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QUASI-CONTRACTS -- TAXATION – RESCISSION OF GIFT FOR FAILURE TO ACHIEVE DONOR'S PURPOSE OF MINIMIZING FEDERAL INCOME TAXES

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QUASI-CONTRACTS — TAXATION — RESCISSION OF GIFT FOR FAILURE TO ACHIEVE DONOR'S PURPOSE OF MINIMIZING FEDERAL INCOME TAXES—In 1937, plaintiff made a gift of stock in a closed corporation to his wife, the defendant. For two years defendant received cash dividends on the stock transferred to her and paid income taxes thereon. Late in 1938 the corporation was dissolved; the assets were distributed to the shareholders, and a partnership was formed. Defendant continued to report the income received by her from the partnership. In 1946, the Tax Court[1] sustained the contention of the commissioner of internal revenue that the entire income from this partnership was taxable to plaintiff under the doctrine of *Commissioner v. Tower.*[2] Plaintiff sought rescission of his gift, claiming that the gratuitous transfer had been induced by a mistaken assumption as to tax consequences. The evidence showed that the prime purpose of the gift was to build up defendant's estate and that the intent to reduce income taxes was only an incidental motive. Relief was denied by the trial court. On appeal, *held,* affirmed. Since the chief purpose in making the gift was not defeated, plaintiff was not entitled to equitable relief. *Lowry v. Kavanagh,* 322 Mich. 532, 34 N.W. (2d) 60 (1948).

A person who has created a family partnership which, though valid by state law, is held ineffective for tax purposes finds himself in the difficult position of having to pay taxes on income which he has not received. Since rescission of a gift theoretically restores the *status quo ante,* this method of relief would seem to be the most advantageous to a taxpayer in this unfortunate situation.[3] The classic rule has been that such relief will be given for a mutual mistake of fact but not for a mistake of law.[4] However, this distinction has been cut away by so many exceptions that it is not wholly accurate to say it still exists.[5] Generally, courts are more willing to grant equitable relief for mistake if the transfer in question is a

[1] Lowry v. Comm., 3 T.C. 730 (1944), affd., Lowry v. Comm., (C.C.A. 6th, 1946) 154 F. (2d) 448.

[2] 327 U.S. 280, 66 S.Ct. 532 (1946).

[3] Mandell & Rubenroit, "Rescinding Trusts of Family Partnership Interests," 26 TAXES 11, 13 (1948).

[4] Bilbie v. Lumley, 2 East 469, 102 Eng. Rep. 448 (1802); RESTITUTION RESTATEMENT 171-181 (1937); 5 WILLISTON, CONTRACTS, rev. ed., § 1582 (1937).

[5] RESTITUTION RESTATEMENT, § 44 (1937); 5 WILLISTON, CONTRACTS, rev. ed., §§ 1581, 1582, 1584-1593 (1937); 75 A.L.R. 896 (1931).

gift instead of a bargain transaction.[6] There is little authority whether rescission will be granted in those transactions in which anticipated tax savings do not materialize.[7] Relief has been denied on the theory that equity will not interfere to aid one who attempts to deprive the state of taxes, or on the theory that avoidance of taxes is analogous to a transfer to defeat creditors.[8] The United States Supreme Court has stated, however, that attempts to decrease taxes by legal means are an undoubted right of the taxpayer.[9] In *Stone v. Stone*,[10] the Michigan court decreed rescission of gifts made to children for the sole purpose of reducing taxes, where the anticipated tax savings were nullified by the *Tower* doctrine. The basis for relief was stated to be plaintiffs' mistake as to their "antecedent and existing private legal rights."[11] Critics of the *Stone* decision have argued that this offers an opportunity of discovering tax avoidance schemes by trial and error to those who gambled on the possible application of the *Tower* decision.[12] In the principal case, there is no apparent change in the court's attitude from that expressed in the *Stone* case; the instant case is distinguished in that here the main purpose in making the gift was not tax saving.[13] Even if it is assumed that tax avoidance was the sole purpose of the gift, it can be argued that rescission still should not have been granted since there was no mistake as to "antecedent and existing private legal rights" at the time of the gift; it was the subsequent change in the form of the business corporation to a partnership which shifted the tax burden from the wife to the plaintiff.[14]

N. S. Peterman, S. Ed.

[6] 5 WILLISTON, CONTRACTS, rev. ed., § 1573 (1937); RESTITUTION RESTATEMENT, § 49 (1937).

[7] 174 A.L.R. 1353-1354 (1948). In Heaton v. Heaton, 55 N.Y.S. (2d) 154 (1945), rescission was allowed. However, the gift was made with an express condition that if tax savings were not realized, the donor could rescind.

[8] Blake v. Ogden, 223 Ill. 204, 79 N.E. 68 (1906); Shaw v. Addison, (Iowa, 1947) 28 N.W. (2d) 816 at 826.

[9] Gregory v. Helvering, 293 U.S. 465, 469, 55 S.Ct. 266 (1935).

[10] 319 Mich. 194, 29 N.W. (2d) 271 (1947).

[11] Id. at 199. For comment on this case and related subject matter, see 46 MICH. L. REV. 1079 (1948). See also 48 COL. L. REV. 470 (1948); 174 A.L.R. 1352 (1948).

[12] 61 HARV. L. REV. 553 (1948). For a discussion of problems resulting from the Tower and Stone decisions, see Gruneberg, "Husband and Wife Partnerships," 26 TAXES 703 (1948).

[13] In addition to plaintiff's testimony as to the purpose of the gift, the court reinforced its conclusion by pointing out that because of low tax rates in 1937, there would not be much incentive in making a gift for tax savings.

[14] As to whether the Tower doctrine is applied to family corporations, see Mannheimer, "Income Tax Status of Gifts of Family Corporation Stock," 25 TAXES 604 (1947); and comment, 57 YALE L.J. 308 (1947).