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THE REALIZATION REQUIREMENT AND TAX AVOIDANCE

*E. George Rudolph**

CONSIDER, for a moment, the plight of G. E. Hall. During 1947 Hall incurred a gambling debt to the Las Vegas Club variously estimated at between 145,000 and 478,000 dollars. The debt came into the sole ownership of one Binion, a partner in the club, and was eventually settled by Hall transferring to Binion an undivided one-half interest in certain cattle located in Arizona and Montana. Thereafter, Hall and Binion engaged in the ranching business as partners. At this point the Internal Revenue Service came forward with a claim that Hall, in the course of this disastrous chain of events, had realized a substantial amount of taxable income.¹

The Government based its claim on the theory that Hall had transferred the cattle in settlement of a debt, and had consequently realized income to the extent that the debt exceeded his basis for the transferred interest in the cattle. The Court of Appeals for the Tenth Circuit disagreed, first, because even under Nevada law, the debt was unenforceable and, second, because the overall transaction had resulted in a loss to Hall, and there consequently could be no taxable income under the learning of the *Bradford* case.² However, the court went on to hold that Hall did realize taxable income to the extent that the value of the interest in the cattle at the time of the transfer exceeded Hall's basis for such interest. The transaction should be treated, the court said, just as if Hall had sold the cattle and paid the proceeds to Binion. No authority was cited for this conclusion, and it certainly seems contrary to the prevailing rules with respect to both charitable and private gifts of appreciated property.

At least in terms of the amount of the unexpected tax liability, Ernest Wilkinson appears to have fared even worse. Wilkinson was the principal counsel for the Ute Indians in certain litigation against the United States which eventually resulted in judgments

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¹ *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962).

² *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956). In this case the taxpayer had executed a note for the accommodation of her husband, and was eventually able to settle it for less than its face amount. The Government sought to tax her for the difference on the theory of debt forgiveness, but the court held for the taxpayer since the overall transaction had resulted in a loss to her.

totalling almost 32,000,000 dollars. In 1951 attorney fees were allowed in the amount of approximately 2,800,000 dollars. A Captain Bonnin had the original contract to represent the Indians, and when the contract was assigned to Wilkinson's firm, Bonnin retained an interest in the eventual fee. In 1938 Wilkinson purchased 44.79 percent of this interest from Bonnin for 12,000 dollars. Wilkinson made charitable contributions of this purchased interest after the judgments were entered but before the attorney fees were paid. The Court of Claims held that the amount paid to the charities, less Wilkinson's cost, constituted ordinary income to Wilkinson.³ The rationale of the decision is not entirely clear. The court devoted most of its attention to the question of whether the purchased interest was a capital asset in Wilkinson's hands, and concluded that it was not. While this may have been correct, it would not seem determinative of the principal issue. There are a number of rulings and decisions to the effect that a taxpayer does not realize taxable income when he makes a charitable gift of property with an ordinary income potential.

It seems plausible to suggest that these two cases, along with other quite different ones which will be considered later, constitute the beginning of a trend in favor of the Government on an issue which it consistently lost, and apparently conceded, in the middle fifties. Stated most broadly, the issue is simply this: does a taxpayer realize the income potential of an asset when he disposes of it in a transaction other than a sale or exchange? The distinguishing characteristic of a sale or exchange, for present purposes, is the receipt by the transferor of a valuable consideration. The consideration may consist of money, other property or the discharge of a legal obligation, but in any event it is clear that the transferor realizes income on the sale or exchange to the extent that the value of the consideration exceeds his basis for the transferred property. On the other hand, it has usually been understood that a transferor realizes no income in a transaction where such consideration is lacking. This general understanding has led to a wide variety of tax-motivated transactions, and several of the more important types will be explored in the following discussion. While these are subject to classification in a number of ways, one distinction should be mentioned at this point. In many of the cases the lack of consideration is obvious, but in others the absence of

³ *Wilkinson v. United States*, 304 F.2d 469 (Ct. Cl. 1962).

adequate consideration has been the principal issue in dispute.

Both historically and logically, the proper starting point for a consideration of the problem is the *Horst* case.⁴ In that case, it will be remembered, the taxpayer detached interest coupons from bonds and gave them to his son shortly prior to maturity. The Supreme Court held that the donor was taxable on the income represented by the coupons. This holding may be supported by either of two propositions. First, the income from property is taxable to the owner of the property, even though the particular income is assigned to another before realization. Or, in the alternative, the donor realizes the income potential of property when he makes a gift of the property. The latter was apparently the basis upon which the Court rested its decision. The significant, and much quoted, language is as follows:

"The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them."

and further:

"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."

The idea expressed in these quotations will hereafter be referred to as the "Horst concept of realization," and the references will be exceedingly frequent since it provides the principal theme of this discussion. It is, however, a rather elusive theme, and other ideas will come in for consideration, the principal one being the equally elusive concept embodied in the phrase, "anticipatory assignments of income."⁵

As previously pointed out, the *Horst* case could have been decided on either the realization concept or an assignment of income rationale. The only practical difference between the two, on facts such as those of the *Horst* case, would be in the time that the income would be taxable to the donor. If the gift is treated as a sufficient realization, the donor would be taxable in the year of the gift, even though the income was not received by the donee

⁴ *Helvering v. Horst*, 311 U.S. 112 (1940).

⁵ See *Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 295 (1962).

until a later year. Since, in the *Horst* case, the coupon was paid in the year of the gift, this question was not presented. It has been presented in a number of later cases, and this aspect of the *Horst* concept of realization has not been well received by the courts.⁶ No effort will be made to consider it in each of the various types of situations hereafter discussed.

Before entering upon a discussion of the cases, it would be well to take a brief look at the principal Code provision which bears on the question. Section 1001 states, in part, as follows: "The gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis. . . ." For present purposes three things should be noted with respect to this section. First, all of the cases under consideration will involve a disposition within the meaning of this provision, even though the particular asset is of such a nature that a sale or exchange would not ordinarily be required to realize its income potential. The interest coupons in the *Horst* case provide a good illustration. Second, the section does not require a sale or exchange.⁷ Any other transfer, such as a gift, will be within the section's literal scope. Lastly, however, the gain is to be measured by the "amount realized," and this would seem to raise obvious difficulties in those cases in which the disposition does not qualify as a sale or exchange. In the *Horst* case, for example, the father's psychic satisfaction in making the gift would apparently constitute the amount realized. This is obviously a difficult thing to value in terms of dollars and cents, but the Supreme Court's decision in the recent *Davis* case⁸ has apparently provided the formula, as will be seen when that case is reached for discussion.

I. CHARITABLE AND FAMILY GIFTS

In 1948 the Internal Revenue Service took the position, in separate rulings, that donors realize taxable income by charitable and private gifts of farm products which they have raised.⁹ These

⁶ See the cases involving gifts of notes and bonds with accrued and defaulted interest, discussed in text accompanying note 28 *infra*.

⁷ Compare INT. REV. CODE OF 1954, §§ 1222, 1231, concerning capital gains which do require a sale or exchange. Conceivably, a taxpayer might make a disposition, of the sort under consideration here, of a capital asset and be held to have realized ordinary income. *But see* *Rudco Oil & Gas Co. v. United States*, 82 F. Supp. 746 (Ct. Cl. 1949).

⁸ *United States v. Davis*, 370 U.S. 65 (1962), discussed in text accompanying note 34 *infra*.

⁹ I.T. 3910, 1948-1 CUM. BULL. 15 (charitable gifts); I.T. 3932, 1948-2 CUM. BULL. 7 (private gifts).

rulings were based squarely on the *Horst* concept of realization. Over a period of several years thereafter, however, the Government lost four cases in which it relied on the theory of these rulings. In the three cases in which opinions were written, the courts reconciled their holdings with the *Horst* case on grounds that were appropriate to the assignment of income rationale but irrelevant to the realization proposition.¹⁰

*Estate of W. G. Farrier*¹¹ involved a private gift of cattle which had been raised by the donor. The court distinguished the *Horst* case largely on the ground that the cattle had not been sold by either the donor or donee, and their income potential, therefore, had not been realized, whereas in the *Horst* case the coupons had been paid and were undeniably income to someone. *Campbell v. Prothro*¹² concerned a charitable contribution of calves which were subsequently sold by the charity. The court reconciled its holding with the *Horst* case principally on the different nature of the assets involved. The interest coupons were considered as pure income items, whereas the income potential of the calves could be realized only by a sale or exchange. Therefore, the court said, the case would not fit the anticipatory assignment or income pattern. *Elsie SoRelle*¹³ involved a private gift of land with a mature but unharvested wheat crop. Here the court was able to distinguish the *Horst* case on the grounds that both the property and the unrealized income were transferred. In the *Horst* case, the court reasoned, it was the retention of the income-producing property by the donor that caused the income to be taxed to him.

Following these decisions the Service, in 1955, issued new rulings under which a farmer realizes no income from a charitable or private gift of raised livestock, but is required to remove such livestock from his opening inventory, if any, and is not permitted to deduct expenses attributable to the donated livestock.¹⁴ These limitations, at best, go only part way in restoring the Government

¹⁰ The fourth case is *White v. Brodrick*, 104 F. Supp. 213 (D. Kan. 1952).

¹¹ 15 T.C. 277 (1950).

¹² 209 F.2d 331 (5th Cir. 1954).

¹³ 22 T.C. 459 (1954).

¹⁴ Rev. Rul. 55-138, 1955-1 CUM. BULL. 223 (charitable gifts); Rev. Rul. 55-531, 1955-2 CUM. BULL. 520 (private gifts). It should be noted that if a rancher reports on a cash basis he will have no inventories, but instead will deduct all expenses currently and report proceeds of sales as income in the year of sale. Treas. Reg. §§ 1.61-4 (1957), 1.162-12 (1961). To take care of this, the first ruling provided that the charitable contribution deduction should be reduced by the amount of expenses deducted in prior years. However, the ruling, in this respect, has been superseded by Treas. Reg. § 1.170-1(c) (1963), under which expenses of prior years will be taken into account only to the extent they reflect in cost of goods sold for the year of contribution.

to the position sought in the original rulings, and the net effect of the 1955 rulings is to give favored taxpayers opportunities for tax avoidance which are broadly inconsistent with the Service's position on related issues. There is, of course, nothing in the law which requires that deductible charitable contributions be made from income subject to tax. Nevertheless, the Service does attempt to prevent deductions for charitable contributions of unrealized income items. The outstanding example is the rule which prohibits a deduction for the rental value of property let rent-free to a charity.¹⁵ The inconsistency between this rule and the rule permitting a deduction for the value of donated farm products is obvious. Likewise, the rule with respect to private gifts of farm products permits income splitting among family members of the sort that is very difficult to achieve through a family partnership.¹⁶ By using the gift device, a farmer or rancher is able to retain exclusive ownership and control of the business and still spread the income among family members for tax purposes.

The 1955 rulings dealt only with charitable and private gifts of raised livestock, and later developments indicate that the Government is not yet ready to concede on the broader issues involved. The *Hall* and *Wilkinson* decisions, discussed above, are good illustrations of this. Neither case comes squarely within the rulings. The transaction in the *Hall* case cannot properly be considered either a charitable or a private gift. However, in view of the court's determination that the gambling debt was unenforceable, it would seem to fall in the same general category so far as the problem of realization is concerned. The *Wilkinson* case did involve a charitable contribution, but the subject matter of the gift was not farm products. Basically, the property was the right to compensation for personal services, and furthermore the services were rendered principally by the donor. This suggests the *Lucas v. Earl*¹⁷ theorem that earned income is taxable to the one who earns it. However, the theorem does not fit the facts of the *Wilkinson* case since, as the dissent pointed out, the interest assigned to the charities

¹⁵ I.T. 3918, 1948-2 CUM. BULL. 33. See also Rev. Rul. 57-462, 1957-2 CUM. BULL. 157, denying a deduction to a newspaper which published an advertisement for a charity free of charge. See also note 94 *infra*.

¹⁶ See *Commissioner v. Culbertson*, 337 U.S. 733 (1949). The problem would appear to be only superficially different under INT. REV. CODE OF 1954, § 724(e), and the regulations thereunder.

¹⁷ 281 U.S. 111 (1930). This is a landmark case in the assignment of income area. The taxpayer assigned to his wife a fractional interest in his future income from personal services. The court held the income taxable to the taxpayer, when received by the wife, in spite of the assignment.

originally belonged to Bonnin, and Wilkinson had acquired it by purchase. While it is thus possible to explain both cases on their peculiar facts, they do seem significant in demonstrating that the concept of realization, in transactions not involving a sale or exchange, may have considerable appeal if the cases are not too closely related to the ill-fated 1948 rulings. A substantial number of cases involving different types of transactions also appear to support this conclusion.

In the first place, there are numerous cases and rulings involving charitable and private gifts, which do not fall literally within the 1955 rulings on livestock. Revenue Ruling 63-66¹⁸ concerns a private gift of wheat which the donor had received as a crop-share rental for land. Under the regulations, a landlord is not required to treat share rentals as income until sold.¹⁹ Nevertheless, the ruling holds that the proceeds of later sales by the donees constitute income to the donor. This holding is reconciled with the 1955 rulings on the basis that rental income is taxable to the owner of the land. This analysis, of course, brings the case within the scope of the alternative proposition stated above for the *Horst* case,²⁰ and makes it unnecessary to consider the question of realization. However, it would seem that the same sort of analysis should be available when the gift is made by the farmer himself, although it might then be necessary to rely on *Lucas v. Earl* also, since the crop or livestock would then be the joint product of the property and the donor's personal efforts.

*Eugene T. Flewellen*²¹ is considerably more difficult to explain on any basis other than the *Horst* concept of realization. In that case the Tax Court held the donor taxable on the amount of a carved out oil payment given to a charity.²² The decision was based entirely on the *Lake* case.²³ The *Lake* case, however, involved sales

¹⁸ 1963 INT. REV. BULL. No. 16, at 9.

¹⁹ Treas. Reg. § 1.61-4(a) (1957).

²⁰ In *United States v. Shafro*, 246 F.2d 338 (4th Cir. 1957), the taxpayer had assigned short-term leases of real property to his wife. The court found that the only significance of the assignments was to give the wife the right to receive the rent, and the court, therefore, held the rent taxable to the taxpayer, relying largely on the *Horst* case. See also *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954).

²¹ 32 T.C. 317 (1959).

²² For the benefit of the uninitiated, if any there be, an oil payment may be described as "the right to a specific sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil if, as and when produced." *Commissioner v. Lake*, 356 U.S. 260, 261 n.1 (1958). An oil payment is "carved out" when it is conveyed from a larger mineral interest and the balance of the interest is retained by the grantor. An oil payment may be carved out of any oil and gas interest, such as a working interest under a lease, a landowner's royalty interest or other royalty interest. Oil payments may also be created by reservations in conveyances of mineral interests.

and exchanges of such oil payments, and there was consequently no question of realization, but rather the question of whether the realized gain constituted ordinary income or capital gain. The Supreme Court in the *Lake* case held that it was ordinary income because it amounted to an advance payment of ordinary income.²⁴ It is possible to treat such oil payments as constituting income from the underlying minerals or royalty interest from which they are carved. However, no effort along those lines was made in the opinion in the *Flewellen* case. Instead the oil payment was simply treated as an ordinary income asset, and in this respect would not seem to differ greatly from the raised livestock of a farmer.

The *Flewellen* case becomes more interesting when consideration is given to the second issue which it raised. With respect to some of the charitable assignments, the oil and gas had already been produced, but payment had not yet been received from the purchaser. The court held that these assignments were not of oil payments but rather of accounts receivable. The donor was a cash basis taxpayer and normally would not take these amounts into income until paid. Nevertheless, the court held the donor taxable on these amounts, when received by the charity, on a sort of a *fortiori* extension of its holding with respect to the oil payments.

While unrealized receivables have played a large part in the corporate distribution cases to be considered later, there seem to be relatively few cases involving either charitable or private gifts of this sort of income asset. The *Wilkinson*²⁵ case probably belongs in this category although it seems unique on its facts. There are a number of cases involving gifts of income-producing property with accrued income by a cash basis taxpayer. For the most part, these involve gifts of notes or bonds with accrued and defaulted interest. While the Government has strongly urged the *Horst* concept of realization in these cases, it has not been favorably received by the courts. Whether the accrued income is taxable to the donor seems to depend upon whether its eventual payment is subject to

²³ Commissioner v. Lake, *supra* note 22. For the situation with respect to charitable contributions of oil payments prior to the *Lake* case, see Lester A. Nordan, 22 T.C. 1132 (1954).

²⁴ The court cited the *Horst* case, *Harrison v. Schaffner*, 312 U.S. 579 (1941), and *Helvering v. Clifford*, 309 U.S. 331 (1940). Both of the latter are like the *Horst* case in that they involved gifts of future income from property which, the court held, remained in the ownership of the grantor. *Hort v. Commissioner*, 313 U.S. 28 (1941), would seem more in point but was not cited. In that case the court held that an amount paid to a landlord for the cancellation of a lease constituted ordinary income since it was, in effect, a substitute for the rent that would have been received.

²⁵ *Wilkinson v. United States*, 304 F.2d 469 (Ct. Cl. 1962).

any substantial uncertainty or contingency at the time of the gift. If it is, the donor is not taxable;²⁶ otherwise he is.²⁷ One proposition, however, is clear from these cases. If the donor is taxable at all, he is taxable at the time of the later payment to the donee and not at the time of the gift.²⁸ The rationale of the cases, then, would seem to be that the income is taxable to the one who owns the property at the time of accrual, and not that the accrued income is realized by the gift. However, it is difficult to see why the uncertainty of payment at the time of the gift should be material under this analysis.

The practical lesson from the foregoing group of cases seems clear. If one contemplates making a charitable or private gift of property with an unrealized ordinary income potential, he would be well advised not to stray too far from the 1955 rulings with respect to the type of property.²⁹

II. QUESTIONABLE CONSIDERATION TRANSACTIONS

There are a substantial number of cases in which the transactions in question are neither charitable nor private gifts but, at the same time, cannot properly be considered as sales or exchanges in the ordinary sense. One of the most interesting for present purposes is *United States v. General Shoe Corp.*,³⁰ concerning a transfer of appreciated real property by a corporate taxpayer to

²⁶ *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (D. Fla. 1961); *Estate of H. H. Timken*, 47 B.T.A. 494 (1942), *aff'd*, 141 F.2d 625 (6th Cir. 1944). Both of the foregoing cases involved charitable gifts of notes with accrued interest which were of doubtful collectibility. Compare *Anthony's Estate v. Commissioner*, 155 F.2d 980 (10th Cir. 1946), involving a private gift of an undivided interest in an oil lease, together with certain amounts for oil already produced which the purchaser had impounded because of litigation concerning the donor's share of development and operating expenses. The donor reported on the cash basis, and the court held him taxable when the impounded amounts were subsequently paid to the donee, on the grounds of "constructive receipt." The *Timken* case was distinguished by saying the amounts involved here had already been earned and were merely subject to a creditor's lien. Compare *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945); *H. Lewis Brown*, 40 B.T.A. 565 (1939).

²⁷ *Austin v. Commissioner*, 161 F.2d 666 (6th Cir. 1947); I.T. 3011, XV-2 CUM. BULL. 132 (1936). *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961), involved a family gift of shares after the declaration of a dividend and before payment. The donor was held taxable when the dividend was paid to the donee.

²⁸ *Austin v. Commissioner*, *supra* note 27; *Estate of H. H. Timken*, 47 B.T.A. 494 (1942), *aff'd*, 141 F.2d 625 (6th Cir. 1944); *Annie A. Colby*, 45 B.T.A. 536 (1941).

²⁹ *Stuart A. Rogers*, 38 T.C. 785 (1963), illustrates the Service's zeal in this area. The taxpayer gave a charity a \$10,000 interest, called an "equity," in a stand of timber, and concurrently offered to sell it as agent for the charity. T then sold the entire tract for a price in excess of \$10,000 and the buyer paid \$10,000 to the charity. The Commissioner argued that this, in fact, constituted a gift of the proceeds of sale, but the Tax Court disagreed, citing *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954).

³⁰ 282 F.2d 9 (6th Cir. 1960).

a qualified retirement trust. The taxpayer, as it was clearly entitled to do, took a deduction in the amount of the value of the property.³¹ The court held that the corporation realized a capital gain equal to the difference between such value and its basis for the property, even though, under the terms of the retirement plan, it was under no obligation to make the contribution. In this respect the case seems similar to the *Hall* case³² because, even though the taxpayer received no consideration, the transfer was not donative in the ordinary sense. The court seemed to suggest that the deduction would serve as a substitute for the amount realized. This suggestion would seem equally appropriate to the charitable contribution cases. The court relied on the earlier *International Freighting Corp.* case,³³ involving a distribution of appreciated property to employees as a bonus. In the latter case the court held that the transferor corporation realized a taxable gain since the past services of the recipients constituted a proper consideration. This analysis, of course, puts the case in the "sale or exchange" category and outside the class of cases with which we are concerned. While the analysis would seem equally appropriate to the facts of the *General Shoe* case, the court there did not follow it, although citing the *International Freighting* case, but instead based its decision on the *Horst* concept of realization.

From the *General Shoe* and *International Freighting* cases it is a short jump, analytically, to the Supreme Court's decision in *United States v. Davis*.³⁴ In that case the Court finally settled the problem of a husband's tax liability when he transfers appreciated property to his wife pursuant to a property settlement incident to a divorce. In reaching its decision the Court considered two issues. First, did the transfer constitute a taxable event? The Court concluded that it did since it was in satisfaction of the wife's inchoate marital interests in the husband's property and her rights to support and maintenance. This, of course, puts the case into the sale or exchange category. However, it obviously does not fit there very comfortably, since such characterization logically raises the question of the wife's possible gain on the transaction.³⁵ It also ignores the likelihood that the settlement may have been made in

³¹ INT. REV. CODE OF 1954, § 404 (formerly Int. Rev. Code of 1939, § 23(p)).

³² 307 F.2d 238 (10th Cir. 1962).

³³ *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943).

³⁴ 370 U.S. 65 (1962).

³⁵ See Scott, *Recent Developments in the Federal Income Tax Laws—A Selective Survey of Recent Judicial Decisions*, 41 N.C.L. REV. 783, 791 (1963).

some degree to secure the wife's acquiescence to the divorce, or for similar intangible and more or less personal reasons. In such respect this case also seems similar to the *Hall* case. Clearly it is not gratuitous, but neither is it a sale or exchange in the ordinary sense, nor even a transfer of property entirely to satisfy a legal obligation as the Court suggested.

The second issue concerned the proper measure of realized gain. On this the Court affirmed a number of lower court cases in holding that the gain equalled the difference between the transferor's basis and the value of the property.³⁶ This proposition is, of course, indispensable to any of the cases under consideration here, when the income potential of the particular asset is such that it would normally be realized by a sale or exchange. However, in the *Davis* case the Court reached this result by reasoning that the marital rights transferred to the husband were equal in value to the property which he transferred in satisfaction of them. This made it possible to determine the husband's gain in terms of the "amount realized." This reasoning is obviously not available in cases where the transfer cannot, by any stretching of the terms, be considered a sale or exchange. In both the *Hall* and *General Shoe* cases the courts overcame this logical difficulty by saying, in effect, that the transfers should be treated just as if the taxpayer had first sold the property and then transferred the proceeds. In the *General Shoe* case the court supported this conclusion largely on the *Horst* concept of realization.³⁷

The problem last discussed is closely related to the question of the transferee's basis, and this was considered in a dictum in the *Davis* opinion. Regardless of possible inadequacies of the statute, it seems clear that in any case where the transferor is held to have realized a gain measured by the value of the transferred property, the same value should serve as the transferee's basis. This is the

³⁶ *Commissioner v. Halliwell*, 131 F.2d 642 (2d Cir. 1942); *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941). *Contra*, *Commissioner v. Marshman*, 279 F.2d 27 (6th Cir. 1960).

³⁷ It is worth noting that the court which decided *General Shoe* had previously decided the principal case, holding contrary to the result eventually established by the *Davis* case, with respect to the realization of gain on transfers pursuant to divorce settlements. *Commissioner v. Marshman*, *supra* note 36. In the latter case the court found that the transfer did involve a sale or exchange, but that the marital rights, which constituted the amount realized, could not be valued, and therefore the gain, if any, could not be determined. The *Marshman* case was distinguished in *General Shoe* on the grounds indicated in the text above. The court in *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943), relied on *Commissioner v. Mesta*, *supra* note 36, which was the principal forerunner of *Davis*. The Supreme Court in *Davis* cited, in turn, both *International Freighting* and *General Shoe*. However, it is clear that the Sixth Circuit has viewed the matter a good deal differently than the other courts.

result which the Supreme Court reached in its dictum. However, it is difficult to defend since the divorce settlement is treated as a sale or exchange on the part of the husband but not on the part of the wife.³⁸ In other words, the wife appears to be receiving a substantial basis tax free. This logical difficulty disappears if the analysis of the *Hall* and *General Shoe* cases is followed, and the transaction is treated as if the property had been sold by the transferor and the proceeds then paid to the transferee. It is interesting to note that the 1948 ruling, which held that a donor realizes income on a family gift of raised livestock, also held that the donee's basis for the livestock would be its value at the time of the gift.³⁹

III. CORPORATE DISTRIBUTIONS

The most important group of cases involve distributions in kind by liquidating corporations. While liquidating distributions are generally taxable exchanges at the shareholder level, section 336 provides that no gain or loss shall be recognized by the corporation except to the extent that the distribution includes installment obligations. Nevertheless, the courts have required the recognition of income by corporations making liquidating distributions of zero basis property with an unrealized ordinary income potential. The recent decision of the Court of Claims in *Williamson v. United States*⁴⁰ provides not only a good illustration of the problem but also a full discussion of the law. Williamson had been the sole shareholder of a corporation engaged in a service business which reported its income on the cash method. He caused the corporation to be liquidated and received almost 200,000 dollars of accounts receivable in the liquidation.

The tax avoidance possibilities are obvious. The corporation, because of its method of accounting, and giving section 336 literal effect, would never be required to take the accounts into income. The shareholder on liquidation would likely have a capital gain roughly equal to the value of the accounts.⁴¹ However, he would then have a market value basis for the accounts and would realize little or no additional income on the eventual collections.⁴² The net effect of the liquidation, then, would be to convert ordinary in-

³⁸ See Scott, *supra* note 35.

³⁹ I.T. 3932, *supra* note 9.

⁴⁰ 292 F.2d 524 (Ct. Cl. 1961).

⁴¹ This assumes that the value of the other assets received in the liquidation would equal or exceed the basis for his shares.

⁴² INT. REV. CODE OF 1954, § 334.

come into capital gain. The separate corporate tax would also be avoided.

This is strongly suggestive of the collapsible corporation device, but is apparently beyond the reach of the collapsible corporation provisions of the Code.⁴³ Even though "unrealized receivables" are included in the definition of "section 341 assets" a corporation, to be collapsible, must engage in the "manufacture, construction or production of property" or the "purchase of property." This would seem to exclude a corporation in a service business, and the government has apparently made no effort to deal with these cases under the collapsible corporation provisions. Strangely enough, however, the collapsible partnership provision will apply to this sort of scheme when worked through a partnership in a service business.⁴⁴

In any event, as indicated above, the courts in this and similar cases have held for the Government in spite of the apparent deficiencies of the statute. The stated basis for decision in the *Williamson* case and others like it is section 446 which authorizes the Commissioner to prescribe a different method of accounting if the one used by the taxpayer does not correctly reflect income.⁴⁵ But this approach is not entirely free of difficulties. In the *Williamson* case the taxpayer argued that, if the corporation was to be put on the accrual basis with respect to the receivables distributed in the liquidation, it should be permitted to exclude the receivables which were outstanding at the beginning of the year and collected during the year. In answer to this the court said:

"In any event the Commissioner's adjustment did not necessarily put the corporation on the accrual basis, but merely affected the accounting treatment of one item in order clearly to reflect the realization by the corporation of earned income."⁴⁶

⁴³ INT. REV. CODE OF 1954, § 341. The collapsible corporation provision, of course, provides a different remedy for the abuse. It taxes the gain at the shareholder level as ordinary income, whereas the cases under consideration here have required the realization of ordinary income at the corporate level, a more drastic remedy.

⁴⁴ INT. REV. CODE OF 1954, § 751. The difference may be the result of the different backgrounds of the two provisions. The collapsible corporation provision was enacted to take care of corporations producing property with ordinary income potential, such as motion pictures and residential property. However, one of the leading partnership cases involved unrealized receivables. *Swiren v. Commissioner*, 183 F.2d 656 (7th Cir. 1950).

⁴⁵ *Idaho First Nat'l Bank v. United States*, 265 F.2d 6 (9th Cir. 1959) (cash basis bank distributed notes with accrued interest); *Floyd v. Scofield*, 193 F.2d 594 (5th Cir. 1952) (unrealized receivables); *Jud Plumbing & Heating Co. v. Commissioner*, 153 F.2d 681 (5th Cir. 1946) (corporation in contracting business, which reported on completed contract method, distributed contracts not yet completed).

⁴⁶ 292 F.2d 524, 531 (Ct. Cl. 1961).

This sentence suggests that the *Horst* concept of realization is necessary to the result and, in fact, most of the opinion in the *Williamson* case is devoted to an analysis of that concept. The chief contribution of section 446 is to provide a statutory means for getting around the positively stated rule of section 336.

From the language of that section it might be argued that the question in distributions in kind is not one of realization at all but rather a question of recognition. In other words, it might be argued that this section is similar to those which, as a matter of policy, provide for the non-recognition of admittedly realized gains, such as section 1034 on the sale of a personal residence and section 351 on tax-free corporate organizations. However, this analysis is not borne out by the history of the subject. This section was intended to codify the rule of *General Util. & Operating Co. v. Helvering*,⁴⁷ and in that case the Court held, although without much in the way of discussion, that a corporation does not realize gain on a dividend distribution of appreciated property. The basis for the holding is clear enough from the opinion. There is no sale or exchange. As an original proposition, this conclusion would seem subject to question. It is true, of course, that a shareholder has no legally enforceable right to a dividend prior to its declaration. However, on the basis of his investment, the shareholder certainly has a justifiable expectation that dividends will be distributed as the success of the corporation warrants, and a dividend, when received, can in no sense be considered a gratuity. The *General Utilities* case, then, is similar in this respect to the *Hall* and *General Shoe* cases considered under the previous heading.

In the case of a liquidating distribution, the argument for sale or exchange treatment is considerably stronger. Once the decision to liquidate a corporation has been made, the shareholders obviously have a legally enforceable right to receive the assets. Furthermore, the distribution is treated as a sale or exchange at the shareholder level and it is difficult to understand the logic in treating it differently at the corporate level. This inconsistency is, of course, similar to the one considered in connection with the *Davis* case. However, as a practical matter these questions have apparently been laid to rest for the general run of cases by the enactment of section 336, and our principal concern here is with the exceptional case such as *Williamson*.

While the law with respect to liquidating distributions of un-

⁴⁷ 296 U.S. 200 (1935).

realized receivables now seems reasonably well established, two interesting variations have recently appeared. Both *Commissioner v. Kuckenberg*⁴⁸ and *Family Record Plan, Inc. v. Commissioner*⁴⁹ involved sales by corporations of what might properly be considered as unrealized receivables during the course of twelve-month liquidations.⁵⁰ The taxpayers relied upon section 337, which provides that gain shall not be recognized to the corporation upon sales during the course of such a liquidation. The Court of Appeals for the Ninth Circuit held for the Government in both cases on the authority of *Williamson* and similar cases discussed above.⁵¹

*Commissioner v. South Lake Farms, Inc.*⁵² is more complicated and brings in still further sections of the Code. The taxpayer was a subsidiary farming corporation which distributed all its assets to its parent in a complete liquidation. Included in the assets were a growing crop of cotton and an item referred to as "land preparation," on both of which the taxpayer had incurred deductible expenses in excess of 800,000 dollars. The parent had acquired the stock of the subsidiary shortly before the liquidation and, therefore, under section 334(b)(2), the parent's total basis for the assets acquired in the liquidation was its cost basis for the stock. Of this total basis, over 1,600,000 dollars was allocated to the growing crop, and over 200,000 dollars to the "land preparation." The effect of this allocation was, of course, to reduce in like amounts the parent's income upon the harvest and sale of the cotton crop, and the crop which was eventually grown on the land subjected to the land preparation. The deductible expenses left the subsidiary with a substantial operating loss for its last accounting period which it sought to carry back to prior years.

The Commissioner made his attack at this point, basing it on alternative grounds. He first sought to include the value of the

⁴⁸ 309 F.2d 202 (9th Cir. 1962).

⁴⁹ 309 F.2d 208 (9th Cir. 1962).

⁵⁰ In *Kuckenberg* the corporation reported income on the completed contract method and sold contracts not yet completed. In the *Family Record Plan* case the corporation reported on the cash basis and sold accounts receivable which were payable in installments.

⁵¹ The Tax Court had held for the taxpayer in the *Kuckenberg* case. 35 T.C. 473 (1960). However, it held for the Government in *Family Record Plan* on the ground that the accounts receivable were installment obligations within the meaning of § 337(b)(1)(B). 36 T.C. 305 (1961). In affirming the latter case the circuit court relied on its decision in *Kuckenberg* and did not pass on the Tax Court's characterization of the accounts.

⁵² 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963). The above discussion of the case was originally prepared on the basis of the Tax Court's opinion and has been rather hastily revised to square with the majority opinion of the court of appeals. Actually the two do not differ greatly. The decision of the court of appeals was somewhat surprising in view of its decisions in the *Kuckenberg* and *Family Record Plan* cases.

crop and the land preparation on the date of the distribution in the subsidiary's income for its last accounting period. For this he relied upon his authority with respect to accounting methods under section 446. However, as the court of appeals held, there is no recognized method of accounting which would require the accrual, as income, of the value of growing crops, much less "land preparation."⁵³ The case is interesting for present purposes since it involves a liquidating distribution of an income asset other than "unrealized receivables," and demonstrates that section 446 is of limited value in such cases. The Tax Court also held against the Government in its attempt to tax the income potential of these assets to the subsidiary. However, the Tax Court did not concern itself so much with accounting methods, but rather based its holding largely on its decision in *Elsie SoRelle*,⁵⁴ which, it will be remembered, involved a family gift of land with a growing crop of wheat. The Commissioner had sought to forestall this result by basing his argument entirely on section 446 and disclaiming any reliance on the *Horst* concept of realization. However, the two cannot be so completely divorced, as the *Williamson* case illustrates.

In the alternative, the Commissioner in the Tax Court sought to disallow the deduction of the expenses by the subsidiary on the ground that these could properly be allocated to the parent under the authority of section 482, and that such expenses were, in effect, deducted by the parent through the allocation of basis described above. However, the court held that this allocation of basis was not equivalent to an expense deduction, and that section 482 did not authorize the disallowance of the deductions altogether.⁵⁵ In the court of appeals the Commissioner made essentially the same argument, but based it on section 446 instead of section 482. However, the revised version fared no better than the original, the

⁵³ See *Estate of Tom L. Burnett*, 2 T.C. 897 (1943).

⁵⁴ 22 T.C. 459 (1954). There was a strong dissenting opinion by Judge Carter to the court of appeals' decision in *South Lake Farms* which discusses the problem from every possible point of view. The tax avoidance possibilities are graphically illustrated under the heading, "The Shocking Results." Judge Carter disposed of the Tax Court's decision by stating that he did not consider *Elsie SoRelle* to represent the law. He then turned the Revenue Ruling acquiescing in the *SoRelle* case (see note 13 *supra*) against the taxpayer by pointing out that it disallows expenses incurred with respect to the gift property, and, to that extent, supports the alternative argument of the Commissioner in *South Lake Farms*.

⁵⁵ Compare *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), in which the taxpayer sought to deduct expenses incurred in connection with a growing crop which was transferred to a corporation prior to harvest in a tax-free organization under section 351. The court sustained the Commissioner in reallocating the expenses to the corporation. It is worth noting that this is also a Ninth Circuit decision.

court holding, in effect, that no method of accounting would require the disallowance of these deductions.

The *South Lake Farms* case, then, ended in a complete victory for the taxpayer. It is difficult to assess its significance in terms of tax avoidance possibilities. Clearly the selling shareholders of the old, or subsidiary corporation, were the principal beneficiaries of the transaction, having both avoided the separate corporate tax and converted ordinary income into capital gain. Had the Commissioner prevailed on his first proposition, these unwarranted benefits would have been denied, just as in the other liquidation cases involving unrealized receivables. Here, however, the corporation was engaged in the production of property which would produce ordinary income if sold in the usual course of business. The case would seem to be the sort that the collapsible corporation provisions of the Code were designed to reach.⁵⁶ However, the shareholders were not involved in the litigation, and the court gave no consideration to the possible application of these provisions. The Commissioner's alternative argument, based on tax benefit principles, would only partially take care of the problem, from his point of view, and would be difficult to sustain under the statute. The case does illustrate that, if the *Horst* concept of realization were applied to all liquidating distributions of assets with an ordinary income potential, the collapsible corporation provisions would be largely unnecessary. It is worth noting that section 336, which provides generally that gain shall not be recognized on liquidating distributions in kind, and which, of course, provides the principal support for the taxpayers in these cases, had its origin in a case involving appreciated capital assets and a current distribution rather than a liquidating one.⁵⁷ Both section 336 and section 341 on collapsible corporations would seem to be in need of re-examination.

Section 311 is a companion section to 336, and provides that no gain or loss shall be recognized by a corporation upon a current distribution in kind. Generally speaking, the tax avoidance potentials of current distributions in kind are not as spectacular as those of liquidating distributions. To the extent that the distributed property includes an element of unrealized income, the separate corporate tax is avoided. However, since the distribution will ordinarily constitute a dividend to the full value of the prop-

⁵⁶ INT. REV. CODE OF 1954, § 341.

⁵⁷ *General Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

erty and be taxed as ordinary income to the recipients, a current distribution will not generally be effective in converting ordinary income to capital gain. This, of course, assumes that the corporation's earnings and profits are equal to the value of the distributed property. Congress foresaw the tax avoidance possibilities when they are not equal to the value of the distributed property, and took care of this by providing that the earnings and profits should be increased by the amount of the unrealized ordinary income potential of the distributed assets, including both inventory assets and unrealized receivables.⁵⁸ It seems strange that Congress did not likewise recognize the more obvious tax avoidance possibilities of section 336.

The Government has won some notable victories in current distribution cases. The most significant case in this area is *Commissioner v. First State Bank of Stratford*,⁵⁹ in which the corporate taxpayer was held taxable on the value of previously charged off notes which it had distributed as a dividend in kind. This, of course, made an exceptionally strong case for the Government since the taxpayer had deducted the notes as bad debts in previous years. While the court talked generally of anticipatory assignments of income, the decision was based squarely on the *Horst* concept of realization. The court reconciled its holding with the *General Utilities* case principally on the different nature of the property distributed, and also drew a distinction between a dividend distribution and a liquidating distribution. Under the 1954 Code, such a distinction is, of course, no longer possible. However, it is worth noting that the Senate Finance Committee's Report concerning section 311 stated that it was not intended to change the rule of the *Bank of Stratford* case.⁶⁰ Unfortunately, the report does not indicate the committee's view as to the scope of the rule. Other cases, all decided before the enactment of the 1954 Code, have reached similar results with respect to distributions of other kinds of property.

*First Nat'l Bank v. United States*⁶¹ involved a distribution of mineral interests in certain land owned by the taxpayer, together with the right to certain royalties which had previously accrued but had been impounded because of pending litigation. The corporate taxpayer reported income on the cash basis and had,

⁵⁸ INT. REV. CODE OF 1954, § 312(b).

⁵⁹ 168 F.2d 1004 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (1948).

⁶⁰ S. REP. NO. 1622, 83d Cong., 2d Sess. 247 (1954).

⁶¹ 194 F.2d 389 (7th Cir. 1952).

therefore, not taken these royalties into income. The royalties were held taxable income to the corporation when paid to the shareholders. With respect to the type of property involved, the case is very similar to those involving charitable or private gifts of notes or bonds with accrued interest.⁶² Like those cases, this one seems to be best explained on the proposition that income from property is taxable to the one owning the property at the time the income was earned, regardless of accounting systems.

In *Rudco Oil & Gas Co. v. United States*,⁶³ the corporation distributed oil payments as a dividend. The oil payments had been carved out of the corporation's working interest in certain oil and gas leases. The case was decided during the time that such oil payments were treated as capital assets,⁶⁴ and the Court of Claims held that the corporation realized a capital gain equal to the difference between its cost basis for the oil payment and its value. The rationale of the decision is not clear. The Government apparently proceeded originally on the *Horst* theory of realization, but then abandoned this out of deference to the *General Utilities* case.⁶⁵ The court based the decision on the anticipatory assignment of income principle, citing *Lucas v. Earl*, *Harrison v. Shaffner*⁶⁶ and *Horst*. Put this way, the distinction between the two principles becomes pretty elusive. Furthermore, the anticipatory assignment of income rationale obviously does not square with the capital gains treatment, although the latter was obviously more the Government's responsibility than the court's.⁶⁷ In fact, if the holding had been in accord with what the court said, the decision would have anticipated both the *Lake*⁶⁸ and *Flewellen*⁶⁹ cases by almost ten years.

The most puzzling case in this area is *United States v. Lynch*,⁷⁰ in which the corporation had declared a dividend in kind of inventory property, and then acted as agent for the shareholders in

⁶² See cases cited in notes 26, 27 *supra*.

⁶³ 82 F. Supp. 746 (Ct. Cl. 1949).

⁶⁴ See *Commissioner v. Lake*, 356 U.S. 260 (1958).

⁶⁵ INT. REV. CODE OF 1954, § 311 had, of course, not yet been enacted.

⁶⁶ 312 U.S. 579 (1941). The taxpayer made a family gift of amounts to be paid to her during the following year as beneficiary of a trust. The Court held that the amounts, when paid, were taxable to the donor.

⁶⁷ The deficiency was originally assessed as a capital gain on the *Horst* concept of realization, the ninety-day letter referring to it as "Gain on Distribution of Dividend in Kind." 82 F. Supp. 746, 747 (Ct. Cl. 1949).

⁶⁸ 356 U.S. 260 (1958).

⁶⁹ 32 T.C. 317 (1959).

⁷⁰ 192 F.2d 718 (9th Cir. 1951).

selling it. The court sustained the Commissioner in taxing the profits of the sale to the corporation, largely on the grounds that the dividend served no business or corporate purpose. The district court had reached the same result, relying upon the *Court Holding Co.* case.⁷¹ While the court of appeals distinguished the latter case on the ground that it involved a liquidating rather than a current distribution, it did not consider the possibility of the distribution constituting a realization at the corporate level, nor the application of the *General Utilities* case. However, the Service has since apparently conceded these issues. Revenue Ruling 57-490⁷² holds that a corporation realizes no income by a dividend distribution of agricultural products which constitute corporate inventory. This ruling was based largely on the 1955 rulings with respect to charitable and private gifts of similar property.⁷³ Consistently with such rulings, it goes on to provide that the distributed property must be removed from the opening inventory, and that expenses of the current year with respect to it may not be deducted.

IV. CONCLUSION

The cases considered in the foregoing discussion are at least sufficient to illustrate that problems of realization on transfers other than a sale or exchange can be presented in a variety of situations. Most of them involve transactions which were obviously tax motivated, and, therefore, any attempt to generalize or summarize must, to be meaningful, take into account the relative tax avoidance possibilities of the various transactions. In other words the problem becomes one of drawing the line between what is permissible in the way of tax avoidance and what is not. With this in mind, the cases are subject to classification along two different lines—first, in terms of the type of transfer involved and second, in terms of the nature of the property.

Thus, there are private gifts and charitable gifts, and there are other transfers which are neither gifts nor sales nor exchanges. Generally, the only tax advantage of a private gift is to split in-

⁷¹ *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). In this case the shareholders received appreciated capital assets in a liquidating distribution and subsequently sold them. The sale had been largely negotiated by agents of the corporation before the distribution and the Supreme Court sustained the Tax Court in finding that the sale had, in fact, been made by the corporation, and taxing the gain to it.

⁷² 1957-2 CUM. BULL. 231.

⁷³ Rev. Rul. 55-138, 1955-1 CUM. BULL. 223 (charitable gifts); Rev. Rul. 55-531, 1955-2 CUM. BULL. 520 (private gifts).

come among family members. On the other hand, in the case of a charitable gift, the income potential of an asset is realized, so to speak, for purposes of the charitable deduction but not for income purposes. Transactions in the gray zone may resemble either a private or charitable gift in this respect. In the *Hall* case⁷⁴ the taxpayer did not obtain any deduction or other tax benefit from the transfer. However, in the *General Shoe*⁷⁵ case the transfer to the pension trust gave rise to a deduction for the unrealized appreciation, much the same as in the case of a charitable contribution. There are, furthermore, current distributions by corporations which serve to avoid the separate corporate tax, and liquidating distributions which may, in addition, operate to convert ordinary income into capital gain.

Differences in tax avoidance potential become more pronounced when consideration is also given to the nature of the property transferred. At one extreme are appreciated capital assets. It would seem clearly improper to tax the donor in the case of a private gift of such property, in view of the express provision of the Code requiring the donee to take the donor's basis for gift property.⁷⁶ However, the problem is much different in the case of charitable gifts where an immediate tax benefit in the form of a deduction is realized, and where the realization of income is avoided rather than being merely deferred.⁷⁷ As it happens, the recommendation on point in President Kennedy's 1963 tax message was almost exactly the opposite. He proposed ". . . a tax at capital gain rates on all net gains accrued on capital assets at the time of the transfer at death or by gift."⁷⁸ Charitable contributions would, however, be exempt. No trace of this appears in H.R. 8363, as recommended by the Ways and Means Committee and passed by the House.⁷⁹ In the writer's opinion, the proposal was not well founded. Private gifts of appreciated capital assets would not seem to present a serious problem since income splitting is less significant in the case of capital gain. The stepped-up basis for property passing

⁷⁴ 307 F.2d 238 (10th Cir. 1962).

⁷⁵ 282 F.2d 9 (6th Cir. 1960).

⁷⁶ INT. REV. CODE OF 1954, § 1015.

⁷⁷ Under some circumstances additional tax advantages may be available. Rev. Rul. 59-196, 1959-1 CUM. BULL. 56, held that the fair market value of an undivided interest in an oil and gas lease, contributed to a charity, could be deducted without reduction for intangible drilling and development costs deducted in prior years. The problem was raised by Rev. Rul. 55-138, 1955-1 CUM. BULL. 223. Compare the provisions of new § 170(e), relating to prior depreciation deductions, discussed in text following note 83 *infra*.

⁷⁸ 1 U.S. CODE, CONG. & ADM. NEWS 43, 58 (1963).

⁷⁹ H.R. REP. No. 749, Sept. 13, 1963.

on death is, of course, a serious loophole, but the obvious solution is to require the heir or legatee to take the decedent's basis as in the case of inter vivos gifts.

Turning to corporate distributions, it would seem that neither liquidating nor current distributions of appreciated capital assets should involve a recognition of gain at the corporate level. In the case of liquidating distributions, such recognition would be clearly contrary to the congressional policy expressed in section 337. And by the enactment of section 311, along with section 336, Congress indicated its intention that current distributions should be treated the same as liquidating distributions, regardless of the distinction suggested by the *Bank of Stratford* case.⁸⁰

At this point consideration should be given to section 1231 assets⁸¹ which have a value greater than their basis because of excessive depreciation deductions in prior years. Before the Revenue Act of 1962,⁸² these would have been treated the same as appreciated capital assets so far as the problems here under consideration are concerned. However, the 1962 act added section 1245 to the Code, and this section, stated most broadly, treats most of these assets as ordinary income property to the extent of such excess value.⁸³ More specifically, it provides that gain upon the sale or exchange of such assets shall be ordinary income up to the amount of depreciation allowed or allowable subsequent to 1961. The significant aspect of section 1245, for present purposes, is that it provides for similar realization of ordinary income upon any other disposition, with certain enumerated exceptions. Among the various types of transactions considered above, this general provision would apply to both current and liquidating distributions by corporations and probably to the gray zone cases typified by the *Hall*,⁸⁴ *General Shoe*⁸⁵ and *Davis*⁸⁶ decisions. The section does not require the recognition of gain in the case of private or family gifts of 1245 property, but the donor's ordinary income

⁸⁰ 168 F.2d 1004 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (1948); see *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961).

⁸¹ Section 1231 assets include, generally, depreciable property used in a trade or business and real property used in a trade or business. INT. REV. CODE OF 1954, § 1231(b).

⁸² 76 Stat. 4 (1962), 26 U.S.C. § 1111 (Supp. IV, 1963).

⁸³ The most conspicuous exceptions are livestock and buildings. The first is especially difficult to understand since livestock held for breeding purposes has provided some of the best opportunities for trading capital gain for ordinary income deductions, the practice at which § 1245 is principally aimed. H.R. 8363, *supra* note 79, would extend the ordinary income treatment to depreciable real estate, subject to rather severe limitations.

⁸⁴ 307 F.2d 238 (10th Cir. 1962).

⁸⁵ 282 F.2d 9 (6th Cir. 1960).

⁸⁶ 370 U.S. 65 (1962).

potential will carry over to the donee. Nor does the section require the recognition of gain upon a charitable contribution. However, section 170(e), also added by the 1962 Act, provides that the charitable deduction shall be reduced by the amount of the ordinary income potential of any 1245 assets. Therefore, even though this income potential still escapes tax, the donor no longer derives a tax benefit from it. It should be noted that any gain in excess of that treated as ordinary income under section 1245 may still escape tax for lack of a sale or exchange.

For purposes of the present discussion, section 1245 is significant because it demonstrates congressional awareness of the need for recognizing gain upon some transfers, other than sales or exchanges, of assets having an unrealized ordinary income potential. In this respect it is not unique. Section 453(d) requires the recognition of gain when an installment obligation is "distributed, transmitted, sold or otherwise disposed of."⁸⁷ Likewise, section 691a(2) provides for the realization of income upon transfers of rights to receive income in respect of a decedent, and defines "transfer" to include dispositions other than sales or exchanges.⁸⁸ The present statutory treatment is very uneven, and further legislative efforts no doubt should be expected.

The third category of assets includes those with an ordinary income potential which would normally be realized in the usual course of business. For present purposes, this is obviously the most important group since it provides most of the opportunities for seemingly unfair tax avoidance. With respect to such assets, however, a further classification is necessary. The income represented by inventory, or other dealer property, is of such a nature that it will usually be realized by a sale or exchange. Therefore, in cases

⁸⁷ See Rev. Rul. 60-352, 1960-2 CUM. BULL. 208, involving a charitable contribution of a limited partner's interest in a partnership. The partnership owned installment obligations, and the ruling holds that the donor realized income equal to his proportionate share of the value of these installment obligations.

⁸⁸ The principal problem, of course, is determining what assets constitute income in respect of a decedent. This problem is related to the present discussion since the purpose of § 691, on income with respect to a decedent, is to prevent the ordinary income potential of certain assets escaping taxation by the asset acquiring a stepped up basis when it passes on death. Some of the decisions are, therefore, interesting. *Commissioner v. Linde*, 213 F.2d 1 (9th Cir. 1954), held that grapes grown by the decedent and delivered to a cooperative constituted income in respect of a decedent, notwithstanding that they had not been sold prior to his death. The result, of course, was that the proceeds of the subsequent sale constituted taxable income to the legatee; the grapes did not acquire a new basis under § 1014. The case bears a certain resemblance, basis-wise, to *South Lake Farms, Inc.*, 36 T.C. 1027 (1961). See also *Davison's Estate v. United States*, 292 F.2d 937 (Ct. Cl. 1961).

involving such assets, the Government must rely largely on the *Horst* concept of realization. To date this has been notably unsuccessful in both the charitable contribution cases and the corporate distribution cases.⁸⁹ On the other hand, realization, in the case of unrealized receivables, requires only the passage of time and is generally controlled by accounting methods. This makes it possible for the Commissioner to base his attack upon section 446, and the lack of a sale or exchange does not seem so significant.⁹⁰

In order to determine the rightful place of the *Horst* concept of realization in the tax law, it will be helpful to take a brief look at the various types of cases which have been decided in terms of "anticipatory assignments of income." Most of the cases involve tax motivated transactions, but beyond that it is difficult to generalize. While many of them could have been decided on the *Horst* concept of realization, most of them were not. One thing, however, is clear. It is not possible to state a single meaningful rule concerning anticipatory assignments of income. Rather, that phrase should serve as a general heading for a number of more concrete propositions, each of which, incidentally, involves its own fair share of difficulties. The *Horst* concept of realization has probably not received sufficient recognition to be included among these, but it will be interesting to note how far it has gone, and how far it can go, in taking care of the difficulties.

The assignment of income terminology apparently originated in *Lucas v. Earl*,⁹¹ and that case can best be explained as standing for the rule that earned income is to be taxed to the one who earns it. Attempts to carry the *Lucas v. Earl* principle over into cases involving other types of income have not been satisfactory.⁹² Nor has *Lucas v. Earl* been adequate in all cases involving earned income. The cases dealing with distributions of unrealized receivables by service corporations reporting on a cash basis would seem to be one good illustration.⁹³ Then there are the cases in which a person, by his own efforts, creates a valuable property which he

⁸⁹ *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); *South Lake Farms, Inc.*, *supra* note 86; Rev. Rul. 57-490, *supra* note 72.

⁹⁰ See the corporate liquidations cases cited in notes 40, 45 *supra*.

⁹¹ 281 U.S. 111 (1930).

⁹² For example, *Lucas v. Earl* was relied on in the *Horst* case. But what was said on the basis of it there would have been just as applicable to the facts of *Elsie So Relle*, 22 T.C. 459 (1954). See also *Rudco Oil & Gas Co. v. United States*, 82 F. Supp. 746 (Ct. Cl. 1949). Obviously, the cases won't support the broad application of *Lucas v. Earl* suggested in that opinion.

⁹³ See cases cited in notes 40, 45 *supra*.

contributes to a charity.⁹⁴ Both of these can be handled better with the *Horst* concept of realization.

The second proposition, for which the *Schaffner*,⁹⁵ *Blair*,⁹⁶ *Horst*, and *Clifford*⁹⁷ cases are the principal authorities, is that income from property is taxable to the owner of the property, and, therefore, if a donor makes a gift of future income but retains the property, he will be taxable on such income when paid to the donee. Since the right to receive income from property is itself a property right, the chief difficulties in this area lie in drawing the line between gifts of income and gifts of property.⁹⁸ As indicated above, there is presently a further problem when the gift includes both the property and accrued but unrealized income. In this area the *Horst* concept of realization does not seem particularly useful except, perhaps, in cases such as *Elsie SoRelle*⁹⁹ and *South Lake Farms*¹⁰⁰ involving the transfer of property together with an income potential such as a growing crop which has not accrued in any conventional sense.

The third proposition, supported by the *Horst*¹⁰¹ and *Lake*¹⁰² cases, is that the gain realized by the sale or exchange of a right to receive ordinary income in the future is itself ordinary income. The principal problem here is much like the first one discussed in connection with the second proposition. At what point does the right to future income become a sufficient property interest so as to qualify as a capital asset? As things stand currently, a carved out oil payment is not such an interest,¹⁰³ but a life estate is.¹⁰⁴ Obviously these cases present no question concerning the *Horst* concept of realization. But, on the other hand, the stated proposition is not helpful when such rights are disposed of in a transaction

⁹⁴ See Hilla Rebay, P-H TAX CT. REP. & MEM. DEC. (P-H Tax Ct. Mem.) ¶ 63-042 (Feb. 18, 1963). The Service has consistently ruled that a contribution of services does not give rise to a charitable deduction (Treas. Reg. § 1.170-2(a)(2) (1963)) but this apparently cannot be extended to tangible property created by the donor's efforts.

⁹⁵ 312 U.S. 579 (1941).

⁹⁶ *Blair v. Commissioner*, 300 U.S. 5 (1937).

⁹⁷ 309 U.S. 331 (1940).

⁹⁸ See the *Clifford* case, *supra* note 97, and the statutory provisions to which it eventually led: INT. REV. CODE OF 1954, §§ 676-75.

⁹⁹ 22 T.C. 459 (1954).

¹⁰⁰ 36 T.C. 1027 (1961).

¹⁰¹ 313 U.S. 28 (1941).

¹⁰² 356 U.S. 260 (1958). See also *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960).

¹⁰³ *Commissioner v. Lake*, *supra* note 102.

¹⁰⁴ *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); *Bell's Estate v. Commissioner*, 137 F.2d 454 (8th Cir. 1943); Treas. Reg. § 1.1014-5(a) (1957).

not involving a sale or exchange as, for a most obvious example, in a charitable contribution. One way over this logical difficulty is to ignore it, as in the *Flewellen* case.¹⁰⁵ Another way is to becloud it by speaking generally in terms of anticipatory assignments of income, as in the *Rudco Oil & Gas Co.* case.¹⁰⁶ However, the *Horst* concept of realization seems to provide a solution that is, at least, more logically satisfying.

What, then, can be said generally with regard to the current status of the *Horst* concept of realization and its future potential? In the first place it seems obvious that it cannot be extended to its full logical scope. That would require recognizing gain upon any gift of appreciated capital assets, and would even seem to support taxing the income of donated property, accruing subsequent to the gift, to the donor.¹⁰⁷ On the other hand, from the point of view of the Government, it would play a useful role in cases involving charitable gifts, corporate distributions, and perhaps other types of transfers of property having an ordinary income potential. Clearly, the established assignment of income principles, as set out above, are not adequate for these cases in view of the Government's notable lack of success in such cases in the past. There are, however, some indications that judicial attitudes may be changing. More significantly, perhaps, the 1962 Revenue Act indicates legislative concern with the subject. Since Congress went to considerable lengths in section 1245, and related provisions, to cover one of the less serious problems, it seems reasonable to suppose that it will find occasion in the future to deal with the more important questions.

* * *

Since the completion of the foregoing article, the Tax Court's decision in *S. M. Friedman* has been reported.¹⁰⁸ The case seems significant since the court comes squarely to grips with the *Horst* concept of realization and puts forth a statement of the concept that is intended to be consistent with all its prior holdings in the area. That, obviously, is no small undertaking. Beyond that, the case seems to illustrate a renewed interest in the concept at the administrative level.

¹⁰⁵ 32 T.C. 317 (1959).

¹⁰⁶ 82 F. Supp. 746 (Ct. Cl. 1949).

¹⁰⁷ This was apparently argued, but the argument rejected, in *Helvering v. Stuart*, 317 U.S. 154, 168 (1942).

¹⁰⁸ 41 T.C. No. 43 (Dec. 31, 1963).

Friedman owned a number of endowment policies all of which would mature on October 29, 1958. His total basis for the policies was 60,000 dollars and on maturity he would receive 100,000 dollars. In 1957 he transferred one of the policies to a charity for a cash price equal to its basis and took a charitable contribution deduction for the remaining value. In 1958 he made a similar transfer of another policy and took a similar deduction. The Commissioner asserted a deficiency for each year on the grounds that Friedman realized income on each transfer equal to the difference between the amount received and the value of the policy. These, of course, were the same amounts that Friedman took as charitable deductions, and it should be noted that no question was raised concerning the propriety of splitting the transactions in two parts in this fashion and treating one part as a sale and the other as a gift.

The court summarized the Government's argument as follows:

"[P]etitioner by making a charitable contribution of the endowment policies shortly before their maturity date has derived the same economic benefit that he would have enjoyed had he surrendered the policies, received payment thereon, and given the money to the various charitable organizations."

This language is, of course, reminiscent of the *Hall*¹⁰⁹ and *General Shoe*¹¹⁰ cases but neither of these cases was cited.

The court held for the Government for the year 1958, relying principally on *Smith's Estate v. Commissioner*¹¹¹ and similar cases holding that when a cash basis taxpayer makes a gift of property with accrued income he is taxable on the income when it is later paid to the donee. Friedman sought to distinguish these cases on the ground that the income potential of the policy had not accrued in any conventional sense prior to the gift. With respect to this the court said:

"The theory of the cases dealing with anticipatory assignment of income by gift has not been concerned with when the income was accrued in a legal sense of accrual but rather with whether the income had been earned so that the right to the payment at a future date existed when the gift was made. . . . It is the giving away of this right to income in advance of

¹⁰⁹ *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962).

¹¹⁰ *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960).

¹¹¹ 292 F.2d 478 (3d Cir. 1961).

payments which has been held not to change the incidence of the tax."

However, the court held for the taxpayer for the year 1957. The key statement of the opinion on this aspect of the case is as follows:

"The determining factor was that the income was not received by the donee until the year following the year of the gift. A cash basis taxpayer is not taxable on income until he receives it actually or constructively. The making of a gift of his right to receive income does not cause such income to be received until the donor derives the economic benefit of having the income received by his donee."

It therefore appears that the Tax Court accepts the *Horst* concept of realization with two rather drastic limitations.

First, the income must be "earned" at the time of the gift. This will exclude gifts of inventory property, as the court's citation of *Estate of W. G. Farrier*¹¹² makes clear. Second, the gift and the receipt of the income by the donee must occur in the same year. For this conclusion the court relied on *Annie A. Colby*¹¹³ and *Austin v. Commissioner*.¹¹⁴ However, it always has seemed possible to explain those decisions on the ground that the Commissioner simply picked the wrong year for asserting the deficiency. In other words, it would seem possible to tax the donor in the later year when the payment is received by the donee. While this seems consistent with the last quotation from the *Friedman* opinion, the court's discussion of the *Horst* case and its decision in *Estate of Bertha May Holmes*¹¹⁵ indicate clearly that it considers receipt of payment by the donee in the year of the gift, as essential to taxing the donor. Apparently, this limitation is to apply even in cases in which the income has accrued in a conventional sense prior to the gift.¹¹⁶

While these limitations are no doubt consistent with the holdings in the prior cases, they clearly destroy the utility of the *Horst* concept of realization in preventing undue tax avoidance. However, it seems obvious that the Tax Court's decision in the *Friedman* case is not the final word on the subject, but merely the latest.

¹¹² 15 T.C. 277 (1950).

¹¹³ 45 B.T.A. 536 (1941).

¹¹⁴ 161 F.2d 666 (6th Cir. 1947).

¹¹⁵ 1 T.C. 508 (1943).

¹¹⁶ This is clearly inconsistent with the rationale for such cases suggested in the article. See text accompanying notes 26-28 *supra*.