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ANTICIPATORY ASSIGNMENT OF INCOME AND THE PERSON TAXABLE UNDER THE INTERNAL REVENUE CODE

Considerations governing the choice of the taxable person and shifting of the tax burden by assignment of income have become more or less important as changes in the Federal income tax laws have been made through the years. The problem with which we are concerned is in selecting the taxable person under the income tax laws. Once this has been settled we find, by definition, that if the assignor is the person properly taxable, then there has been an anticipatory assignment of income, but if the assignee must bear the tax burden, the assignment of income is not deemed anticipatory in nature.

The first income tax law under the Sixteenth Amendment was enacted as part of the Tariff Act of 1913 and individuals, under the progressive feature of the tax, were subject to a combined normal and surtax of 7 per cent on taxable net income in excess of \$500,000 per year. Steeply graduated progressive rates did not appear until the outbreak of World War I and the Revenue Act of 1916, the peak of wartime taxes being reached with the Revenue Act of 1918 with the combined normal and surtax being 71 per cent on net taxable income in excess of \$1,000,000. Even though rates declined thereafter until the depression of 1932, extremely high tax rates on the top brackets of individual income have become a permanent feature of all subsequent revenue acts.¹ The reduction in tax liability that can be effected by individuals in the higher brackets, if they are able to shift income from one taxable person to another, is too obviously a matter of common experience to warrant further elaboration.

A measure of relief from the progressive tax rates was found in the community property states of the west and southwest,² where husband and wife, under applicable provisions of local law, were each allowed to return one-half of the income constituting the property of the community.³ The mounting surtaxes of World War II brought additional pressure on noncommunity states for the tax advantages of the community property system, resulting first in the adoption of community property laws in several more jurisdictions,⁴ and finally in the provision of the

¹ Int. Rev. Code § 1, 26 U.S.C.A. § 1 (1954); Int. Rev. Code § 11(a), 26 U.S.C.A. § 11(a) (1939).

² In 1913, when the first income tax was passed, the community property system existed in the eight states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington.

³ *Poe v. Seaborn*, 282 U.S. 101 (1930); *United States v. Malcolm*, 282 U.S. 792 (1931).

⁴ Between 1945 and 1947, community property laws were passed in Michigan, Oklahoma, Oregon, Pennsylvania, Nebraska and the Territory of Hawaii.

Revenue Act of 1948⁵ permitting spouses to divide their combined income between them for purposes of computing their total tax. However, even though the substantial relief allowed by split-income provisions is as much a part of our income tax laws today as are the progressive rates, the problem of anticipatory assignment of income and possible shifting of the tax burden will remain so long as a tax advantage can thereby be gained.

The first, and to this day the foremost, case involving a construction of the concept of the "taxable person" under the income tax law was *Lucas v. Earl*,⁶ and concerned the taxable years 1920 and 1921. Taxpayer and his wife, by a written contract entered into in 1901, agreed that any property they then had or might thereafter acquire, including salaries, would be treated as held in joint tenancy. Taxpayer was an attorney, and under this agreement sought to split income from legal fees with his wife. The Revenue Act of 1921 imposed a tax on the income of every individual ". . . from salaries, wages or compensation for personal services of whatever kind and in whatever form paid."⁷ Justice Holmes, in his oft-quoted decision, in finding against the taxpayer held that the taxpayer was the only party to the contracts by which the legal fees were earned and the taxpayer alone could take the last step in the performance of these contracts. He stated, further, ". . . 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 impact 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."

The following year, the doctrine enunciated in *Lucas v. Earl*⁸ was expanded in *Burnet v. Leininger*.⁹ There, taxpayer and his wife, by written contract, agreed to be one-half partners in the husband's one-half share in a partnership. No changes were made on the books of the partnership, in the active management or in cash distributions, but taxpayer and his wife each returned one-half of the husband's share of partnership income. In interpreting Section 218(a) of the Revenue Act of 1921,¹⁰ the Court held,

⁵ Int. Rev. Code § 51(b), 26 U.S.C.A. § 51(b) (1939); Int. Rev. Code §§ 2, 6013, 26 U.S.C.A. §§ 2, 6013 (1954).

⁶ 281 U.S. 111 (1930).

⁷ Revenue Act of 1921, c. 136 § 213(a), 42 Stat. 227.

⁸ 281 U.S. 111 (1930).

⁹ 285 U.S. 136 (1931).

¹⁰ "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net in-

under the *Lucas* case, that the wife was not a partner and not entitled to return partnership income even though she might be beneficially entitled to one-half of her husband's partnership income. In both cases, the Court made the distinction, although not in so many words, between property and income. The anticipatory assignment of income was invalid for purposes of shifting the tax burden under the income tax laws, even though the agreements might be binding under local law as an assignment of money or property *after* the proper taxable person had returned the income under Federal law.

Subsequent cases evolved the distinction between income derived from services and income derived from capital or, where capital rather than labor or services so largely predominated in the production of income that labor, as a contributing factor, may be considered *de minimis*.¹¹ This distinction, although implicit in the facts of the *Lucas* and *Leininger* cases, was first clearly stated in *Saenger v. Commissioner of Internal Revenue*,¹² in which the Court said, ". . . the rule of the *Earl*¹³ case, while made graphic by a figure, is more than a figure of speech. It is an expression of the simple truth that earned incomes are taxed to and [the tax] must be paid by those who earn them, and unearned incomes to those who own the property or right that produces them, not to those to whom their earners or owners are under contract to pay them.¹⁴ It establishes once and for all that no device or arrangement, be it ever so shrewdly or cunningly contrived, can make future earnings taxable to any but the earner of them, can make future incomes from property taxable to any but the owner of the right or title from which the income springs." An assignment of the right to receive future income, without more, is not enough to insulate the assignor from income tax liability.¹⁵ Where the income is derived from salaries or other compensation for personal services, the *Lucas* case has been consistently applied.¹⁶ Where, as in the case of an assignment of an interest in a partnership, the income is derived from a combination of

come of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. . . ." Revenue Act of 1921, c. 136, § 218(a), 42 Stat. 245.

¹¹ John J. Wheelock, 16 T.C. 1435 (1951).

¹² 69 F. 2d 631 (C.A.5th, 1934).

¹³ *Lucas v. Earl*, 281 U.S. 111 (1930).

¹⁴ Taxpayer had organized a corporation to whom he was under contract to perform services as a theater operator and the theaters which taxpayer operated paid the corporation directly for his services. The payment for taxpayer's services, although billed from the corporation by whom taxpayer was employed, was held income to taxpayer.

¹⁵ *Wisdom et ux. v. United States*, 205 F. 2d 30 (C.A. 9th, 1953).

¹⁶ *Jones v. Page*, 102 F.2d 144 (C.A.5th, 1939), cert. denied 308 U.S. 562 (1939); *Saenger v. Commissioner of Internal Revenue*, 69 F.2d 631 (C.A.5th, 1934).

capital and services, a question of fact is always involved as to whether there has been a valid assignment of the property primarily instrumental in the production of the income. If no attempt is even made to assign partnership property, the case is clearly an anticipatory assignment of income and squarely within the doctrine of the *Leininger* and *Lucas* cases. Even where the partnership has assignable assets, if the partnership income is primarily attributed to the personal efforts of the active partner or partners, a valid assignment of the partnership assets under local law may not be sufficient to shift the tax burden to the assignees who do not contribute their personal services to the production of income.¹⁷

Considerations of the assignment of partnership income lead logically into the area of the assignment of income-producing property or property rights, where the services or efforts of the assignor do not contribute in any way, or at least not materially, to the production of income. The critical question and paramount criterion in finding the facts is ". . . whether the assignor retains sufficient power and control over the assigned property . . . to make it reasonable to treat him as the recipient of the income for tax purposes."¹⁸ Three cases were decided in the circuit court of appeals shortly after *Lucas v. Earl*,¹⁹ all involving the assignment of property held in trust or assigned into trust, and the person taxable on the trust income. In *Lowery v. Helvering*²⁰ taxpayer assigned her life interest in a residuary estate held in trust to the remaindermen. The court said, in effect, that the assignment of the life income was completely effective in denuding the taxpayer of all interest in the property and distinguished the *Lucas* and *Leininger* cases by pointing out that in the latter, although the assignment of the choses in action was just as absolute and unconditional as in the instant case, they were conditional upon the continued performance of the assignor. The same court later held that where a settlor created a trust for the benefit of his wife and creditors, reserving in himself the right to repurchase the certificates of beneficial interest, thereby terminating the trust, there was an outright assignment of an interest recognized as existing property and the income from the trust was taxable to the holders of the certificates of beneficial interest.²¹ The third circuit also distinguished the *Lucas* case when a taxpayer assigned patents which he owned to himself as trustee and then, in his individual capacity, assigned and sold to his wife an undivided one-third interest in all the

¹⁷ *Wisdom et ux. v. United States*, 205 F. 2d 30 (C.A. 9th, 1953). The decision in the case was strengthened by reason of the fact that the assignees were taxpayer's wife and daughters, indicating an attempt merely to shift the tax burden.

¹⁸ *Commissioner of Internal Revenue v. Sunnen*, 333 U.S. 591 (1948).

¹⁹ 281 U.S. 111 (1930).

²⁰ 70 F.2d 713 (C.A.2d, 1934).

²¹ *Shanley v. Bowers*, 81 F.2d 13 (C.A.2d, 1936).

revenues on the patents to which he might be entitled in his individual capacity.²² This court held, as did the second circuit, that all right, title, and interest in and to the property had been assigned; that since the liability for income taxes falls upon the true owner of the property or upon him who effectively controls the use and disposition of the income, the assignor was successful in shifting the tax burden.

The first, and still the most important, case to reach the Supreme Court relating to the assignment of the right or title to property held in trust was *Blair v. Commissioner of Internal Revenue*.²³ Taxpayer was the income beneficiary of a trust for life. From time to time he irrevocably assigned to his children the right to receive the income under the trust during the taxpayer's life in varying fixed amounts.²⁴ Sections 162(a) and (b) of the Revenue Act of 1928²⁵ impose upon the beneficiary of a trust liability for tax upon the income distributable to the beneficiary. The Court, speaking through Chief Justice Hughes, once again distinguished the *Lucas* and *Leininger* cases, pointing out that the tax is imposed not upon the beneficiary, but upon the person entitled to the beneficial interest under the trust. Valid assignments, under local law, of the beneficial interest in a trust are not prohibited by the revenue acts. The assignee of a valid assignment of the beneficial interest becomes the beneficiary of the trust and the income is distributable to him. "An assignment by the life beneficiary, of the right to trust income for the lifetime of said beneficiary, is an assignment of all the rights which the assignor has in the trust estate."²⁶ As the assignees became the owners of the specified beneficial interest in the income of the trust, these interests were taxable to them. The same conclusion was subsequently reached as in the *Blair* case where a taxpayer made a gift by assignment to his wife of his interest in an oil lease, the wife receiving all future payments.²⁷

The series of cases relating the taxable person to the source of the income, whether the source be a natural person, as in the *Lucas* case, the combined effect of personal services and capital as in the *Leininger* case or exclusively capital, as in the *Blair* case, culminated in 1940 with the

²² *Byrnes v. Commissioner of Internal Revenue*, 89F.2d 243 (C.A.3d, 1937).

²³ 300 U.S. 5 (1937).

²⁴ See *Ellen v. Booth*, 36 B.T.A. 141 (1937), clarifying the rule that where only a portion of a life beneficiary's right to trust income is irrevocably assigned, the *Blair* case, if otherwise applicable, is to be applied to that fractional share.

²⁵ Revenue Act of 1928 § 162 (a) (b), 26 U.S.C.A. § 162 (a) (b) (1928).

²⁶ *Blair v. Commissioner of Internal Revenue*, 300 U.S. 5 (1937).

²⁷ *Commissioner of Internal Revenue v. O'Donnell*, 90 F.2d 907 (C.A.9th, 1937), the court holding this was not an anticipatory assignment of income since the interest-producing property was the contract, which taxpayer assigned, the assignee acquiring all rights formerly held by the taxpayer.

decision in *Helvering v. Horst*.²⁸ Taxpayer, who was on the cash basis, detached coupons from a series of negotiable bonds of which he was the owner and presented them to the donee as a gift shortly before the coupons matured. The court held under the *Lucas* case that the income from the coupons was taxable to the donor as though no gift had been made. Realization of income is the taxable event, rather than the acquisition of the right to receive it, said the Court, and realization is generally not deemed to occur until the income is paid. However, where no payment is received, “. . . realization may occur when the last step is taken by which [taxpayer] obtains the fruition of the economic gain which has already accrued to him.”²⁹ Procuring the payment of income directly to creditors³⁰ or other third persons by anticipatory assignment will not avail in escaping tax liability even though no money or property is received by the taxpayer.

The decision in the *Horst* case does not immediately appear to be a startling departure from the other cases in this line until one realizes that the assignment did not in any manner depend upon the continued services of the taxpayer in producing the income. Instead, the *Lucas* case doctrine was broadened so that the crucial question became the exercise of the power of assignment over the right to the income rather than the continued performance of services by the assignor as a condition precedent to validating the assignment. The illogical inconsistency between this decision and the traditional concept of cash basis accounting was ineptly handled by allowing the assignor to return the income in the year in which paid, even though the realization of income was accelerated by the assignment to the date on which the assignment took place.

The decision in the *Horst* case resulted in an entirely new line of cases involving the assignment of personal property or choses in action and whether or not an anticipatory assignment of income resulted therefrom. The *Blair* and *Horst* cases were arrayed one against the other, the former being favorable to the taxpayer and the latter to the government. The first issue, if present, was whether the taxpayer had sufficiently divested himself of control over the income-producing property to treat the assignee as the true owner, as under the *Blair* case. If the taxpayer sustained his burden on this issue, he might still be forced to overcome the ruling in the *Horst* case by showing that no “economic gain” or “realization of income” inured to his benefit by reason of the assignment if accrued but unrealized income was also assigned.³¹ Generally the applica-

²⁸ 311 U.S. 112 (1940).

²⁹ *Ibid.*

³⁰ *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716 (1929).

³¹ “The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid.” *Helvering v. Horst*, 311 U.S. 112, 119 (1940).

tion of one case has resulted in distinguishing the other.³² One of the clearest applications of the *Horst* case in this area appeared in *Austin v. Commissioner of Internal Revenue*³³ where taxpayer, the holder of an interest-bearing note, gave it to her sons together with the right to receive the accrued interest. The interest, when paid, was taxed to the donor under the *Horst* case, even though the donor had completely divested herself of control over the income-producing property.³⁴ The Court refused to apply the *Blair* case because the interest was earned, though unpaid, at the time the gift was made.³⁵ The question as to whether the decision in the *Horst* case would have been different had the taxpayer made a gift of the bonds at the same time he made a gift of the attached coupons was disposed of under the ruling in the *Austin* case. However, the Court went on to state that any interest accruing on the note after the date of the gift was taxable to the donees, applying the *Blair* case in this instance. In *Galt v. Commissioner of Internal Revenue*,³⁶ taxpayer irrevocably assigned a portion of the proceeds of a twenty year lease to his four sons, but retained the leasehold himself after the expiration of the twenty year period. Once again it was held that the retention of the leasehold, the income-producing property, by the assignor resulted in an anticipatory assignment of income. The *Blair* case could not be applied since there was no attempt to assign the leasehold.

Questions arising under the *Blair* case relating to the retention of control over trust property or trust income³⁷ have now been settled by a controlling provision of the Internal Revenue Code of 1954 and a correlative Internal Revenue Bulletin issued shortly after the 1954 Code went

³² *Huber v. Helvering*, 117 F.2d 782 (App.D.C., 1941); *United States v. Horschel*, 205 F.2d 646 (C.A.9th, 1953); *Fisher v. Commissioner of Internal Revenue*, 209 F.2d 513 (C.A.6th, 1954); *Galt v. Commissioner of Internal Revenue*, 216 F.2d 41 (C.A.7th, 1954).

³³ 161 F.2d 666 (C.A.6th, 1947).

³⁴ But where the obligor was insolvent at the time of the assignment, there could be no intent to shift the tax burden by anticipatory assignment. *Commissioner of Internal Revenue v. Timken*, 141 F.2d 625 (C.A.6th, 1944).

³⁵ Cf., where taxpayer sold defaulted notes with interest in arrears at a price in excess of the principal amount, the excess was taxed as ordinary income rather than capital gain, it making no difference whether the obligor or a subsequent purchaser of the note pays the interest. *Fisher v. Commissioner of Internal Revenue*, 209 F.2d 513 (C.A.6th, 1954). But where a corporation distributed notes with accrued interest which it was holding to the shareholders in dissolution of the corporation, there was no anticipatory assignment of income of the corporation. *United States v. Horschel*, 205 F.2d 646 (C.A.9th, 1953).

³⁶ 216 F.2d 41 (C.A.7th, 1954).

³⁷ *Harrison v. Schaffner*, 312 U.S. 579 (1941); *Farkas v. Commissioner of Internal Revenue*, 170 F.2d 201 (C.A.5th, 1948); *Huber v. Helvering*, 117 F.2d 782 (C.A.5th, 1941).

into effect. Sections 673 and 676 of the Internal Revenue Code of 1954³⁸ provide that if a reversionary interest or power of revocation retained by the settlor of a trust is not to take effect for at least ten years from the inception of the trust, the settlor will not be treated as the owner of the trust corpus. The corresponding Revenue Ruling³⁹ provides that where a life income beneficiary consents to the payment of trust income to another, the beneficiary will be taxed, as he has parted with no substantial property, except that a valid and irrevocable assignment under local law for a period of not less than ten years will make the income taxable to the assignee. This, of course, does not dispose of the more general question of fact, which will continue to arise in non-trust cases as to whether the taxpayer has parted with a substantial enough interest in the property so as not to be taxed as the owner thereof.

In conclusion, this writer believes it possible to formulate three criteria for determining whether an assignment is to be treated as an anticipatory assignment of income and taxable to the assignor or whether the tax burden can successfully be shifted. Where the assignment is of income-producing property, we will ignore the subtleties of legal title and tax the person who retains effective ownership and control over the property, subject to Sections 673 and 676 of the Internal Revenue Code of 1954⁴⁰ relating to trusts. Where the assignment is of unpaid income, choice of the taxable person will depend upon whether any economic gain has inured to the benefit of the assignor. Finally, in the instance of an assignment of future income, the sole criterion should be whether the assignor retains effective control over the income-producing entity, be it property or the assignor's personal services. If the assignor must continue to perform some personal service subsequent to the assignment as a condition to the production of income, then he is deemed not to have relinquished control over the income-producing entity. Unfortunately, the entire area of anticipatory assignment of income has been defined by judicial construction of the broadest possible statutory language. This leaves the taxpayer with no assurance that judicial fiat will not once again alter the effect of a decision on which the taxpayer has relied in selecting the proper taxable person to return the income. The best we can hope for is that the few well-lighted guideposts will not be dimmed by retrospective judicial decision, but rather replaced by the affirmative assurances of Congressional enactment.

³⁸ Int. Rev. Code §§ 673, 676, 26 U.S.C.A. §§ 673, 676 (1954).

³⁹ Rev. Rul. 55-38, I.R.B. 1955-4, 24 (1955). This ruling is an acquiescence by the Commissioner to the decision in *Farkas v. Commissioner of Internal Revenue*, 170 F.2d 201 (C.A.5th, 1948).

⁴⁰ Int. Rev. Code §§ 673, 676, 26 U.S.C.A. §§ 673, 676 (1954).