INCOME TAXES ON THE REALIZATION OF FUTURE INTERESTS

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It often happens that property held in trust or on a chain of legal limitations changes in value before reaching the hands of the ultimate beneficial owner. It is obvious, too, that as time passes the relative values of the different interests in such property necessarily change, and the absolute values of these interests tend to follow suit. If the action of these processes causes a future interest to appreciate,

(a) Is a gain of this sort subject to income tax?
(b) Under what circumstances does the tax become payable?
(c) What is the proper measure of the tax?

We must return an affirmative answer to the first of these three questions. The United States Supreme Court holds that appreciation of capital assets may, when realized by sale, be subjected to an income tax levied under the Sixteenth Amendment.[1] State courts will probably follow this rule in passing upon local income taxes.

The second and third questions are harder nuts to crack. We have few precedents. Great Britain's long and painful income tax experience is practically a blank in this aspect because the British tax has been quite closely confined to annually recurrent or habitual gains.[2] It is hard to imagine a person so fortunate as to indulge habitually in the realization of future interests acquired by gift, and sales and purchases of such interests are somewhat rare. Continental nations have largely followed the British practice. Thus the United States is left to write its own text-book and learn its own lessons.

Under the circumstances it would be presumptuous to offer this article as the last word, or even as the true word so far as it goes. But it needs no apology, if only because of human forgetfulness. Almost every practicing lawyer has forgotten, or had a client who forgot, all about the deferred inheritance tax on some future interest in property. Every lawyer knows how such incidents lead to annoyance, flaws in title, increased cost of tax collection, and improper shrinkage in the public revenues, not to speak of the pains and penalties which the government's fiscal agents sometimes impose. Since income taxes on the

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[1] *Merchants' Loan & Trust Co. v. Smietanka* (1921) 255 U. S. 509, 41 Sup. Ct. 386; *Eldorado Coal & Mining Co. v. Mager* (1921) 255 U. S. 522, 41 Sup. Ct. 390; *Goodrich v. Edwards* (1921) 255 U. S. 527, 41 Sup. Ct. 390; *Walsh v. Brewster* (1921) 255 U. S. 536, 41 Sup. Ct. 392.

[2] *Report of the Royal Commission on the Income Tax* (1920) paragraphs 84-86.

realization of future interests are still comparatively novel inflictions, we are rather more likely to forget them. Hence the value of the present discussion as a goad to memory, whatever its intrinsic merit or lack of merit.

The topic does not call for very elaborate analysis. Headlines will indicate the subdivisions.

STATUTORY ASSUMPTION

I shall assume that all questions here considered arise under the existing Federal Income Tax.[3] This should be a satisfying assumption for the most speculative, since in the federal laws we find the maximum exertion of taxing power over income. The revenue acts running from 1913 on have been most searching and thoroughgoing. The enthusiasm of Congress for taxing income was from the start almost as intense as its enthusiasm for prohibition. (One is tempted to add that popular enthusiasm over these types of legislation displays an equally striking parallel in the reverse direction!) Moreover, the later revenue acts have operated under terrific pressure. In 1917 the safety valve was lashed down and the Congressional boiler-makers have since had called to their attention many a leak through which hard-driven fiscal steam escapes. Probably a number of these outlets will be suffered to remain, but at least we know fairly well where they are and how to stop them if stoppage be deemed the part of wisdom.

The "capital gain" provision in the Revenue Act of 1921 will apparently dilute the tax on owners who dispose of appreciated future interests.[4] But twelve and one-half per cent is far from negligible. Besides, the scope of this novel provision is not entirely clear. We shall know more after it has been in force for a year or two.

I. THE QUESTION OF REALIZATION

In enforcing the income tax, the Treasury has found that all which glitters is not gold. Not every gain, in and of itself, suffices to justify taxation. Few who have read the second and conclusive stock dividend opinion will forget the dramatic emphasis, alike of logic and typography, placed by the majority upon the last three words of the phrase *"gain-derived-from-capital."*[5] For us this opinion establishes a double prerequisite to the imposition of a true income tax in respect of property accretions. First must come the accumulation of a gain, second the "realization" of that gain by severance form the capital mass in which it has been embedded. Laying the basis for the tax by appre-

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[3] The Revenue Act of 1921 (Act of November 23, 1921) Pub. No. 98, tit. II.

[4] *Ibid.* sec. 206.

[5] *Eisner v. Macomber* (1920) 252 U. S. 189, 207, 40 Sup. Ct. 189, 193; see also Clark, *Some Income Tax Problems* (1920) 29 YALE LAW JOURNAL, 735.

ciation is often, perhaps usually, a gradual and unimpressive proceeding. The "closing of the transaction" which enables the government's fiscal agents to get at the increase is likely to be more sudden and dramatic. Now a government pushed for revenue will try to impose its taxes as early and as often as possible, particularly when they are directed at such ephemeral creatures as capital gains. A bird in the hand is worth a dozen will o' the wisps. Hence we are likely during the next few years to hear much argument about the point at which the drama becomes intense enough for the Collectors of Internal Revenue to begin operations.

Here, as elsewhere in this discussion, it will be found necessary to draw some distinction between donated future interests and future interests obtained for valuable considerations. To begin with, I assume this simple concrete case involving a donation, and follow it through various situations:

A testamentary trust provides that the income of the fund shall be paid to L for life, and that on L's death the principal is to go to R absolutely. The reader will observe here three taxable entities: the trust, represented by the trustee T; L, the owner of the life interest; and R, who could be accurately termed the remainderman if this were a legal limitation of real estate.

First situation: The property appreciates, L dies, the property is delivered to R, and R sells at a fair price for cash. Without now attempting to fix the measure of taxation, it is plain that R will have to contribute to the federal revenues. This distance the rulings of the Treasury Department and the decisions of the Supreme Court certainly carry us. An obvious variant of this situation is possible. The property appreciates, and before L's death R sells his future interest at a fair price for cash. So far as realization is concerned, this case presents the same problem as the first one, and there seems very little doubt that the Treasury under its existing rulings would demand a tax.[6] But unless the price realized by R exceeds the value of the property at the death of the testator, something of a question exists as to whether the wording of the Statute would sustain the Treasury's demand if R decided to make a fight of it. This matter comes up naturally under the next subdivision of the article and will be passed for the present.

Second situation: Follow the original chain of events up to and including the point at which R receives the property, but stop there. Is R taxable without more? The Treasury seems as yet to have made no such claim, and perhaps will never make it. Still, I have commented upon the probable acceleration of taxes to meet pressing fiscal needs, and the argument for taxability here is not to be despised.

[6] Regs. 45, art. 1562; Bull. 38-21-1830 (O. D. 1040). The foregoing and many related articles of Regulations 45 were recently amended by T. D. 3206.

The typical stock dividend is held non-taxable because immediately before and immediately after it is paid each stockholder has precisely the same interest in the corporation, both proportionally and in kind. He might change that interest and close the transaction by selling his stock and thus getting out of the corporation. Or the corporation might close the transaction by putting him out through the declaration and payment of a full dividend in liquidation, receipt of which would substitute for the stockholder's somewhat nebulous claim against the corporate assets a direct, possessory title to his proportionate part of them. The Court's clear intimation is that in the latter case as well as in the former an income tax might forthwith be levied if the result of the distribution were a net gain to the investor.[7] It would seem to make no difference that part only of the liquidating dividend took the form of money, or even that it included no money at all. An exchange leading to a real alteration in property rights results in taxable realization just as surely as does a cash sale.[8]

Test this general principle in the present connection. Why may it not be argued that R, by coming into the possession and enjoyment of property previously held in trust for him, has made a taxable exchange? The moment before L's death he had something which the classic authorities treat as a mere *chose in action*. We moderns are more inclined to think of it and treat it as "equitable title."[9] But even so we know very well that it is quite different in its legal incidents and practical possibilities of enjoyment from full possessory ownership. Here manual delivery of the trust *res* signalized a distinct and striking change in R's relation to the property. The act had qualities every bit as dramatic as a sale.[10]

One feels even more force in this argument as applied to a purchased future interest. If during L's life a stranger to the original trust had bought R's interest for $10,000 and at L's death had received from the trustee property with a fair market value of $20,000, has not the transaction closed and should not the stranger's gain become immediately taxable?[11]

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[7] *Eisner v. Macomber*, *supra* at p. 208, 40 Sup. Ct. at p. 193.

[8] Revenue Act of 1921, sec. 202 (a), (b); compare sec. 202 (c); also Regs. 45, art. 1563.

[9] Huston, *Enforcement of Decrees in Equity* (1915) 87 *et seq.*; *Brown v. Fletcher* (1915) 235 U. S. 589, 599, 35 Sup. Ct. 154, 157.

[10] The dramatic element would have been considerably less evident if R had been given legal title to and physical possession of real property charged with annual payments to L for L's life. It is worth noting that the Treasury holds a partner not immediately taxable after the distribution of appreciated firm assets; he must make a sale or exchange before the tax can strike him. Bull. 36-20-1182 (Sol. Op. 42) reprinted in Cum. Bull. no. 3, p. 61; Regs. 45, art. 1570.

[11] This is more than a mere rhetorical question. Some good authorities might call for a conversion of the trust property into money before a tax could be

Of course, taxation at the point of mere receipt by R carries with it substantial possibilities of inconvenence. An appraisal would be necessary. There might be much difference of opinion as to values. This sort of trouble has to be faced philosophically in connection with the Federal Estate Tax, but the Treasury may wisely hesitate to multiply the occasions for meeting it.

Third situation: During L's lifetime the trustee T sells the trust fund or part of it at a price higher than the market value when the testator died. Here the law and the Treasury rulings are now clear that the trustee as representative of those having interests in the trust capital must pay a tax at once.[12]

Fourth situation: During L's lifetime the appreciation of the trust fund is manifested by increased dividends or severed income in some other form. So far as this income is paid to L it will be taxed to him. So far as T accumulates it for future distribution or to satisfy the demands of persons whose rights are still imperfect it is also taxable forthwith under the terms of the present Revenue Act.[13]

Fifth situation: The trust fund appreciates, but is not sold and does not produce a greater distributable income. The government seeks to reach this increase before L's death. The reasons preventing success are cumulative. No tax can be extracted from R. The Supreme Court will not let a man be harried on the strength of a prospective profit which may melt away before he can grasp it. Similarly, no collection from L is possible. He cannot ever fill his pockets from gains pertaining to principal. Nor is T taxable, for the fundamental reason that there has not been a sufficient realization to satisfy the Supreme Court's requirements. Indeed, this last reason without more would negative the possibility of levying upon any of the interested parties.

II. THE MEASURE OF THE TAX

Assuming a taxable realization to have taken place, the next important problem is the determination of the amount which the income

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exacted. See *The Federal Income Tax* (Columbia Income Tax Lectures, 1921) 124-125. Compare Bull. 14-20-821 (O. D. 429), reprinted in Cum. Bull. no. 2, p. 38. Nor should it be forgotten in considering the text at this point that our recent Revenue Acts tend to distinguish transactions deliberately entered into for gain or profit, and to set them apart from non-commercial transactions.

[12] Revenue Act of 1921, sec. 219, (a) (3); Regs. 45, sec. 347.

[13] Revenue Act of 1921, sec. 219, (a) (2), (3). The 1913 Act was perhaps not so effective. *First Trust & Savings Bank v. Smietanka* (1920, C. C. A. 7th) 268 Fed. 230, case to be reviewed on certiorari by the Supreme Court. Compare *Lederer v. Stockton* (1920, C. C. A. 3d) 266 Fed. 676, certiorari refused.

It should be observed that if the trustee has thus paid the tax on accumulated income, no further tax may be collected when distribution to beneficiaries occurs. Regs. 45, art. 344.

recipient must pay the government for his good fortune. A sharper distinction between donated and purchased interests now becomes essential. And, under the head of donations, the Treasury rulings make it necessary to treat separately vested and contingent interests.

A. *Donated Future Interests.* (1) *Vested Interests.* Let us again assume the same hypothetical case, in which L, R, T, and the trust fund are the chief actors. As time rolls on, R's interest may appreciate in two ways. To begin with, it is inevitable that as his rights move nearer the point of possession and enjoyment their value will rise, if all other factors remain the same. This is caused simply by erosion of the prior life interest.[14] Then, of course, if the value of the trust property itself increases between the time when the future interest vests and the time when its actual enjoyment commences, that increase will be a gain to R. An income tax might be fashioned to reach either of these appreciations. It appears to be the contention of the Treasury officials that their tax can and does reach both.

What they say in substance is this: If R's future interest was worth $5,000 the instant after the death of the testator who established the trust, the present value of the whole fund being at that instant $10,000, R's taxable gain when he ultimately realizes upon the fund will be everything which he then receives in excess of $5,000. For purposes of clarity, suppose R sells the property for $15,000 after he gets it from the trustee. According to the latest published opinion of the Solicitor of the Treasury he would have to return no less than $10,000 of the proceeds as taxable income.[15]

At first glance this calculation seems not startlingly unfair, but the alert reader will quickly see the painful result to which it leads. When R's interest vested, it was priced below par for two reasons. First, L was to receive all the current income of the trust until he died. Second, the trustee, acting for the security and benefit of L, was bound to hold the principal and thus prevent R from enjoying the advantages of immediate possession. Of these reasons, the first is by all odds the more important in respect of the productive, intangible property which makes up most modern trust funds. The right to receive income so overshadows the temporary detention of the principal that in practice life interests are valued by making a more or less accurate calculation and present capitalization of the periodical receipts which will come in during their continuance. Assuming this method to have been applied

[14] For a consideration of this problem from the point of view of one holding a terminable present interest, see Maguire, *Capitalization of Periodical Payments by Gift* (1920) 34 Harv. L. Rev. 20, 41.

[15] Bull. 33-20-1126 (Sol. Op. 35) reprinted in Cum. Bull. no. 3, p. 50. This opinion refers to real estate. But the testator's will directed its conversion. And, in any event, it seems incredible that for this kind of taxation different principles will be applied to real and personal property.

in the hypothetical case under discussion, it appears that L was expected to receive a string of income payments which could be capitalized at $5,000 on the instant when the trust went into effect. As this capitalization allows for deferment, it is plain that if L lived out his expectancy of life he would be paid by way of income sums aggregating considerably more than $5,000—say $8,000. On these sums he would of course have to pay income tax.

Hence, if L does complete exactly his expectancy of life and thereupon dies, and R receives and realizes upon the trust fund at the price stated above, the Federal Government will have been enabled during the continuance of this trust and as a result of the ultimate realization to tax a total of $18,000. But if the very same fund had been given outright to R, or to R and L in equal shares, carried for the same period, invested in the same way, and disposed of at the same time and price, the taxable income would have been no more than the sum of the periodical receipts plus an ultimate profit of $5,000, which gives a grand total of only $13,000.

By what black magic can the Government add so substantially to its revenues merely because the interests of L and R happen to be driven in tandem instead of in double harness? The answer lies in a trick of definition. The Revenue Act provides that from "gross income" shall be excluded—"The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income)."[16] This is a very unsatisfactory subdivision of the Statute, for it leaves quite undefined the two vital words "property" and "acquired." It would do well enough for a primitive civilization, where all gifts were simple, outright affairs, but it does not suffice under our complex doctrines of successive estates and interests splitting up the absolute ownership of property. Yet the provision has been carried down from the Act of 1913 with practically identical wording, and it may well stay with us for some time to come.

A layman would of course think of the "property" in question as being the land or money or securities given *inter vivos* or by will. The lawyer knows that there is another kind of "property" here, namely the estates or interests of the several successive owners or beneficiaries. It will be convenient to refer to the first kind of property as "property in fact," and to the second kind as "property in law."[17]

Now what the Treasury has done is to take this statutory clause and play both ends against the middle in the matter of definitions. When taxing L, the Collector of Internal Revenue is instructed to pay no attention to the fact that his life interest is a wasting one. There is to

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[16] Revenue Act of 1921, sec. 213 (b) (3).

[17] For a discussion of the meaning of "property," see COMMENTS, *infra* at p. 429. See also COMMENTS (1922) 31 YALE LAW JOURNAL, 318.

be no allowance for its depreciation or exhaustion. The face of authority is set strongly against any argument that "the value of the property" given L is the present value of his life interest when he first gets it and that the periodical payments he is to receive will not be taxable income except when and so far as they transcend this value.[18] L is forced to pay tribute as upon the continuing income from an unexhausted fund of principal, not as upon the terminable income derived from a right which steadily wears thinner and thinner until it finally vanishes. With respect to L, the "property" is the property in fact—the actual real estate or chattels or securities composing the fund. But when the Collector turns his attention to the future interest of R he is told to forget all about this standard of assessment. He is not to measure his tax by the realized increase of the trust capital itself—the property in fact. Instead he is informed first that R "acquires" his property the moment his interest vests and second that "the value of the property" given R is the value of that interest at that moment. In short, the Collector is instructed to swap horses in the middle of the stream and clamber into the saddle of the "property in law" definition. Thus the tax on R is to be measured by the appreciation of a right which waxes fatter and fatter not only because the trust principal rises in value but also because all the blood is being drained out of the precedent life interest.

Under all the rules of just logic this situation presents to the Government a balanced alternative. Either (1) the tax must be measured by the periodical income from and the capital accession to the trust principal, irrespective of the growth or shrinkage of the several interests therein, or else (2) it must be measured as to L by the excess of the aggregate income he receives over the original capital value of his terminable interest which perishes in producing that income, and as to R by the excess of his receipts upon sale of the principal over the market value of his interest when it first vested. The first method of calculation throws a larger proportion of the total tax on L, while the second method shifts the burden to R. The Treasury should adhere consistently to one definition of the word "property."

As the Revenue Act now stands it does not in terms require the inconsistency which is being practiced. It is hard to believe that any court with a backbone and a reasonable sense of the realities of life will sustain the "heads I win, tails you lose" attitude of the taxing authorities. The problem would be more difficult if the Statute were amended so as to give explicit backing to the Treasury practice. But that is a

[18] *Notes on the Revenue Act of 1918*, part I, p. 11. These are the notes submitted by the Secretary of the Treasury to the House Committee on Ways and Means in November, 1919. Cf. *Gavit v. Irwin* (1921, N. D. N. Y.) 275 Fed. 643; also Revenue Act of 1921, sec. 215 (b).

bridge which we may never have to cross. Certainly with the law in its present state lawyers representing the divergent interests of present temporary beneficiaries and future outright owners will find it worth while to form an opinion as to which definition of "property" is more likely to receive judicial sanction.

The "property in fact" definition appears to have the better chance of adoption. It squares with the understanding of the taxpayers at large, who know and care very little about the technical rules of successive estates or interests in realty or personalty. The judges have wisely recognized that in dealing with tax laws which affect so considerable a fraction of the population, the terms employed should where reasonably possible be defined as "the man in the street" would define them.[19]

Moreover, so far as the terminable interests are concerned, this definition unquestionably accords with legal conventions. If we turn to British fiscal history, we find that periodical receipts representing the realization of life interests in trust funds have been regularly taxed as pure income without allowance for wastage of the "estate" from which they proceed.[20] The same rule appears to have held under practically every income tax, state or federal, with which the United States has been blessed. Adherence to this practice calls for rejection of the theory that the owner of a future interest may be taxed on more than the actual appreciation of the tangible or intangible property involved when he realizes by sale or exchange. Otherwise the overlapping of taxes already indicated will take place. With respect to the federal law, it is important to note in this connection that an amendment of 1921 explicitly forbids the owner of a donated terminable interest to claim "any deduction for shrinkage . . . due to the lapse of time."[21]

Almost the only judicial decision which comes near the point is that of *Halstead v. Pratt*,[22] a Hawaiian case. Unfortunately, it is somewhat inconclusive for present purposes. The facts were briefly as follows: Hawaii adopted an income tax on "gains, profits and income . . . . derived" after a certain date, *including* "money and the value of all personal property acquired by gift or inheritance." X died in 1900

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[19] *United States v. Oregon-Washington R. & Nav. Co.* (1918, C. C. A. 2d) 251 Fed. 211, 212; *Tax Commissioner v. Putnam* (1917) 227 Mass. 522, 527, 528, 116 N. E. 904, 908; and the dissenting opinion of Mr. Justice Holmes in *Eisner v. Macomber* (1920) 252 U. S. 189, 219, 220, 40 Sup. Ct. 189, 197.

[20] One judge in *Drummond v. Collins* [1914, C. A.] 2 K. B. 643, 658, expressed the opinion that certain discretionary periodical payments were not taxable income. But this was not on any ground of wastage. None of the numerous other judges who heard the case at various stages accepted his view. [1913] 3 K. B. 583; [1915, H. L.] A. C. 1011. An interesting comparison is afforded by the British decisions discussed in Maguire, *op. cit.* 34 HARV. L. REV. 20, 28 *et seq.*

[21] Revenue Act of 1921, sec. 215 (b).

[22] (1902) 14 Haw. T. 38.

before the tax became operative. About a year later, after the tax had become operative, Y, X's son, received over $20,000 as a distributive share of the estate. Y of course argued that he "acquired" or "derived" this property forthwith upon his father's death and that it was therefore non-taxable. But the Court accepted the government's argument and held that "acquired" should be construed as meaning either "received" or becoming "payable," rather than as referring to mere passage of "legal title" (*sic*). This seemed more just than to tax as of a time when the exact amount to be received was still doubtful. Hence the inheritance was taxable.

Taking this decision at face value, our friend R would never "acquire" any "property" under the terms of the Federal Revenue Act until L died and the trustee delivered over the principal of the trust fund. If so, it follows that R may not be taxed on account of any appreciation between the date when the trust becomes operative and the date when L dies. This is a stand more extreme in favor of the taxpayer than is the one which I have suggested as being just and fair. It might be pleasing thus to hoist the government with its own petard, but *Halstead v. Pratt* probably lacks the requisite explosive power. Observe that the Hawaiian Court had no occasion to consider the question of appreciation. It does not appear that the assets composing X's estate did appreciate before distribution. Besides, the Statute construed drew no distinction between the principal and the income of a gift. The whole thing, whether principal or income, was taxed to the donee. Then, too, the arguments advanced for the delayed application of the Hawaiian Tax apply far less intensely to the trust case with which we are dealing. The holder of a beneficial interest in trust property is much more reasonably sure of the amount he will finally receive than is one of the next of kin or a residuary legatee before a decedent's estate is settled. Finally, the Supreme Court's rule requiring the realization of profit before it becomes taxable fully protects people in R's position, even though the "value of the property" donated be fixed as of the date when the future interest first comes into being. If an accession vanishes before being realized no tax ever falls due.

Assuming that *Halstead v. Pratt* will have little effect one way or the other upon the legal situation, it is still submitted that the "property" involved in "gift, bequest, devise, or descent" is the actual money or thing which passes, and not the mere beneficial right thereto, which may be partial or postponed or both postponed and partial, thus having a distinctly lower value than the property in fact. If this is not to be the accepted rule under the law as it now stands, the phraseology of the Statute should be changed to make it so. Otherwise we do not attain balanced justice between government and taxpayers.

(2) *Contingent Interests.* The Treasury's scheme for taxing donated contingent future interests is a tacit confession of the weakness

of its scheme for taxing donated vested future interests. Take here the hypothetical case of a testamentary trust fund limited to L for life, then to RX absolutely if he is living at L's death, but if RX is then dead, to RY absolutely. Now suppose that either RX or RY takes upon L's death, and thereafter sells the trust property. The ruling is that he is not taxable upon the excess of the sale price over the value of his interest when it was created, but rather upon the excess of the sale price over the value of his interest when it became a vested one.[23] Normally the result will be a much smaller tax.

We encounter here a clear inconsistency, for the ruling about vested future interests was based upon the fact that they are "property," and a contingent remainder or interest in the nature of a remainder is just as much "property" as if it were vested. The United States Supreme Court has said that by the term property "all titles are embraced, legal or equitable, perfect or imperfect."[24] A painstaking Rhode Island decision reaches the conclusion that rights in contingent remainders are property which must be protected under the due process clause.[25]

Two reasons for the inconsistency are easily perceived. Suppose in our hypothetical case that RX were an ailing old gentleman of eighty and RY a healthy young sprig of twenty. The original value of the former's contingent future interest would be far lower than that of the latter's. The amount taxable on ultimate realization might vary enormously in accordance with the accidents of existence affecting the three beneficiaries. From the Government's viewpoint the law of averages would even up the results of these accidents, but from the viewpoint of any specific group of taxpayers the matter would seem a pure gamble. Very likely the Treasury officials have appreciated and given way to this individual sense of injustice.[26] Then, too, contingent interests may be created which cannot well receive immediate practical valuations. If a trust fund were limited to L for life and on his death

[23] Bull. 46-20-1301 (O. D. 727) reprinted in Cum. Bull. no. 3, p. 53. Also Bull. 51-21-1976 (O. D. 1136).

[24] *Hornsby v. United States* (1869, U. S.) 10 Wall. 224, 242.

[25] *Green v. Edwards* (1910) 31 R. I. 1, 30, 77 Atl. 188, 199. This case and the one cited in the previous note are of course only samples selected from an array of dozens.

[26] It is worth noting that this feeling might be justified in certain cases of vested future interests. If a testator creates a trust, giving his widow the income for life and also the right to expend principal at her discretion, and providing that any remaining principal shall go absolutely to his son after the widow's death, the son's interest is a vested one. But its present value at the testator's death will be comparatively low because of the widow's rights to principal. Nevertheless, it seems to be the rule that the son is taxable on any excess which he realizes over and above the original value of his interest. Bull. 43-20-1255 (O. D. 694) reprinted in Cum. Bull. no. 3, p. 53. This case was complicated by the fact that the interests were created before March 1, 1913, but the underlying principle is apparently the one above indicated.

to his eldest surviving son absolutely, L being unmarried, it would be guesswork to appraise the future interest forthwith.

Surely it is simpler and probably more satisfactory to deal with both contingent and vested interests upon the "property in fact" basis, which calls for no haggling over the internal divisions of property rights yet at the same time gives the Government a fair chance to tax all the income derived from the fund, whether periodically or by sale or exchange.

(3) *New 1921 Provision for Fixing Original Value.* Until this year it has been the rule that the value of property passing by gratuitous transfer should for purposes of future income taxes on accretions be fixed as of a date not earlier than that of the transfer. In the case of contingent future interests we have seen that the date might be much longer postponed. Evidently it has been felt that income taxes were being unduly avoided through gifts of property which had appreciated in the donors' hands. So the Revenue Act of 1921 provides that in the case of a gift *inter vivos* the basis for determining gain or loss upon disposal of the donated property is to be the same as though the disposal had been made by the last preceding owner who acquired the property otherwise than by gift. The old rule remains unchanged with respect to property passing by will or intestacy.[27]

Several comments may be made upon the innovation. One wonders whether it is likely to accomplish its purpose fully. Since donees can carry at full original cost or value any property which has *depreciated* in the hands of donors, such property may well become popular as the subject matter of gifts *inter vivos* while appreciated property is retained for transfer upon death.

Whether or not the clause accomplishes its purpose, it is open to both technical and practical objections. Keen analysts of the stock dividend cases have concluded that the tax failed there not because no realization had taken place, but because realization had occurred so long ago that a present income tax could not reach it.[28] We know, to be sure, that an income tax may stretch back a year or so—that income of 1920 may be made the measure of taxation under a law passed in 1921.[29] Still, we have had hints that there are limits upon this power to drag the dead past into the living present.[30] The new rule controlling the valuation of gifts covers none save those made since December 31, 1920. But as applied to the realization of future interests it would reach back

[27] Revenue Act of 1921, sec. 202 (a) (2), (3).

[28] The Federal Income Tax (Columbia Income Tax Lectures, 1921) 8 and also citations in note on p. 70. These lectures are an intellectual delight for students of the income tax.

[29] This is clearly to be inferred from *Brushaber v. Union Pacific Ry.* (1916) 240 U. S. 1, 11, 20, 36 Sup. Ct. 236, 239, 242.

[30] *Tax Commissioner v. Putnam* (1917) 227 Mass. 522, 529, 116 N. E. 904, 908.

not only all the way to the date of gift—as under the previous practice—but also five, ten, or fifty years further to pick up that part of the donation taxable under the terms of the new law as an accession. Observe that much of the ancient history thus covered might have elapsed before the passage of the Revenue Act of 1921 or even before the adoption of the Federal Income Tax Amendment.

If we are to have any limit on retroactivity, it might well be within the shortest of the periods above suggested, namely, five years. For the income tax is a business tax. It ought to be part of pay-as-you-go business life. It is most objectionable when turned into a financial sword of Damocles. I realize that this argument implies an assault upon the whole doctrine of taxing suddenly and in a lump capital gains which have slowly accrued. Unquestionably the practical application of the doctrine is open to considerable objection. Perhaps as it has been applied from 1913 to the end of 1920, its benefits more than balance its burdens. Yet when the Government insists upon grubbing deeper and deeper into dusty, dead-and-buried property transfers or acquisitions, the balance tends to swing the other way. There must come a point at which the governmental expense of investigation and collection, the annoyance and private expense put upon the taxpayer, the restraint upon free transfer of property, should lead Congress and the Treasury to call a halt.

It is clear that Congress could take much of the sting out of the practical objection above outlined by providing that immediately upon the making of a gift the fraction of it representing appreciation since the last preceding transfer for value should become taxable as income realized by the donee or donees. There is good reason for arguing that the technical objection as well would thus be met.[31] Assuming the legality of an income tax upon the recipient measured by the full value of the gift it is hard to see why a tax upon a reasonably segregated fraction of that value is not equally legal. But those who contend that the whole present value of a gift is capital to the donee would vigorously challenge the foregoing assumption. Here we come upon debatable ground. It is true that gifts are customarily exempted wholly from income tax.[32] But we have seen that Hawaii deemed them taxable income. The Federal Income Tax Act of 1894 took the same position.[33] We might very well emerge from the controversy with a compromise decision holding gifts for permanent investment to be capital,

[31] Probably the appreciation could not upon such an occasion be taxed to the *donor*. See New York cases which, while they go only on a point of interpretation, contain some strong general language. *People v. Wendell* (1921) 196 App. Div. 596, 188 N. Y. Supp. 273, and *People v. Wendell* (1921) 196 App. Div. 613, 188 N. Y. Supp. 510.

[32] See references in Maguire, *op. cit.* 34 HARV. L. REV. 20, 21.

[33] Act of Aug. 27, 1894 (28 Stat. at L. 509, 553).

while those for immediate expenditure would be taxable income of the donee.[34] The answers to cases between these two extremes are harder to guess at.

B. *Future Interests Acquired for Value.* Here we find the measure of the tax much easier to fix. Let us return to our original hypothetical case, the trust fund in which L had a life interest, while R was to take absolutely on L's death. Suppose that during L's life, R sells his interest to X for $5,000 and that ultimately the trustee turns over to X a mixed aggregate of property with a fair market value of $10,000. It would seem clear that X's taxable gain is $5,000. Moreover, the transfer from the trustee perhaps results in a closed transaction—a realization upon which the Treasury may claim and collect its tribute immediately.[35] The same rule would apply if R's future interest had been contingent. The question is not what sort of speculation X bought his way into but whether as things ultimately worked out he received more than his original stake. If he did, the excess is taxable. Nor would it appear that the rule should be different if R had paid the creator of the trust for limiting a future interest to him, had retained the interest instead of selling, and had received the trust principal on L's death.

III. MISCELLANEOUS POINTS

The reader familiar with income tax work will have noted my omission of numerous points which may be termed variations of those discussed.

For one thing, I have assumed all future interests dealt with to have been created subsequent to the passage of the taxing statute, or at least subsequent to that memorable date February 28, 1913.[36] Taxation of future interests earlier created is complicated by additional considerations which would add no particular novelty or interest to this discussion.[37]

For purposes of concrete illustration I have spoken only of trust funds and the equitable interests therein. The problems relating to legal future interests are not essentially different in the present connection.

I have not referred to future interests such as reversions, rights of entry for condition broken, and the like. The principles controlling income taxation as applied to these interests are in the main modifica-

[34] See *United States v. Oregon-Washington R. & Nav. Co.* (1918, C. C. A. 2d) 251 Fed. 211, 213.

[35] See *supra* note 11 and the accompanying text. But this point is far from settled.

[36] It might be sounder to refer to February 25, 1913, when the Federal Income Tax Amendment was certified.

[37] Revenue Act of 1921, sec. 202 (b), covers this in careful detail.

tions or extensions of the principles controlling such taxation applied to remainders and interests analogous to remainders.

Powers of appointment raise a more peculiar question. Suppose X establishes by will a trust under which L takes the income for life and also has a general testamentary power of appointment over the principal. The exercise of this power may easily accomplish such a break in the devolution of title that L's appointee will not be taxable for any accession occurring between the deaths of X and L.[38]

Finally, the feverish pulling and hauling incident to the passage of the Revenue Act of 1921 brought forth several more or less freakish ideas which, although ultimately abandoned, were debated and in some cases temporarily adopted. One of these was the proposal by the junior Massachusetts Senator for a graduated tax on the donors of large gifts *inter vivos*.[39] The conferees sliced this out of the Senate draft. Had the gift tax remained, it would have merited discussion on constitutional and common sense grounds. But in the presence of so many unpleasant tax actualities we may wisely refrain from debating might-have-beens.

SUMMARY

I have already referred to the importance of not forgetting that an income tax can strike profits on future interests. Assuming the taxpayer's memory to have functioned, the first decision he must make is whether a taxable realization has occurred. The rules governing this decision are on the whole tolerably clear, although some very closely balanced situations may be encountered. After passing upon the question of realization, the taxpayer next considers the amount of his tax. Here he finds that all is simple if he bought his future interest. If the interest was given to him, he has more trouble. In case the gift was *inter vivos,* he has to inquire about value or cost price of the property in the hands of some prior owner. In every case of gift, whether the donor be alive or dead, the present Treasury rulings force the donee to draw delicate distinctions between vested and contingent future interests. This last requirement seems needless and often leads to an excessive tax. It ought to be discontinued.

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[38] Revenue Act of 1921, sec. 202 (a) (3) and sec. 402 (e), is explicit as to the exercise of general powers of appointment in certain instances.

[39] Corporation Trust Co., bulletin no. 5, series of 1921, "The Revenue Act of 1921," secs. 412-417.