whole of his salary and fees earned by him in the tax years, or only upon one-half by reason of an agreement with his wife by which his earnings were to be received and owned by them jointly. We were of the opinion that the case turned upon the construction of the taxing act. We said 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 skilfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it."

That was deemed to be the meaning of the statute as to compensation for personal service, and the one who earned the income was held to be subject to the tax. In *Burnet v. Leininger, supra*, a husband, a member of a firm, assigned future partnership income to his wife. We found that the revenue act dealt explicitly with the liability of partners as such. The wife did not become a member of the firm; the act specifically taxed the distributive share of each partner in the net income of the

firm, and the husband, by the fair import of the act, remained taxable upon his distributive share. These cases are not in point. The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation. There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer's retention of control.

In the instant case, the tax is upon income as to which, in the general application of the revenue acts, the tax liability attaches to ownership. *See Poe v. Seaborn, supra.*

....

The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property. By virtue of that interest, he was entitled to enforce the trust, to have a breach of trust enjoined, and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. The beneficiary may thus transfer a part of his interest, as well as the whole. 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 for the tax years in question. The judgment of the Circuit Court of Appeals is reversed, and the cause is remanded with direction to affirm the decision of the Board of Tax Appeals.

It is so ordered.

Horst v. Commissioner

311 U.S. 112 (1940)

MR. JUSTICE STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935, respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son, who, in the same year, collected them at maturity. The Commissioner ruled that . . . the interest payments were taxable, in the years when paid, to the respondent donor, who reported his income on the cash receipts basis. . . . We granted certiorari because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of *Lucas v. Earl*, 281 U. S. 111, and with that of decisions by other circuit courts of appeals.

....

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together, they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning, the revenue laws have been interpreted as defining "realization" of income as the taxable event, rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property, realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. his may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is whether, because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. . . .

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money, he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the

procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.

....

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it. . . . [I]t is the assignment by which the disposition of income is controlled when the service precedes the assignment, and, in both cases, it is the exercise of the power of disposition of the interest or compensation, with the resulting payment to the donee, which is the enjoyment by the donor of income derived from them.

....

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings, and, in both cases, the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. *See Lucas v. Earl, supra.*

Reversed.

The separate opinion of MR. JUSTICE McREYNOLDS.

The facts were stipulated. In the opinion of the court below (107 F.2d 907), the issues are thus adequately stated:

"The petitioner owned a number of coupon bonds. The coupons represented the interest on the bonds and were payable to bearer. In 1934, he detached unmatured coupons of face value of \$25,182.50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, \$25,182.50, as his own property. There was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year. The Board of Tax Appeals, three members dissenting, sustained the Commissioner, holding that the amounts collected on the coupons were taxable as income to the petitioner."

The decision of the Board of Tax Appeals was reversed, and properly so, I think.

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift, they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

Neither *Lucas v. Earl* nor *Burnet v. Leininger* supports petitioner's view. *Blair v. Commissioner*, shows that neither involved an unrestricted completed transfer of property.

....

The general principles approved in *Blair v. Commissioner*, are applicable and controlling. The challenged judgment should be affirmed.

Notes

1. *Blair* and *Horst*. In *Blair*, the Court held that the assignee was taxed on the funds she received because she became owner of the underlying property. In *Horst*, the Court held that the assignor was taxable on funds received by the assignee because the assignor retained the underlying property but assigned only some of the income from the property. In at least a formal sense, the options are consistent. But is it fair to deny "property" status to the coupon in *Horst*? That was the argument made by Justice McReynolds in his separate opinion in *Horst*.

2. *The loaf metaphor*. The *Blair* case is said to have involved a "vertical" slice of property (part of the income of the property for as long as the property exists) while *Horst* is said to involve a "horizontal" slice (a portion of the income from the property for a limited period of time).

3. *Testing the Blair/Horst distinction*. Suppose the donor in *Horst* simultaneously had made a gift of each coupon to a different family member and had retained the stripped bond. Would that change the outcome? What if the value of the stripped bond was a small fraction of the initial bond with coupons? What if he also gave the stripped bond to someone else, perhaps to a charitable organization?

4. *Further testing of the Blair/Horst distinction*. Suppose F leases Blackacre for 9 years and then immediately subleases it to a third party for \$10,000 per year. Who should be taxed on the annual rent if F gives his son the right to the first year's rent? What if F gives his son the right to all the rent for all nine years? What if he gives his son the right to rent for the first seven years and he gives to his grandchild the right to the rent for years eight and nine?

5. *Eliminating the Blair/Horst distinction*. An alternate approach would be to treat all valuable rights as "property," assign a basis to each using the usual basis rules, and then tax each party using the familiar tax provisions. For example, the following chart sets for

the various values of a 3-year, 12% simple interest bond that sells for its face value of \$1,000.

	<u>Start</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Coupon 1	\$ 107.14	\$ 120.00	----	----
Coupon 2	95.66	107.14	\$ 120.00	----
Coupon 3	85.41	95.66	107.14	\$ 120.00
"Bond"	<u>711.79</u>	<u>797.20</u>	<u>892.86</u>	<u>1000.00</u>
Total	\$1000.00	\$1120.00	\$1120.00	\$1120.00

a. Suppose Father gives coupon 1 to Son as soon as Father purchases the bond. How should they be taxed at the end of year 1? Son should take a carryover basis of \$107.14 in coupon 1, so that at the end of the year, he should be taxed on \$120.00 - \$107.14, or \$12.86. Father, on the other hand, should be taxed on the implicit interest on coupon 2, on coupon 3, and on the principal amount. That implicit interest equals $(\$107.14 - \$95.66) + (\$95.66 - \$85.41) + (\$797.19 - \$711.78)$, or \$107.14. It is no coincidence that the total interest under this method equals \$120.00, precisely what would be taxed to Father if he had not gifted coupon 1. That is, we are allocating the year's taxable income, not creating or eliminating any taxable income.

b. Suppose that Father gives coupon 2 to Son as soon as Father purchases the bond. How should they be taxed? At the end of year 1, Son should be taxed on the implicit interest on coupon 2, or \$11.48. Father should be taxed on the explicit interest on coupon 1 [\$12.86], plus the implicit interest on coupon 3 [\$10.25] and the principal [\$85.41], for a total of \$108.52. At the end of year 2, Son should be taxed on the amount he receives (\$120.00) over his adjusted basis in coupon 2 (original carryover basis of \$95.66 plus adjustment for implicit interest already taxed of \$11.48), or \$120.00 - \$107.14, or \$12.86. Father should be taxed on the implicit interest on coupon 3 and on the principal, or \$107.14.

c. Suppose Father gives coupon 2 to Son at the end of year 1. How should they be taxed? At the end of year 1, Father should be taxed on \$120.00, that being the explicit interest on coupon 1 plus the implicit interest on coupon 2, coupon 3 and the principal. Son will take a basis in coupon 2 of \$107.14, that being Father's original basis in coupon 2 plus the implicit interest on coupon 2 already taxed. Thus, at the end of year 2, Son should be taxed on \$12.86 and Father should be taxed on \$107.14.

6. *Implicit interest and the realization doctrine.* In what sense is implicit interest the opposite of depreciation? Implicit interest represents the inevitable increase in the value of a future income stream, ignoring any changes in value due to market conditions. Is it inappropriate to tax the bondholder on his implicit interest when he receives no (current) cash? Surely this method is fairer than *Horst*, where the bondholder was forced to pay tax on the full \$120.00 interest without receiving any cash. Why is a bond not just a fixed-term annuity with a balloon payment at the end? From that perspective, some of the cost of the bond should be allocated to coupon 1 as basis as described above. Is *Irwin v. Gavit*

relevant? If so, how should *Horst* have been decided? How should Father be taxed if he strips the coupons and immediately sells the naked bond?

E. A Mix of Labor and Capital

Commissioner v. Eubank

311 U.S. 122 (1940)

MR. JUSTICE STONE delivered the opinion of the Court.

This is a companion case to *Helvering v. Horst, ante*, and presents issues not distinguishable from those in that case.

Respondent, a general life insurance agent, after the termination of his agency contracts and services as agent, made assignments in 1924 and 1928, respectively, of renewal commissions to become payable to him for services which had been rendered in writing policies of insurance under two of his agency contracts. The Commissioner assessed the renewal commissions paid by the companies to the assignees in 1933 as income taxable to the assignor in that year

No purpose of the assignments appears other than to confer on the assignees the power to collect the commissions, which they did in the taxable year. The Government and respondent have briefed and argued the case here on the assumption that the assignments were voluntary transfers to the assignees of the right to collect the commissions as and when they became payable, and the record affords no basis for any other.

For the reasons stated at length in the opinion in the *Horst* case, we hold that the commissions were taxable as income of the assignor in the year when paid. The judgment below is

Reversed.

The separate opinion of MR. JUSTICE MCREYNOLDS.

The cause was decided upon stipulated facts. The following statement taken from the court's opinion discloses the issues:

"The question presented is whether renewal commissions payable to a general agent of a life insurance company after the termination of his agency and by him assigned prior to the taxable year must be included in his income despite the assignment."

"During part of the year 1924, the petitioner was employed by The Canada Life Assurance Company as its branch manager for the state of Michigan. His compensation consisted of a salary plus certain commissions. His employment terminated on September 1, 1924. Under the terms of his contract, he was entitled to renewal commissions on premiums thereafter collected by the company on policies written prior to the termination of his agency, without the

obligation to perform any further services. In November, 1924, he assigned his right, title and interest in the contract, as well as the renewal commissions, to a corporate trustee. From September 1, 1924 to June 30, 1927, the petitioner and another, constituting the firm of Hart & Eubank, were general agents in New York City for the Aetna Life Assurance Company, and from July 1, 1927, to August 31, 1927, the petitioner individually was general agent for said Aetna Company. The Aetna contracts likewise contained terms entitling the agent to commissions on renewal premiums paid after termination of the agency, without the performance of any further services. On March 28, 1928, the petitioner assigned to the corporate trustee all commissions to become due him under the Aetna contracts. During the year 1933, the trustee collected by virtue of the assignments renewal commissions payable under the three agency contracts above mentioned amounting to some \$15,600. These commissions were taxed to the petitioner by the commissioner, and the Board has sustained the deficiency resulting therefrom."

... By an assignment of future earnings, a taxpayer may not escape taxation upon his compensation in the year when he earns it. But when a taxpayer who makes his income tax return on a cash basis assigns a right to money payable in the future for work already performed, we believe that he transfers a property right, and the money, when received by the assignee, is not income taxable to the assignor.

....

The assignment in question denuded the assignor of all right to commissions thereafter to accrue under the contract with the insurance company. He could do nothing further in respect of them; they were entirely beyond his control. In no proper sense were they something either earned or received by him during the taxable year. The right to collect became the absolute property of the assignee, without relation to future action by the assignor.

A mere right to collect future payments for services already performed is not presently taxable as "income derived" from such services. It is property which may be assigned. Whatever the assignor receives as consideration may be his income, but the statute does not undertake to impose liability upon him because of payments to another under a contract which he had transferred in good faith under circumstances like those here disclosed.

As in *Helvering v. Horst*, just decided, the petitioner relies upon opinions here, but obviously they arose upon facts essentially different from those now presented. They do not support his contention. The general principles approved in *Blair v. Commissioner*, and applied in *Helvering v. Horst*, are controlling, and call for affirmation of the judgment under review.

Note

1. Was Eubank *about income from services or income from property*? Assume that there will be \$1,000 in renewals if all policy holders renew. Assume further that the value of the insurance salesman's efforts in selling the policies was \$600; that is, if he had been paid cash rather than in uncertain renewals, he would have been paid \$600. Lastly, assume that the present value of the renewal rights as of the time when they were earned was \$750. From these facts, we can determine that the \$1,000 ultimately to be collected as renewals can be divided into three amounts. Six hundred dollars represents the value of the agent's labor; \$150 represents the risk associated with nonrenewal; and \$250 represents the time value of money. It seems clear under *Earl* that at least \$600 should be taxed to the insurance agent. It seems equally clear under *Blair* that at least \$250 should be taxable to the assignee. The remaining \$150 (representing risk of nonrenewal) arguably could be considered earned income (the better the sales job, the more likely a renewal) or as unearned income (risk of default usually is part of interest). When should Eubank be taxed? Presumably when his daughter collects the renewals. *Horst*.

F. Non-Gratuitous Assignments of Income

Cotlow v. Commissioner

228 F.2d 186 (2d Cir. 1955)

WATERMAN, CIRCUIT JUDGE.

Petitioner is a life insurance agent who has been engaged since 1927 in purchasing from other insurance agents their rights to renewal commissions on life insurance policies. In 1948 he filed his individual return on the cash receipts and disbursements basis. He reported no income on account of assigned renewal commissions that year although he received during the year the total sum of \$45,500.70 from assigned commissions on 1,648 policies. Of this amount \$23,563.33 represented receipts over and above the aggregate original cost of the assignments to the petitioner, which cost had been recovered by him in the form of prior receipts. The Tax Court held, 22 T.C. 1019, that \$22,694.50 (being the \$23,563.33 less \$868.83 representing unrecovered costs of policies lapsed during 1948) was taxable to the petitioner as ordinary income for 1948. Petitioner now seeks to upset this determination on this appeal. He raises three questions: (1) whether he realized any taxable income on the receipt by him of commissions on assigned renewals; (2) if so, whether the income received is taxable as ordinary income or long-term capital gain; and (3) whether he may deduct from such income the total cost of all assignments of renewal commissions purchased in 1948.

I

Petitioner performs a form of brokerage service for life insurance agents when he converts their rights to future income into immediate hard cash. He not only performs a discounting function, but, in addition, he undertakes the risk that by lapse or termination of a policy renewal commissions will cease. We find it difficult, under

these circumstances, to view the petitioner's earnings or profits arising from the performance of these services as other than taxable income. And petitioner relies on cases which have no application to this case. *Lucas v. Earl*, 1930, 281 U.S. 111; *Helvering v. Horst*, 1940, 311 U.S. 112; and *Helvering v. Eubank*, 1940, 311 U.S. 122. The principle of those cases is that a taxpayer, despite an intra-family gratuitous assignment of income rights, remains taxable on the income which he earns by his personal services or which is derived from property which he owns. The rationale of the Horst case was that the receipt of income by the donee is an economic benefit or satisfaction to the donor, and therefore a realization of income by him. Where there is an arm's length assignment of income rights for a valuable consideration, it is clear that the assignor realizes only the amount of the consideration received, *Rhodes v. Commissioner*, 1941, 43 B.T.A. 780, affirmed 6 Cir., 1942, 131 F.2d 50, and the assignee is taxable for receipts in excess of this amount. See *Blair v. Commissioner*, 1937, 300 U.S.5; G.C.M. 24849, 1946-1 Cum.Bull. 66, 67-68.

II

[Discussion of the capital gains issues omitted.]

III

The taxpayer also contends that he should be allowed to deduct, against the profits realized in the current year, the cost of acquiring additional assignments of renewal commissions, which will start to yield payments only in future years. The cost of acquiring additional assignments of renewal commissions is a capital expenditure to be recovered by allocation against the income derived from the asset acquired; it is not, in its entirety, an "ordinary and necessary" business expense of the year of purchase.

The decision of the Tax Court is affirmed.

Notes

1. *Is there an abuse?* Is the abuse to which the assignment of income doctrine speaks present in this case? No: since the assignor (the insurance agent) received taxable proceeds on the sale, no earned income is shifted to a lower bracket taxpayer.
2. *Earned or unearned income?* Note that the purchaser will collect more than he paid for the commissions. Since that excess would have been taxable to the insurance agent but for the assignment, is there a potential for abuse? No: that excess represents compensation for (1) deferred collection of the commissions in the future and (2) bearing the risk that the policies will not be renewed. That is, it is interest income. Such unearned income should be taxed to the owner of the property producing it, and in the case of interest income, that is the person who owns the debt (and who is waiting for repayment). In this case, that is the purchaser. The insurance agent has been paid the discounted and risk-free value of his services, and that is all to which *Lucas v. Earl* speaks.
3. *Why no split decision in Eubank?* One way to explain *Cotlow* is by saying that courts will not draw the line between the earned and unearned component of a future income

stream, but when the market draws that line, the courts will follow it. In this sense the assignment of income cases are similar to *Irwin v. Gavit*. Note, though, that in *Gavit* the assignee of the income interest was given too little basis while in *Horst* the assignee of the income interest was given too much.

Estate of Stranahan v. Commissioner

472 F.2d 867 (6th Cir. 1973)

PECK, CIRCUIT JUDGE

The facts before us are briefly recounted as follows: on March 11, 1964, the decedent, Frank D. Stranahan, entered into a closing agreement with the Commissioner of Internal Revenue Service (IRS) under which it was agreed that decedent owed the IRS \$754,815.72 for interest due to deficiencies in Federal income, estate and gift taxes regarding several trusts created in 1932. Decedent, a cash-basis taxpayer, paid the amount during his 1964 tax year. Because his personal income for the 1964 tax year would not normally have been high enough to fully absorb the large interest deduction, decedent accelerated his future income to avoid losing the tax benefit of the interest deduction. To accelerate the income, decedent executed an agreement dated December 22, 1964, under which he assigned to his son, Duane Stranahan, \$122,820 in anticipated stock dividends from decedent's Champion Spark Plug Company common stock (12,500 shares). At the time both decedent and his son were employees and shareholders of Champion. As consideration for this assignment of future stock dividends, decedent's son paid the decedent \$115,000 by check dated December 22, 1964. The decedent thereafter directed the transfer agent for Champion to issue all future dividend checks to his son, Duane, until the aggregate amount of \$122,820 had been paid to him. Decedent reported this \$115,000 payment as ordinary income for the 1964 tax year and thus was able to deduct the full interest payment from the sum of this payment and his other income. During decedent's taxable year in question, dividends in the total amount of \$40,050 were paid to and received by decedent's son. No part of the \$40,050 was reported as income in the return filed by decedent's estate for this period. Decedent's son reported this dividend income on his own return as ordinary income subject to the offset of his basis of \$115,000, resulting in a net amount of \$7,282 of taxable income.

Subsequently, the Commissioner sent appellant (decedent's estate) a Notice of Deficiency claiming that the \$40,050 received by the decedent's son was actually income attributable to the decedent. After making an adjustment which is not relevant here, the Tax Court upheld the deficiency in the amount of \$50,916.78. The Tax Court concluded that decedent's assignment of future dividends in exchange for the present discounted cash value of those dividends "though conducted in the form of an assignment of a property right, was in reality a loan to decedent masquerading as a sale and so disguised lacked any business purpose; and, therefore, decedent realized taxable income in the year 1965 when the dividend was declared paid."

As pointed out by the Tax Court, several long-standing principles must be recognized. First, under section 451(a) of the Internal Revenue Code of 1954, a cash basis

taxpayer ordinarily realizes income in the year of receipt rather than the year when earned. Second, a taxpayer who assigns future income for consideration in a bona fide commercial transaction will ordinarily realize ordinary income in the year of receipt. *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Hort v. Commissioner*, 313 U.S. 28 (1941). Third, a taxpayer is free to arrange his financial affairs to minimize his tax liability. Thus, the presence of tax avoidance motives will not nullify an otherwise bona fide transaction. We also note there are no claims that the transaction was a sham, the purchase price was inadequate or that decedent did not actually receive the full payment of \$115,000 in tax year 1964. And it is agreed decedent had the right to enter into a binding contract to sell his right to future dividends. 12 Ohio Jur.2d, Corporations, sec. 604.

The Commissioner's view regards the transaction as merely a temporary shift of funds, with an appropriate interest factor, within the family unit. He argues that no change in the beneficial ownership of the stock was effected and no real risks of ownership were assumed by the son. Therefore, the Commissioner concludes, taxable income was realized not on the formal assignment but rather on the actual payment of the dividends.

It is conceded by taxpayer that the sole aim of the assignment was the acceleration of income so as to fully utilize the interest deduction. *Gregory v. Helvering*, 293 U.S. 465 (1935), established the landmark principle that the substance of a transaction, and not the form, determines the taxable consequences of that transaction. See also *Higgins v. Smith*, 308 U.S. 473 (1940). In the present transaction, however, it appears that both the form and the substance of the agreement assigned the right to receive future income. What was received by the decedent was the present value of that income the son could expect in the future. On the basis of the stock's past performance, the future income could have been (and was) estimated with reasonable accuracy. Essentially, decedent's son paid consideration to receive future income. Of course, the fact of a family transaction does not vitiate the transaction but merely subjects it to special scrutiny. *Helvering v. Clifford*, 309 U.S. 331 (1940).

We recognize the oft-stated principle that a taxpayer cannot escape taxation by legally assigning or giving away a portion of the income derived from income producing property retained by the taxpayer. *Lucas v. Earl*, 281 U.S. 111 (1930); . . . Here, however, the acceleration of income was not designed to avoid or escape recognition of the dividends but rather to reduce taxation by fully utilizing a substantial interest deduction which was available. As stated previously, tax avoidance motives alone will not serve to obviate the tax benefits of a transaction. Further, the fact that this was a transaction for good and sufficient consideration, and not merely gratuitous, distinguishes the instant case from the line of authority beginning with *Helvering v. Horst*, supra.

The Tax Court in its opinion relied on three cases. In *Fred W. Warner*, 5 B.T.A. 963 (1926), which involved an assignment by taxpayer to his wife of all dividend income respecting his 12,500 shares of general motors corporation stock, it was held the dividends were income to the taxpayer and were not diverted to the wife through the purported assignment. However, this was a mere gratuitous assignment of income

since apparently the only consideration for the assignment was ten dollars. *Alfred Leblanc*, 7 B.T.A. 256 (1927), involved a shareholder-father assigning dividends to his son for as long as the son remained with the father's corporation. The court held that in effect the father postdated his assignment to the dates when he was to receive dividends and hence the dividends were income to the father. However, here again it is apparent that at the time of the assignment there was no consideration. In *Trousdale v. Commissioner*, 219 F.2d 563 (9th Cir. 1955), a taxpayer-partner attempted to convert future ordinary income into capital by selling his partnership interest. The Ninth Circuit determined that the sale of future partnership profits cannot be converted to capital gain but must be considered ordinary income. It is significant to note that the consideration for the assignment was recognized as ordinary income in the year the assignment was executed even though several outstanding accounts were apparently not collected in full until the following year.

Hence the fact that valuable consideration was an integral part of the transaction distinguishes this case from those where the simple expedient of drawing up legal papers and assigning income to others is used. The Tax Court uses the celebrated metaphor of Justice Holmes regarding the "fruit" and the "tree," and concludes there has been no effective separation of the fruit from the tree. Judge Cardozo's comment that "metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it" (*Berkey v. Third Avenue Railway Co.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926)) is appropriate here, as the genesis of the metaphor lies in a gratuitous transaction, while the instant situation concerns a transaction for a valuable consideration.

The Commissioner also argues that the possibility of not receiving the dividends was remote, and that since this was particularly known to the parties as shareholders and employees of the corporation, no risks inured to the son. The Commissioner attempts to bolster this argument by pointing out that consideration was computed merely as a discount based on a prevailing interest rate and that the dividends were in fact paid at a rate faster than anticipated. However, it seems clear that risks, however remote, did in fact exist. The fact that the risks did not materialize is irrelevant. Assessment of the risks is a matter of negotiation between the parties and is usually reflected in the terms of the agreement. Since we are not in a position to evaluate those terms, and since we are not aware of any terms which dilute the son's dependence on the dividends alone to return his investment, we cannot say he does not bear the risks of ownership.

Accordingly, we conclude the transaction to be economically realistic, with substance, and therefore should be recognized for tax purposes even though the consequences may be unfavorable to the Commissioner. The facts establish decedent did in fact receive payment. Decedent deposited his son's check for \$115,000 to his personal account on December 23, 1964, the day after the agreement was signed. The agreement is unquestionably a complete and valid assignment to decedent's son of all dividends up to \$122,820. The son acquired an independent right against the corporation since the latter was notified of the private agreement. Decedent

completely divested himself of any interest in the dividends and vested the interest on the day of execution of the agreement with his son. . . .

The judgment is reversed and the cause remanded for further proceedings consistent with this opinion.

Note

1. *The Stranahan outcome.* The taxpayer sold the right to \$122,820 in future dividends to his Son for an immediate payment of \$115,000. Note that the excess of what the Son will receive over what he paid is nothing but interest on the immediate payment of \$115,000. Father has already been taxed on the present value of the income stream (on his receipt from Son).

Problem

P-1. Assuming *Stranahan* was decided properly, and using the facts of that case, how should taxation be allocated between father and son when the dividends of \$122,800 are paid to son, assuming son paid father \$50,000 for the dividends when the right to the dividends was worth \$115,000?

Answers to Problems

P-1. Assuming *Stranahan* was decided properly, and using the facts of that case, how should taxation be allocated between father and son when the dividends of \$122,800 are paid to son, assuming son paid father \$50,000 for the dividends when the right to the dividends was worth \$115,000?

Conceptually, we should tax Father on the accrued (i.e., present value of the) dividends, or \$115,000, regardless of what Son pays. The additional \$7,820 should then be taxed to Son as interest on his (partially purchased, partially received as a gift) capital. If, though, we try to apply *Horst* and *Stranahan*, then presumably we ought to bifurcate the transaction into a gratuitous component (controlled by *Horst*) and a nongratuitous component (controlled by *Stranahan*). Because the fair market value of the future dividends equals \$115,000 while the gross value to be received equals \$122,800, the difference of \$7,820 should be treated as interest on the present value of \$115,000. Of that \$115,000 principal amount, \$50,000 is Son's money and the remaining \$65,000 is Father's money (under *Horst*), so presumably Son should be taxed on 50/115 of the interest and Father should be taxed on 65/115 of the interest. In round numbers, that means that Son should be taxed on about \$3,400 of the interest while Father should be taxed on about \$4,400 of the interest as well as on the \$115,000 present value of the dividend stream. Note that Father will be taxed on \$50,000 when he receives the money from Son and on the additional \$69,400 when Son receives the dividend payment.