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Income Tax--Annuities and Incomes of Trusts

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of the decedent estate commission and the tax commission, which recommended, and the legislature, which enacted the new Estate Tax Law, which intent, as we have seen, was to "harmonize so far as possible the construction and application of the federal and of the state statutes." Briefly stated, the present New York rule, on this point, as its federal counterpart, makes death of one of the parties the "generating source" of the succession to the entire property, and the whole fund or property must be included in the gross estate of the decedent. The application of this general rule would be unfair, unreasonable and illogical in the case of a survivor who had made contribution or who had been, with the decedent, a beneficiary of a gift, bequest or devise which had created the estate. It is the death of the grantor which brings about "that shifting of the economic benefits of the property which is the real subject of the tax." [66] In the case of a tenant who has contributed to the cost of the estate or who has been the recipient of such bequest, devise or gift, there is no shifting of the economic benefits from the deceased upon which the tax might be levied, for from the time of the estate's creation, the survivor was entitled to such economic benefits of his proportionate share. The New York legislature has wisely and prudently adopted the exception to the general rule, as embodied in the federal statute,[67] that there shall be excepted such part of the value of the property "as is proportionate to the consideration furnished" by the survivor; or, "where property has been acquired by gift, bequest, devise or inheritance, as in a tenancy by the entirety by the decedent and spouse, then to the extent of one-half of the value thereof, or where so acquired by the decedent and any other person as joint tenants * * *, then to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants." [68]

MURRAY W. DUBERSTEIN.

INCOME TAX—ANNUITIES AND INCOMES OF TRUSTS.—As the law governing the taxation of incomes has been of comparatively recent development, it is natural to find that the early decisions of the courts concerning the taxability of different kinds of incomes have left many points unsettled, requiring later decisions to determine their status for taxation purposes. Within the last decade, for example, the courts have been confronted with a series of cases presenting the question whether, in a given instance, that which the donee acquired under a will was a bequest or was income. If

[66] Chase National Bank v. United States, 278 U. S. 327, 49 Sup. Ct. 126 (1928).
[67] REVENUE ACT OF 1926, §302 (e); *supra* note 8.
[68] N. Y. ESTATE TAX LAW §249—r (5); *supra* note 43.

it were the latter, it would be subject to the tax; if the former, it would be exempt.[1]

One of the first cases to be considered by the Supreme Court arose where a will provided that the income of a certain part of the deceased's estate should be paid to a certain person. No charge was made on the corpus of the trust. It was held that the sum paid to the taxpayer was taxable income within the statute and was not property acquired by gift, devise or descent.[2]

A few years later the court was called upon to decide whether a person to whom a definite sum is bequeathed as an annuity payable out of income, but, if need be, out of the corpus, is taxable on such annuity as income when, in a given year, the annuity is met entirely by payments from the trust income. The court there held that such an annuity was not a part of the gross income of the donee, but was exempt from taxation as property acquired by bequest.[3] This decision has been criticized[4] as being too technical in its interpretation of the word "income," and, as it was the intention of Congress to exercise its taxing power to the fullest extent,[5] it would appear that such criticism was not unjustified.

Prior to the decision in the *Whitehouse*[6] case there was presented to the lower federal courts a series of cases which, when decided, resulted in such confusion and uncertainty that a decision of the Supreme Court was needed to set at ease the minds of taxpayers and Treasury officials alike.

A man would make a will leaving to his wife an annuity or the income of a trust fund for life in lieu of dower. After his death the widow would elect to take under the will and would receive from the fiduciary the annuity or the trust income, as the case might be. The Treasury Department taxed the widow on the amounts thus received, and several suits were brought to recover taxes claimed to have been unlawfully exacted. The decisions in

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[1] REVENUE ACT OF 1924 §213 (b) (3), 43 Stat. 253, 268, 26 U. S. C. §954 (b) (3); REVENUE ACT OF 1926 §213 (b) (3), 44 Stat. 9, 26 U. S. C. §954 (b) (3); REVENUE ACT OF 1928 §22 (b) (3), 45 Stat. 791, 798, 26 U. S. C. §2022 (b) (3); REVENUE ACT OF 1932 §22 (b) (3), 47 Stat. 169, 178, 26 U. S. C. §2022 (b) (3).

[2] Irwin v. Gavit, 268 U. S. 161, 45 Sup. Ct. 475 (1925); see also Drexel v. United States, 61 Ct. Cl. 216, cert. den. 271 U. S. 660, 46 Sup. Ct. 473 (1926); Verner v. United States, 62 Ct. Cl. 574, cert. den. 275 U. S. 524, 48 Sup. Ct. 18 (1926).

[3] Burnet v. Whitehouse, 283 U. S. 148, 51 Sup. Ct. 374, 73 A. L. R. 1534 (1931).

[4] "Economists determine what is income from the standpoint of the recipient, whereas the court uses the source of payment as its criterion. Even under the latter view, it should be held that annuity is income when properly paid from income and a bequest when properly paid from corpus." (1931) COL. L. REV. 1053.

[5] Eisner v. Macomber, 252 U. S. 189, 203, 40 Sup. Ct. 189 (1920).

[6] *Supra* note 3.

three cases,[7] each tried in a different circuit of the Circuit Court of Appeals, held that the widow who elected to take an annuity or the income of a trust in lieu of dower was a purchaser for value of an annuity (the consideration being the waiver of her right of dower), and was as such exempt from taxation under the statute until an amount equal to the sum paid in (in this case the value of her dower right) should have been received.[8]

The Treasury officials apparently thought the matter settled and failed to prosecute appeals to the Supreme Court. However, a large source of revenue had been cut off by these decisions, and, in order to compensate for such loss, the department determined to place the tax burden upon the fiduciary,[9] relying on dicta to the effect that the trustee was the proper one to be taxed.[10]

A new series of cases came before the courts, this time brought by fiduciaries under trusts such as outlined above, who contended that they were expressly granted authority to deduct those sums which were periodically paid to beneficiaries, and that under such a trust a widow was clearly a beneficiary.[11] The courts of two other circuits upheld the trustees in their assertion of the right to make deductions for such payments,[12] and thus it appeared that,

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[7] Warner v. Walsh, 15 F. (2d) 367 (C. C. A. 2d, 1926); U. S. v. Bolster, 26 F. (2d) 760, 59 A. L. R. 491 (C. C. A. 1st, 1928); Allen v. Brandeis, 29 F. (2d) 363 (C. C. A. 8th, 1928). The annuity granted in the *Bolster* case was payable only out of income. In the other two cases the corpus of the trust was charged with the payment of the annuity in the event of an insufficiency of income.

[8] REVENUE ACT OF 1924 §213 (b) (2), 43 Stat. 253, 268, 26 U. S. C. §954 (b) (2); REVENUE ACT OF 1926 §213 (b) (2), 44 Stat. 9, 24, 26 U. S. C. §954 (b) (2); REVENUE ACT OF 1928 §22 (b) (2), 45 Stat. 791, 797, 26 U. S. C. §2022 (b) (2); REVENUE ACT OF 1932 §22 (b) (2), 47 Stat. 169, 178, 26 U. S. C. §2022 (b) (2).

[9] I. T. 2480, VIII—2 Cum. Bul. 141 (1929); I. T. 2506, VIII—2 Cum. Bul. 129 (1929).

[10] United States v. Bolster, *supra* note 7, at 763, 59 A. L. R. at 495. "We think the government must look to the trustee for its tax."

[11] REVENUE ACT OF 1924 §219 (b) (2), 43 Stat. 253, 275, 26 U. S. C. §960 (b) (2), "There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, * * * but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. * * *" This section was incorporated in the REVENUE ACT OF 1926 §219 (b) (2), 44 Stat. 9, 32, 26 U. S. C. §960 (b) (2). Substantially the same language is used in the REVENUE ACT OF 1928 §162 (b), 45 Stat. 791, 838, 26 U. S. C. §2162 (b), and in the REVENUE ACT OF 1932 §162 (b), 47 Stat. 169, 220, 26 U. S. C. §2162 (b).

[12] Butterworth v. Com'r of Int. Rev., 63 F. (2d) 944 (C. C. A. 3rd, 1933), *rev'g*, 23 B. T. A. 838 (1931); Pardee v. Com'r of Int. Rev., 63 F. (2d) 948 (C. C. A. 3rd, 1933), *rev'g*, 23 B. T. A. 846 (1931); Fidelity-Philadelphia Trust Co. v. Com'r of Int. Rev., 63 F. (2d) 949 (C. C. A. 3rd, 1933), *rev'g*, 25 B. T. A. 1359 (1932); Title Guarantee Loan and Trust Co. v. Com'r of Int. Rev., 63 F. (2d) 621 (C. C. A. 5th, 1933), *rev'g*, 25 B. T. A. 1450 (1932). But see Atkins v. Com'r of Int. Rev., 63 F. (2d) 88 (C. C. A. 1st, 1933), denying a trustee's claim for an exemption as to such payments.

unless one of the two conflicting lines of cases should be overruled, the government would be without the right to tax either the fiduciary or the widow. The Commissioner of Internal Revenue thereupon took an appeal of those decisions which had upheld the right of the fiduciaries to deduct the sums paid to a widow under a trust.

Three of the cases were essentially the same. The trust established made the sum to be distributed to the widow payable only out of income. In a given taxable year the sum so disbursed was deducted from the tax return of the fiduciary and the government had demanded an accounting therefor and payment thereon. The Supreme Court unanimously held that the sums were deductible by the trustee [13] and expressly declined to follow the reasoning of the earlier cases which had rested their decision for the widow on the ground that she was a purchaser of an annuity and so was not taxable on such sums as she received until the value of her dower right had been returned to her. As it says, per McReynolds, *J.*:

> "When she makes her election the widow decides to accept the benefits of the will with the accompanying rights and liabilities. In no proper sense does she purchase an annuity. For reasons satisfactory to herself, she expresses a desire to occupy the position of a beneficiary and we think she should be so treated." [14]

The Supreme Court was clearly right in its holding in these three cases.[15] The decisions [16] advanced by the lower courts as authority for their declaring that a widow electing to take under a will in lieu of dower was a purchaser of an annuity were concerned solely with the priority of a widow over other legatees in the distribution of her husband's estate and were therefore very dubious authority for reaching a decision in the construction of a tax statute,

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[13] Helvering v. Butterworth, Helvering v. Fidelity-Philadelphia Trust Co., Helvering v. Title Guarantee Loan and Trust Co., 290 U. S. —, 54 Sup. Ct. 221 (1933). See also Atwood v. Com'r of Int. Rev., 29 B. T. A. — (1934), which, following the foregoing cases, upholds a tax upon the income received by a widow under a trust where the payments were not chargeable against the corpus.

[14] Helvering v. Butterworth, *supra* note 13, at 222.

[15] It is interesting to note that New York established the rule finally settled in the instant cases in People *ex rel.* Kight v. Lynch, 255 N. Y. 323, 174 N. E. 696 (1931), where a widow receiving the income of a trust in lieu of dower was held taxable, the payment being neither a gift nor a bequest nor a purchased annuity within the purview of the TAX LAW §359 (2) (b), (c). See (1931) 5 ST. JOHN'S L. REV. 299.

[16] The cases are listed at length in Allen v. Brandeis, *supra* note 7, at 364.

especially when such construction was opposed to the very wording of the statute.[17]

While it has been said that the decision in these three cases has overruled the earlier series of cases,[18] a close study of the facts in each will show that this is not so. Wherever, as in the *Warner*[19] or *Brandeis*[20] cases, the annuity is payable out of the corpus in the event of an inadequacy of income, such payment is not taxable to the recipient under the rule in *Burnet* v. *Whitehouse*.[21]

At the same time the court was faced with exactly the same problem as in those set out above, but, in addition, the annuity was expressly made a charge upon the corpus in the event of an insufficiency of income. It reversed the decision of the Circuit Court of Appeals[22] and held[23] that the annuity was not a distribution of income to a beneficiary but was a gift or legacy, and was therefore exempt to the widow by reason of the decision in the *Whitehouse*[24] case, but was properly taxable to the fiduciary to the extent that the annuity was paid out of income. Mr. Chief Justice Hughes dissented on the ground that the trustee should be permitted to deduct those sums actually paid out of income, for as to such sums the widow is not a legatee but a beneficiary.

While the dissent may be supported as logically correct, the majority holding was the only one possible in view of the decision in *Whitehouse*[25] case. To follow the Chief Justice's dissent to its logical conclusion would be to overrule, or at least greatly to modify, the rule established by the latter case.[26]

In summation, it may be said that the following rules have been established with reference to periodic payments out of trust estates:

I. An annuity payable solely out of the income of the trust is taxable to the donee[27] and not to the fiduciary.[28]

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[17] As the court says, "It is unnecessary to discuss her rights under other circumstances. We are dealing with a tax statute and seeking to determine the will of Congress." Helvering v. Butterworth, *supra* note 13, at 222.

[18] "These cases [the Warner, Bolster, and Brandeis cases] have therefore ceased to be the law." Note (1934) 18 MINN. L. REV. 342, 343.

[19] *Supra* note 7.

[20] *Supra* note 7.

[21] *Supra* note 3.

[22] Pardee v. Com'r of Int. Rev., *supra* note 12.

[23] Helvering v. Pardee, 290 U. S. —, 54 Sup. Ct. 221 (1933); see also George D. Harter Bank v. Com'r of Int. Rev., 29 B. T. A. — (1934).

[24] *Supra* note 3.

[25] "It would be an anomaly to tax the receipts for one year and exempt those for another simply because the executors paid the first from income received and the second out of the corpus." Burnet v. Whitehouse, *supra* note 3, at 151.

[26] "The dissent may mark a significant defection from the doubtful doctrine of the *Whitehouse* case." (1934) 34 COL. L. REV. 183, 184.

[27] Irwin v. Gavit, *supra* note 2.

[28] Helvering v. Butterworth, *supra* note 13.

II. An annuity payable out of the corpus of the trust in the event of an inadequacy of income is taxable to the fiduciary,[29] but only to the extent that such annuity is met with payments from the income of the trust, there being, of course, no tax liability for such part of the annuity as is met with disbursements from the corpus. Such an annuity is not taxable to the recipient,[30] even although, in a given taxable year, the entire payment is met with income.

JOHN F. MITCHELL.

GAIN OR LOSS TO REMAINDERMAN OF PROPERTY ACQUIRED BY BEQUEST, DEVISE OR INHERITANCE.—The basis prescribed under the Revenue Acts of 1924, 1926 and prior acts,[1] for determining gain or loss upon the disposition of property acquired by bequest, devise or inheritance, has resulted in much confusion, due to the contradictory interpretations of the acts by the courts, the Board of Tax Appeals and the Treasury Department. These acts[2] specifically provide that, "in case of property acquired by bequest, devise or inheritance, the basis (*i. e.*, for determining gain or loss upon a subsequent sale) should be *the fair market value of such property at the time of such acquisition.*" The Treasury Department's consistent attitude has been that in case of property (real and personal) acquired as a result of death, the date of acquisition was the date of the death of decedent.[3] This contention was based on the theory that immediately upon the decedent's death, a vested equitable interest in the property was acquired by the legatees. Upon distribution of the property, their title reverts to the date of death. The Board of Tax Appeals, however, held that the date of acquisition of property by specific legatees[4] and residuary legatees[5] was the date when the property bequeathed was actually distributed and made available to them, the value on that date being the basis for determining gain or loss upon a subsequent sale of the property by the legatees.[6] The Treasury

[29] Helvering v. Pardee, *supra* note 23.
[30] Burnet v. Whitehouse, *supra* note 3.

[1] REVENUE ACT OF 1924 §204 (a), (5), Reg. 65, art. 1594; REVENUE ACT OF 1926 §204 (A), (5), Reg. 69, art. 1594; REVENUE ACT OF 1921 §202 (a), (3), is substantially identical.
[2] *Ibid.*
[3] Reg. 74, art. 595; art. 1594, Regs. 69 and 65; Reg. 62, art. 1563; Reg. 45, art. 1562.
[4] Brewster v. Gage, 25 F. (2d) 915 (1927); Moser v. Commissioner, 12 B. T. A. 672 (1928).
[5] Foster v. Commissioner, 7 B. T. A. 1137 (1927); Mathiessen v. United States, 65 Ct. Cl. 484 (1928).
[6] See, particularly, Mathiessen v. United States, *supra* note 5.