PROPOSALS FOR PREVENTING FAMILY TAX AVOIDANCE

Although marriage and the family had long been important in legal doctrines of property and ownership, no recognition was given to these factors in drafting the income tax amendment to the United States Constitution.¹ Subsequent legislation determining tax incidence has similarly failed to take account of these national institutions.² But where the legislators have not chosen to interfere, married taxpayers have been eager to act, and, encouraged by Congressional oversight, the family has become a major instrument for income-tax avoidance.

When it became clear that the tax-collector would compute surtax charges against “individual income recipients” without regard to the family entity, the taxpayer responded by splitting his income among non-earning family members—resulting in smaller surtax charges for each, and sizeable over-all tax savings for the real income recipient.³ The taxpayer found the common

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¹ See Bruton, The Taxation of Family Income, 41 Yale L. J. 1172 (1932).
² This failure becomes evident from a reading of the cases cited note 17 infra.
³ In 1939 a couple without children and a total income of $10,000, all earned by one spouse, would have been able to save $190 in income taxes if their income could have been
law ready with a roster of concepts to aid in private schemes for reducing his tax liability, e.g., partnership, assignment, trust, etc. Even without resort to these techniques the family could be used to avoid high surtax payments if it resided in a community property state, or in a state with somewhat analogous common-law concepts of concurrent ownership such as tenancy by the entirety; for under influence of the marital institution such laws defined "income receipt" in such a way as to divide family income between spouses. And the federal government looked no further.

With the present sharply graduated surtax rates, the failure to take into account the importance of the family entity in shaping federal tax policy has become increasingly serious. A billion dollars in revenue hangs in the balance. More important, 4,900,000 taxpaying couples are affected by the resulting irrational discrimination in tax liability. For example, privately-contrived income-splitting has produced income-group discrimination against low income married couples who, because of the present tax structure, can gain nothing from a two-way split of income. Within similar income groups further discrimination arises on the basis of the marital relationship itself, for a single taxpayer is hard put to arrange a satisfactory private income-splitting plan. Legalized income-splitting for tax purposes under state law produces these same inequities on a greater scale, and adds a geographical discrimination against couples who reside in states where such laws do not exist—a discrimination on which politicians have capitalized, leading states divided equally and reported in separate returns. Under the increased 1944 rates the couple would have effected a tax saving of $560 by the same maneuver. In higher brackets the incentive to split income for tax purposes would have been even greater. But see Rudick, *The Problem of Personal Income Tax Avoidance*, 7 LAW & CONTEMP. PROB. 243, 245 (1940), for a somewhat different explanation of the upward "curve of tax avoidance." On the general problem of taxing family income, see Magill, *Taxable Income* c. 8 (rev. ed. 1945); Bruton, supra note 1; Rudick, supra note 3; Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COL. L. REV. 791 (1933); Comment, 49 YALE L.J. 1279 (1940).


6. Under 1947 income tax rates, for instance, a couple without children and a total income of less than $3000, earned entirely by one spouse, would achieve no tax gain from a division of income between spouses. But a couple with a combined income of $25,000, all earned by one spouse, would effect a saving of $2,622 by splitting the income for tax purposes. Similarly, a couple receiving a total income of $50,000 would save $6,071 under an equal division of income. See app. A. Further savings may be effected in the higher surtax brackets if income can be split three or more ways. See app. B.

7. It is evident also that single taxpayers of the high income groups are at a tax disadvantage where it is possible for couples in corresponding income groups to split their incomes in submitting returns, since the single taxpayer cannot participate in the plan. He may, however, be able to divide income with children or other relatives by using the same devices.

8. See notes 23, 30 infra as to the states in which such tax benefits may be derived.

See app. A. The maximum percentage tax saving under legalized income-splitting,
to compete with each other to procure favorable utilization of the federal
error for their married citizens.

Solution to this problem seems to lie only in a plan which recognizes the
legal, economic and sociological implications of marriage in levying the fed-
eral income tax. The gravity of the problem has prompted a variety of solu-
tions and corrective suggestions.

THE SCOPE OF INDIVIDUAL AND STATE-SPONSORED FAMILY TAX AVOIDANCE

Individual schemes for splitting income among family members

For a number of years the actual steps taken by Congress in preventing
family income tax avoidance were limited to a piecemeal and uncoordinated
attack upon privately conceived tax avoidance plans, which led to a race
diligence between tax lawyers and the Treasury—a race in which the lat-
ter has frequently come off second best. However, it appears likely, as a
result of combined legislative, judicial and administrative efforts, that no
one of these private family schemes individually can now result in any major

assuming a couple without children and with an otherwise 100:0 division of income, appears
at a combined net income of $25,000, where it reaches 28.9%.

Legalized income-splitting produces even more marked discrimination against high in-
come single taxpayers than does the use of privately-contrived devices. While the single
taxpayer may be able to avail himself of these schemes to divide income with relatives, he
is prevented by state property laws from dividing property and income under community
property or tenancy by the entirety concepts. Both of these forms of ownership may be
employed only as between spouses. See authorities cited notes 20 and 25 infra.

9. See authorities cited note 3 supra. Typical of Congressional treatment are the fol-
nowing amendments to the Code: § 102 (improper accumulation of surplus), § 118 (wash
sales), § 166 (revocable trusts). INT. REV. CODE §§ 102, 118, 166. The usual pattern has
been one of Congressional action directed against the results of family income-splitting
rather than its causes. Congress has shown a marked reluctance to effect broad changes in
the revenue laws which might bring a more efficient tax system with diminished premiums
upon successful tax avoidance. On the other hand, the Treasury has waged a determined
fight to shift the basis of federal income taxation from “ownership” to “control and
benefit.” Typical was its attempt to tax income from short-term trusts to the settlor, and
to tax family income in community property states to the spouse who earned it or exercises
control. MAGILL, THE IMPACT OF FEDERAL TAXES 50, nn. 20, 21 (1943). This attitude has
been attacked as going beyond the proper realm of tax administration. Rudick, supra note 3,
at 264. See generally, MAGILL, THE IMPACT OF FEDERAL TAXES 49 et seq. (1943); cf.

Tax experts have discussed for a number of years a complete reworking of the Code
from a functional standpoint—only to meet with failure. The following works have made
outstanding contributions in this field, and outline the history of this movement: GROVES,
POSTWAR TAXATION AND ECONOMIC PROGRESS (1946); PAUL, TAXATION FOR PROSPERITY
(1947); SIMONS, PERSONAL INCOME TAXATION (1938); TWENTIETH CENTURY FUND,
FACEING THE TAX PROBLEM (1937); VICKERY, AGENDA FOR PROGRESSIVE TAXATION (1947);
U. S. TREAS., STUDY, FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION
AND FOR CORRELATION WITH THE INCOME TAX (1947); Griswold, Income, Estate and Gift
Taxes, 56 HARV. L. REV. 337 (1942); WATTEN, CORRELATION OF GIFT AND ESTATE TAXES, 55
HARV. L. REV. 1 (1941).
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tax avoidance. For instance, the bona fide gift should perhaps not be considered a "tax avoidance" device since for a number of years such transfers of assets have been partially dealt with under the federal gift tax. Similarly, legislative and judicial action has limited the effectiveness of assignments.

10. "... [T]he Court has clearly indicated that one of the principal dangers of legislative particularity—encouragement to tax avoidance, will be countered by judicial protection of the Congressional policy, and, if that policy be unclear, of the underlying tenets of an income tax." Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779, 810 (1941); cf. Eisenstein, Some Iconoclastic Reflections on Tax Administration, 58 Harv. L. Rev. 477, 490 (1945).

"The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute." Higgins v. Smith, 308 U.S. 473, 477 (1940).

11. Where the donor feels great trust in his family, he can effect sizable income tax savings by making outright gifts to relatives. For many years there was no federal gift tax legislation, and even after passage of the gift tax provisions of the 1932 Act the device often proved advantageous to higher bracket taxpayers, since the gift tax itself makes no provision for taxing to the donor income later arising from the gift corpus. Revenue Act of 1932, § 501, 47 Stat. 245 (1932); Int. Rev. Code §§ 1000-1031. See Montgomery, Federal Taxes—Estates, Trusts and Gifts 20 (1947).

For a discussion of the many ways in which Congress has made inter vivos gifts attractive, see Magill, The Impact of Federal Taxes 88 et seq. (1943). In spite of this favorable Congressional attitude, however, the total money value of taxable gifts has shown a sharp decline over the past few years. Federal gift taxes collected in fiscal 1946 amounted to $47,231,604.85, as compared with $160,053,761.77 in 1936. Id. at 89, n. 62; Rep. Sec. of Treas. 403 (1946).

Perhaps partially responsible for this decline has been the fact that a transaction may satisfy the requirements for a valid gift, as prescribed by the Code, and yet, under some circumstances, subject the donor to income tax upon income arising from the gift corpus, because the gift and income tax provisions of the Code have not yet been integrated. Commissioner v. Beck's Estate, 129 F.2d 243 (C. C. A. 2d 1942); cf. Higgins v. Commissioner, 129 F.2d 237 (C. C. A. 1st 1942).

The original gift tax provisions appeared in the Revenue Act of 1932, § 501, 47 Stat. 245 (1932). The modern counterpart of these provisions is to be found at Int. Rev. Code §§ 1000-1031.

12. Assignments have dealt both with income from property and income earned or to be earned by the assignor in the future. E.g., Helvering v. Horst, 311 U.S. 112 (1940) (unmatured interest coupons from bonds assigned to son); Helvering v. Eubank, 311 U.S. 122 (1940) (assignment of earned premium renewal coupons to be received in future); Lucas v. Earl, 281 U.S. 111 (1930) (future earnings assigned to wife).

Previous to Helvering v. Horst, supra, the courts and the Treasury had determined taxability as of the time income was "realized" to the taxpayer, without having any clear conception of what constituted this "realization." See 2 Mertens, Law of Federal Income Taxation § 18.02 (1942). In the Horst case the Supreme Court clarified this point and held that "realization" may take place upon completion of the final step by which the taxpayer "obtains the fruition of the economic gain which has ... accrued to him." Helvering v. Horst, 311 U.S. 112, 115 (1940). The Court went on to announce that, regardless of valid assignment, income may be taxed under this new definition of realization to the person who earns it, or creates the right to receive it, and enjoys some non-material, vicarious satisfaction from it, even though actual payment of the income is made to another. Although the Internal Revenue Code failed to deal specifically with the assignment
revocable and short-term trusts,\textsuperscript{13} tax-free exchanges,\textsuperscript{14} security transactions

problem, the Court apparently analogized the assignment to the establishment of a trust for the discharge of familial obligations. Section 219(h) of the Revenue Acts of 1924 and 1926 provided that the income from a trust used to pay the premiums on a life insurance policy payable to the dependents of the trust settlor was taxable to the settlor. \textit{43 Stat. 277} (1924), \textit{44 Stat. 34} (1926); \textit{Burnet v. Wells}, 289 U.S. 670 (1933).


The short-term trust has never been the subject of legislative treatment, and after the revocable trust lost favor the short-term arrangement became a popular means of distributing income to family members without a complete loss of power over the trust corpus. Congress, by providing in §166 of the Code that income from a revocable trust is taxable to the settlor, has closed the door upon effective employment of that device. Revenue Act of 1926, §219(g), \textit{44 Stat. 34} (1926), \textit{Int. Rev. Code} §166; \textit{Corliss v. Bowers}, 281 U.S. 376 (1930) (income from revocable trust held taxable to settlor). For a summary of the subsequent decisions and statutes pertaining to the revocable trust, see \textit{Magill, Taxable Income} 317–25 (rev. ed. 1945).

The Supreme Court, through judicial interpretation, has rendered extremely hazardous the use of the short-term trust arrangement. In \textit{Helvering v. Clifford}, 300 U.S. 331 (1940), the Court found the income from a short-term trust taxable to the settlor under the general provisions of \textit{Int. Rev. Code} §22(a), although the dissenting justices insisted that, by refusing to include the taxation of short-term trusts within §166, Congress had indicated a desire to give these trusts preferential tax treatment. Apparently, under the rule of the \textit{Clifford} case, there are now three criteria for measuring the validity of trust arrangements for income tax purposes: (1) the length of the trust, (2) whether the beneficiary is a dependent and a member of the immediate family, and (3) the extent of the powers retained by the settlor under the terms of the trust. See \textit{Magill, Taxable Income} 327 (rev. ed. 1945). Although the \textit{Clifford} case resulted in much initial confusion among tax lawyers because of uncertainty as to its real meaning (see, e.g., \textit{Paul, op. cit. supra} note 9, at 296), the Treasury has recently promulgated regulations which should prevent further misunderstanding of the \textit{Clifford} doctrine. \textit{T. D. 5488}, 1946–1 \textit{Cum. Bull. 19}; \textit{T. D. 5557}, 1947 \textit{Int. Rev. Bull. No. 14} at 2 (1947). \textit{T. D. 5557} will apply to taxable years commencing after 1945. \textit{Min. 5568}, 1946–1 \textit{Cum. Bull. 25}, provides that, for any trust created before 1946 and terminated prior to January 1, 1948, no liability will be asserted for 1946 and 1947 under the \textit{Clifford} regulations. It would thus appear that the Treasury, aided by a determined Court, has effectively encircled the family trust with clear and understandable requirements which will bring decreased use of the device for tax avoidance purposes. There may be some question, however, as to whether the new T. D.'s will be supported by the courts, due to the fact that the Treasury has deviated from the apparent holding of the \textit{Clifford} case in several important respects. Estate of Louis Stockstrom, 7 T. C. 251 (1946). See \textit{Pavenstedt, The Treasury Legislates: The Distortion of the Clifford Rule}, 2 Tax L. Rev. 7 (1946).

14. \textit{E.g.}, Revenue Act of 1921, §202, \textit{42 Stat. 229} (1921). These provisions authorized tax-free exchanges and distributions of securities in corporate reorganization. As liberalized by the 1921 Act and subsequent amendments to the Code this legislation inadvertently opened the way to family tax avoidance, because it provided that income taxes due from such exchanges might be postponed until a gain was realized in cash or property substantially different from the original property. Revenue Act of 1928, §112(g), \textit{45 Stat. 818} (1928); see \textit{Rudick, supra} note 3, at 254.
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between family members,\(^1\)\(^5\) and family partnerships,\(^1\)\(^6\)

But despite success in limiting the individual effectiveness of each of these techniques, their total impact remains. Attempts at tax avoidance have not slackened and litigation has flourished at the expense of consistency and certainty. This situation has bred confusion among tax practitioners and taxpayers as to where the line must be drawn between lawful and unlawful tax reduction efforts. To this extent the present policy may be considered a failure, emphasizing the need for an over-all uniform legislative program.

State-sponsored income-splitting

Efficacious as these privately-contrived devices have been, certain civil or common-law concepts of concurrent property ownership have provided more effective instruments of individual tax reduction. For the Supreme Court has held that federal income taxes under present law must be levied upon

\(\text{In Gregory v. Helvering, 293 U.S. 465 (1935), the Supreme Court established supplementary criteria to be used in determining the validity for federal tax purposes of such capital transactions. The Court in this case first announced the requirement that the exchange have a proper "business purpose," and went on in subsequent decisions to stress the necessity of the transferor's retaining a substantial proprietary stake in the enterprise if undesirable tax consequences are to be avoided. LeTulle v. Scofield, 303 U.S. 415 (1940); see Helvering v. Bashford, 302 U.S. 454, 458 (1938); Groman v. Commissioner, 302 U.S. 82, 87-8 (1937).}\)

\(\text{15. I.R.T. Rev. Code § 24(b), E.g., McWilliams v. Commissioner, 331 U.S. 694 (1947) (loss disallowed where sale of securities made through exchange with corresponding purchase shortly thereafter by another family member).}\)

\(\text{16. This method of tax avoidance usually involves a gift of assets from the original income-recipient, with which the donee then purchases an interest in a partnership formed under state law with the donor. E.g., Davis B. Thornton, 5 T.C. 116 (1945); H. D. Webster, 4 T.C. 1169 (1945); M. W. Smith, Jr., 3 T.C. 894 (1944).}\)

\(\text{The Supreme Court, in Commissioner v. Tower, 327 U.S. 289 (1946) and Lusthaus v. Commissioner, 327 U.S. 293 (1946), cast doubt on the future success of this device when it held the partnerships involved to be nothing more than tax avoidance schemes, and held the entire income in each case taxable to the donor of the assets which were used to purchase the partnership interests. As in the Clifford case, the Court's decision created havoc among tax practitioners, and the subsequent failure of the Treasury to issue prompt administrative provisions interpreting the decisions added to the confusion. In 1947 the latter shortcoming was remedied by the issuance of I. T. 3845, 1947-1 Cum. Bull. 65, which clearly established the requirements for a valid family partnership. Under the Treasury's ruling, every family partnership must provide for (1) the rendition of services in the regular conduct of the business and substantial participation in control and management by the spouse or other "family" partner, (2) a bona fide contribution to the business by the "family" partner, in the event that additional working capital is needed or is not already available to the business, and (3) distribution to the "family" partner of no more than a reasonable share of the firm profits. The regulation divides all family partnerships into three classes: those effective for federal tax purposes, those determined to be entirely sham, and those in an intermediate class. Id. at 67-8. In the last of these categories the examining officer is instructed to scrutinize carefully the surrounding fact situation before reaching a result adverse to the taxpayer and to effect an equitable redistribution of the partnership interests for purposes of tax assessment on the basis of what he finds to be the proper ratio. Id. at 68.}\)
the "owners" of the income as determined by state property law.\textsuperscript{17} Although it has realistically insisted upon taxation to the spouse exercising management and control of income when weighing the validity of private income-splitting devices,\textsuperscript{18} the Court has allowed several of these peculiarly "legal" distinctions of state law to defeat federal taxation of income to its actual recipients in those states where such doctrines have been put to use.

\textbf{Tax Benefits Under Common Law Concepts of Concurrent Ownership.} It is possible today under two common-law theories of concurrent ownership—tenancy by the entirety and joint tenancy—for a recipient of property income to divide that income with his spouse in filing federal income tax returns.\textsuperscript{19} On a factual level it is usually necessary to show only that the property is held concurrently by the couple and that there is the right of survivorship as between the spouses.\textsuperscript{20} In one respect, at least, joint tenancy offers the taxpayer greater flexibility than tenancy by the entirety, for it may be employed as a means of dividing income between any two or more individuals, not just with the other spouse.\textsuperscript{21} An additional limiting factor to the use of the tenancy by the entirety lies in the fact that it is valid for federal income tax purposes only in those states which have eliminated the unrestricted common law right of the husband to take all income arising under the entirety arrangement.\textsuperscript{22}

Since courts make no inquiry into the source of funds used to purchase property held jointly or by entirety, these forms of ownership have enabled couples with large property incomes a considerable income tax saving.\textsuperscript{23} Inherent in the use of these devices are the three types of discrimination previously discussed, as well as a fourth: discrimination against those couples who depend chiefly upon earned incomes.\textsuperscript{24}

\textbf{Tax Savings Under Community Property Law.} Even more useful as a tax avoidance mechanism than common law concepts of concurrent ownership,

\begin{itemize}
\item \textsuperscript{17} Poe v. Seaborn, 282 U.S. 101 (1930) (community property); F. J. Haynes, 7 B.T.A. 465 (1927) (joint tenancy); Paul G. Greene, 7 T.C. 142 (1946) (tenancy by the entirety); cf. Sharp v. Commissioner, 303 U.S. 624 (1938); Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1934).
\item \textsuperscript{18} E.g., Lusthaus v. Commissioner, 327 U.S. 293 (1946); Commissioner v. Tower, 327 U.S. 280 (1946); Helvering v. Clifford, 309 U.S. 331 (1940).
\item \textsuperscript{19} See cases cited note 17 \textit{supra}.
\item \textsuperscript{20} See generally on the requirements for these forms of property ownership, 2 \textit{Tiffany, Real Property} §§ 417–36 (3d ed. 1939).
\item \textsuperscript{21} Id. at 430.
\item \textsuperscript{23} See Walter G. Morley, 8 T.C. 904 (1947) (joint tenancy). See generally, \textit{Rabin and Johnson, Federal Income, Gift and Estate Taxation} E4, § 6 (1944). As to disadvantages attendant upon the use of these forms of ownership, see Dane, \textit{Tenancies—Joint, in Common and by the Entirety}, 25 \textit{Taxes} 634 (1947); Rudick, \textit{Marriage, Divorce and Taxes}, 2 \textit{Tax L. Rev.} 123, 133 (1947).
\item \textsuperscript{24} The concurrent ownership concepts are limited to income from property and do not extend to earned income; see 2 \textit{Tiffany, op. cit. supra} note 20, §§ 417–36.
\end{itemize}
PREVENTING FAMILY TAX AVOIDANCE

is the community property system. Taking root in a small group of western states under the influence of Spanish and French civil law,25 by legal fiat it divides between husband and wife all the income earned by either or arising from community-held property. The Supreme Court in Poe v. Seaborn25 recognized this peculiarly local concept of property ownership for tax purposes, holding that, where the community property system prevails, half of all earned family income and income from community property is taxable as income to each spouse. The decision rests on the theory that, under community property law, whatever is acquired by the efforts of either spouse belongs one-half to each, immediately upon receipt.27 Regardless of the merits of this theory or the system itself, its recognition by the Supreme Court for income tax purposes has resulted in marked tax discrimination geographically, and against low income couples and single taxpayers.23

The failure of Congress to prevent this discrimination by a thorough revision of the revenue laws29 has led several states to do what they could to remove the geographical inequity individually. Their answer has been the engrafiting of modified community property systems upon their established common law,30 a solution which has been increasingly used despite initial judicial disfavor. In Commissioner v. Harmon,31 the Supreme Court struck

27. This distinction exists chiefly in theory, however. The husband may exercise broad powers over the community property. See Fernandez v. Wiener, 326 U.S. 340, 349 (1945).
28. Geographical discrimination exists because of the fact that all income from services, in addition to that from community-held property, can be split in community property states, while in non-community property areas only income from property may be so divided.

As to income-group and marital discrimination, see notes 6, 7 supra.
29. See note 42 infra.

31. 323 U.S. 44 (1944). The statute construed in this case was the Community Property Act of 1939, Okla. Laws 1939, c. 62, art. 2.
down Oklahoma's attempt to take advantage of the *Seaborn* holding, because the Oklahoma legislation had made adoption of the system by each married couple available at the couple's option. Refusing to extend its *Seaborn* decision in any way, the Court distinguished the Oklahoma "consensual" arrangement from the "legal" community systems of the original community property states.\(^{32}\) Undeterred, the Oklahoma legislature promptly drafted a new law omitting the objectionable option clause of the former act, and making the system mandatory for all citizens. Since the enactment and subsequent approval of this later legislation, other states have taken similar action,\(^{33}\) and New York, a key tax state, appears likely to follow this trend.\(^{34}\)

But leaving the problem of community property tax discrimination to solution by the individual states seems inadvisable. First, there are serious disadvantages to adoption *in toto* of the community property system, as required by the *Harmon* case. For example, couples may find themselves in unanticipated difficulties in the event that divorce, separation, or death should end their marital status. For upon such occurrences the community property must be divided equally between the spouses or their estates.\(^{35}\)

Furthermore, under a 1942 amendment to the Code\(^ {36}\) all community property is taxable under the federal estate tax to the spouse who predeceases, except that derived from the surviving spouse's earnings or separate

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\(^{32}\) Such a distinction seems difficult to defend on a realistic level, for even under the approved "legal" statutes voluntary arrangements hold an important position: not only is the act of marriage, which puts into operation the community system, at least a partially voluntary act, but it is also possible for married couples by voluntary agreements to add to or exempt from the community estate such property as they desire. See Mr. Justice Douglas, dissenting in Commissioner v. Harmon, 323 U.S. 44, 49 (1944).

\(^{33}\) Oregon, Nebraska, Michigan and Pennsylvania. See statutes cited note 30 supra.

\(^{34}\) Governor Dewey has indicated he will ask for community property legislation in the next session of the legislature if Congress takes no action to eliminate this tax discrimination. N.Y. Times, Dec. 14, 1947, p. 1, col. 7.

\(^{35}\) See 1 DE FUINAI, op. cit. supra note 25, §§ 187, 203, 227.

\(^{36}\) Revenue Act of 1942, § 402(b), 56 Stat. 942 (1942). INT. REV. CODE § 811:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States. . . . (e) (2) To the extent of the interest therein held as community property by the decedent and surviving spouse under the law of any State, Territory, or Possession of the United States, or any foreign country, except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse. In no case shall such interest included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition."

Similarly provisions have applied to joint tenancy and tenancy by the entireties for many years. INT. REV. CODE § 811 (e) (1).

property. This provision may impose estate taxes on some couples far out of proportion to the income tax savings they may achieve under the community property system. 37 Other difficulties arise where life insurance has been purchased from commingled separate funds. In this situation the named beneficiary may be forced to surrender a portion of the insurance proceeds to the spouse of the insured. 33 Thus, although the states are virtually compelled to adopt the community property system in order to answer the challenge of geographical discrimination, in many ways their action amounts to an exchange of one set of inequities for another, less visible set.

In addition to inherent disadvantages to the states from adoption of the community property principle, such a solution to the tax problem may not be uniformly available to all states. Constitutional difficulties of due process may arise, similar to those which recently caused the Pennsylvania Supreme Court to invalidate that state's community property law. 31 But even if all states could adopt a community property system such a move would accentuate discrimination against low income couples and single taxpayers who would derive no benefits from its adoption. 33 And finally, adoption of the community property system would not prevent attempted use of other avoidance devices such as family partnerships or trusts, where the incentive for their use survives, as where family income is sufficient to make worthwhile a multiple split of income among several family members. 41

Because of these serious objections to state-by-state adoption of the community property system, it seems essential that Congress take corrective action on a federal basis. The need for remedial legislation in this field has been recognized for some years by many members of both the House and Senate, and each body has held extensive discussions on the problem. 42 Unfortunately, most of the debate so far has failed to emphasize the need for a solution which will eliminate all forms of discrimination inherent in the present federal income tax treatment of family income. 43

37. For instance, if a marital community has assets of $300,000 and debts amounting to $350,000, the estates tax is determined by deducting one-half of the debts, or $175,000, from the assets, leaving $125,000. After subtracting the exemption of $60,000, the surviving spouse is forced to pay an estates tax on $65,000 even though the deceased left no net estate whatsoever. See Hearings before Committee on Ways and Means on Revenue Revisions, 80th Cong., 1st Sess. 765 et seq. (1947).


40. See notes 6, 7 supra.

41. See note 6 supra.

42. See, e.g., Hearings before Committee on Ways and Means on H. R. 8376, 73d Cong., 2d Sess. (1934); Hearings before Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 309 (1937); 93 Cong. Rec. 9013 (July 14, 1947); 93 Cong. Rec. 8753 et seq. (July 10, 1947); 93 Cong. Rec. 6069 (May 28, 1947); 93 Cong. Rec. 1395-9 (1947).

43. See, e.g., 93 Cong. Rec. 8755 (July 10, 1947).
The Suggested Remedies

Taxing Earned Income to the Earner

Partial answer to the problem of family tax avoidance is found in the proposal to tax all earned income to the earner and community property income to the spouse who exercises management and control.\(^4\) This plan would repudiate *Poe v. Seaborn* by refusing to recognize a sufficient distinction between state community and non-community systems to justify separate treatment under the Internal Revenue Code.\(^4\)

The proposal would eliminate geographical, income-group and marital tax discrimination by extending to community property areas the theory of family taxation now applied to the common law states, but would increase discrimination against earned income, because of its failure to prevent attempted splitting of property income through the use of privately contrived avoidance devices.\(^4\) A further objection to the plan inheres in the great difficulty of accurately and simply defining "earned income"—a problem largely responsible for the repeal of the Code provision allowing earned income credits.\(^4\) Because of these shortcomings the proposal does not appear a satisfactory substitute for present treatment of family income.

Legalized Family Partnerships

Some Congressional support has been given to legislation which would recognize family partnerships for federal income tax purposes, where capital is contributed by both spouses and the partnership otherwise measures up to the requirements of state law.\(^4\) This proposal would attempt to remedy the present inequities of family taxation by legalizing a particular form of tax avoidance on a national basis.

Like an extension of the community property system, legalizing family partnerships would remove geographical discrimination, but at the expense of low income couples and single taxpayers.\(^4\) In addition, there are certain


\(^4\) Ibid. The Treasury's study also foresees a transition period, if this scheme were adopted, during which couples in community property states would seek to avail themselves of certain privately-contrived splitting devices, a resort to which has hitherto been unnecessary.

\(^4\) Int. Rev. Code §§ 25 (a) (3), (4), repealed by § 107, Revenue Act of 1943, 58 Stat. 31 (1944), as to the difficulties encountered in determining "earned income" under these provisions of the Code, see 5 Mertens, *op. cit. supra* note 12, § 32.05. But cf. Statement of Lovell H. Parker, *Hearings before Committee on Finance on H. R. 1, 80th Cong., 1st Sess. 351 (1947).*

\(^4\) See, *e.g.*, S. 793, H. R. 2355, 80th Cong., 1st Sess. (1947); 93 Cong. Rec. 6069 (May 28, 1947); 93 Cong. Rec. 9013 (July 14, 1947).

\(^4\) While the mandatory joint return removes the tax advantage from splitting, the partnership plan would allow it to remain, instead extending its benefits to wealthy couples in all states. Single and low income married taxpayers could not avail themselves of
married taxpayers who, because of the nature of their occupations, could not easily avail themselves of the partnership privilege. Passage of the proposal would also create a difficult administrative problem for the Treasury, which would be forced to interpret the law's provisions in light of court decisions from 48 different jurisdictions in order to ascertain federal income tax liability. Thus, in its practical effect, this plan would perpetuate in another field the objectionable feature of Poe v. Seaborn: the reliance upon state property law in shaping federal tax policy.

Contractual Splitting

Recent Congressional hearings indicate that community property states now favor a plan which would authorize contractual adoption of the community property principle in all states. H. R. 2842, which was sponsored by this group in the first session of the 80th Congress, specified as requirements for this contractual arrangement that the contract must be "bona fide" and valid under state law and that it must establish real and substantial property rights between the spouses as regards the future earnings of the marriage. In effect, this proposal would eliminate family tax avoidance by allowing couples in the common-law states to establish contractual "islands" where the principles of community property law would apply. The plan's proponents argue that it is superior to other suggestions in that it relates the adjustment of taxes to real property rights or to the real ownership of income, improves the wife's position within the family, and is probably free from constitutional attack.

However, a plan of this kind shares the disadvantages of legalized family such tax savings under present tax rates. Those groups would be penalized in that any general increase in rate structures to make up revenue loss resulting from this plan would be partly at their expense although they received no benefit from its adoption.

50. It may be that, where one spouse is a doctor, lawyer, accountant, etc., the ethics of his profession will deter him from forming a partnership with someone other than a member of that same profession. Cf. Cheatham, Cases and Materials on the Legal Profession 62 (1938). But cf. Humphreys v. Commissioner, 88 F.2d 430 (C. C. A. 2d 1937). "Impossibility" may result from other causes: e.g., Pugh v. U. S., 48 F.2d 600 (S. D. W. Va. 1931) (partnership between husband and wife not recognized under West Virginia law). For a tabulation of such situations, see 2 Mertens, op. cit. supra note 12, § 18.07, n. 86; 3 C.C.H. Fed. Tax Rep. ¶1169.21-1169.22 (1948).

51. Hearings before Committee on Ways and Means on Revenue Revisions, 80th Cong., 1st Sess. 763 et seq. (1947).

52. Ibid.

53. See, e.g., id. at 762, 763, 826 et seq.

Advantages claimed for the bill include, in addition to those listed, the following: (1) absence of administrative difficulties; (2) uniformity of treatment; (3) recognition to wives for substantial services toward accumulations of marriage; and (4) equality of estates tax burden between community and non-community property states, since upon death of one spouse, the survivor's interest in the community properties held under the contract shall not be included in the decedent's estate. Id. at 764-765. See also Statement of Senator Hatch at 93 Cong. Rec. 6003 (May 27, 1947).
partnerships. While removing geographical discrimination, it would accentuate tax discrimination against low income couples and single taxpayers, and would be extremely difficult to administer. Such a proposal would not prevent the use of other tax avoidance devices by couples unwilling to bind themselves to community property agreements, or by those who find it profitable to subdivide family income among children or other relatives. Clear and workable definitions of "contract" and "real and substantial property rights," within the terms of the act, might be exceedingly difficult to obtain and would result in protracted litigation. Finally, voluntary adoption of the community property principle by contract within non-community property states would merge within one jurisdiction the conflicting theories of common and civil property law, and thus produce greater confusion than has already resulted in those states which have adopted the community property system in toto.

Mandatory Joint Returns

Under the mandatory joint returns proposal, total income of the family would be combined in one return, and tax avoidance through the subdivision of family income would be prevented. One disadvantage of this plan is the probable difficulty of obtaining passage, for it has encountered violent opposition. Some groups argue its adoption would break up family groups, lead to a decrease in the freedom of women, and have other equally undesirable social effects, arguments apparently accounting for the proposal's defeat in 1941. A further source of opposition was evidenced some years ago when measures providing for mandatory joint returns were introduced in both the Senate and the House of Representatives.

54. Hearings before Committee on Ways and Means on Revenue Revisions, 80th Cong., 1st Sess. 826 (1947); see note 49 supra.
55. See note 71 infra.
56. The problems encountered here would be similar to those which contributed to the repeal of the "earned income credits" provision in the Code. Int. Rev. Code §§ 25 (a) (3), (4), repealed by Revenue Act of 1943, § 107, 58 Stat. 31 (1944). See note 47 supra.
58. By forcing all couples to combine their incomes in joint returns, the plan would destroy the tax advantage now resulting from transfers of income to the non-earning spouse. By the same token, the income tax advantage held by community property states would disappear. However, the incentive to subdivide very high incomes among children or other relatives would remain. By providing for mandatory inclusion of children's income with the "family" return this avoidance channel would largely be closed.
60. In 1941 measures providing for mandatory joint returns were introduced in both
earlier, when threats of filibuster by Senators from community property states defeated a Congressional move to adopt the plan. As additional objection, the diffident point out that in *Hooper v. Wisconsin,* a state income tax statute was invalidated under the Fourteenth Amendment. The Court interpreted the statute as imposing upon the husband a tax based upon the *entire* family income, from whatever source obtained. However, it seems unlikely that this case would be persuasive today. The Court, as now constituted, might well reverse the *Hooper* case and follow the position of the realistic dissent by Mr. Justice Holmes who felt that, "taxation may consider not only command over, but actual enjoyment of, the property taxed." Moreover, the plan could reasonably be interpreted as no more than a tax computation device, with each spouse liable for only his or her proportional share of the income reported.

A third objection to the mandatory joint returns plan is more serious. The plan would *reverse,* rather than remove, discrimination based on marital status. For instance, under the mandatory returns proposal, where the combined family net income before personal exemption is $25,000, half attributable to each spouse, the couple would pay an annual income tax of approximately $2,622 more than if each were allowed to report his income in a separate return. This factor, combined with the aforementioned political and sociological objections, renders adoption of mandatory joint returns neither practicable nor desirable.

**Optional Splitting**

Most popular of the proposals for removing discrimination resulting from family tax avoidance is that which would allow nation-wide optional splitting of family income for income tax purposes, thus destroying the incentive to

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63. Mr. Justice Holmes' dissent, in which Justice Brandeis and Stone joined defended the constitutionality of the Wisconsin statute on the grounds that the state legislature had "[the] power to determine what the consequences of marriage shall be," and that it therefore could hold the husband "liable for taxes on an income that in every probability will make his life easier and help pay his bills." *Hooper v. Wisconsin,* 234 U.S. 206, 220 (1931).
65. See app. A.
66. The differing approaches of the compulsory joint return and the optional splitting plan have been analogized to the conflict between the common law and civil law concepts of marriage. According to that writer the compulsory joint return closely parallels the common law attitude that "husband and wife are one and that one the husband," while the optional splitting arrangement comes nearer to the community property-civil law recognition of the wife's definable and separable rights in the family income. *Vickrey, Agenda for Progressive Taxation,* 281, n. d (1947).
seek other income-splitting devices. Proponents of the plan have suggested
two possible ways in which it might be applied. The first, embodied in the
Knutson bill 67 now before Congress, provides for optional joint returns,69
in which spouses would combine their total income, subtract aggregate de-
ductions, calculate tax liability on one-half of their aggregate taxable income,
and multiply this amount by two to find the family tax liability. The second
alternative—the optional separate return—produces identical tax results but
would require the filing of two pieces of paper rather than one.69

However, the simple optional splitting plan, by itself, does not appear
capable of removing all major tax discrimination in the field of family income
taxation. Current versions of the proposal, such as that in the Knutson bill,
effectively dispose of geographical inequity by allowing taxpayers in all 48
states the income tax advantage now accorded to couples residing in com-

(continued)
Although the present version of optional splitting does not appear desirable, appropriate modification of its provisions would not be difficult. The discrimination against low income couples could be eliminated by allowing smaller percentage cuts in the upper surtax brackets to offset the very large tax advantage which will result to high income married taxpayers. Second, the discrimination visited upon single taxpayers by the plan could be removed by adoption of a separate rate schedule or considerably increased personal exemptions for such individuals. Third, in order to prevent further subdivision among other family members it would seem necessary to require inclusion of children's income in the parents' return. This arrangement would not, of course, deprive taxpaying couples of the usual exemptions for dependents.

In order to make workable the family tax provisions of the Knutson bill, a fourth modification seems essential. For most of the benefits possibly to be derived from the Knutson variation of the splitting plan appear to be counteracted by the bill's other provision which would abolish the present practice of including all community-held property in the estate of the spouse who predeceases, for purposes of levying the federal estate tax. If this portion of the Code were repealed, many couples in community property states would effect sizeable estate tax savings in comparison with couples in other states, since only half of community-held property would be reported in the estate of the spouse predeceasing. Thus, although the major premise of the Knutson splitting provisions is that there do not exist sufficient distinctions between community and non-community property systems to justify separate federal tax treatment, the bill discards these distinctions for income tax purposes, only to transplant them into the field of estate taxation.

72. See note 70 supra. Tax cuts should be made in inverse proportion to the tax savings gained by income-splitting. See app. A.

73. It is true that this suggestion could be applied equally to other proposals. It further appears that the establishment of this form of a dual rate schedule would create administrative difficulties for the Treasury. But see Statement of Randolph Paul, Hearings before Committee on Finance on H. R. 1, 80th Cong., 1st Sess. 528 (1947). Some such provision seems necessary, however, to correct the inequities which would otherwise face single taxpayers under the splitting proposal. An increase in the standard deduction does not seem to give adequate relief to single taxpayers in the higher surtax brackets.


The community property states have seized upon the adoption of income-splitting as an opportunity to eliminate the 1942 inheritance tax amendment. There has been little discussion of the merits of this proposal, and most writers have summarily urged its adoption in conjunction with the optional splitting plan as a necessary concomitant of "complete
CONCLUSION

Although solution of this problem is 35 years overdue, the nature of the proposed corrections and the political elements behind them make it desirable that reforms be made cautiously. No one of the plans suggested would completely eliminate the tax discrimination resulting from the present federal income tax treatment of the family. Although it appears the most desirable of the proposals, even the modified optional splitting plan will permit income to be distributed to non-dependent members of the family or to close friends by means of a trust, or other similar device.\(^{77}\)

Moreover, it should be emphasized that a continuation of present inequities seems preferable to passage of an optional splitting plan like the Knutson bill in its present form. That plan fails to give adequate consideration to compensating rate adjustments in the upper surtax brackets, to the plight of the single taxpayer, and to the accompanying problem of federal estate tax treatment of family income. It seems imperative that Congress amend the family income provisions of the Knutson Bill so as to correct these shortcomings before final passage of the measure. Such action would not only give proper tax recognition to the family entity but would also cope effectively with the problems of income-group and geographical tax discrimination.

equity\(^{76}\) between community and non-community property states. *Hearings before Committee on Ways and Means on Revenue Revisions*, 80th Cong., 1st Sess. 765 et seq. (1947).

Furthermore, elimination of the provision would fail to provide tax equity, even of a geographical nature. While the optional splitting plan "equalizes" the income taxes of similar groups in all states, it has no effect upon community property estate and gift taxation. In non-community property states it would still be necessary to pay gift or estate taxes upon actual transfers to one spouse of property initially acquired by the other. But, with the removal of the 1942 amendment, such transfers made under community property law would be free of estate and gift taxation to the extent that they represented "income" to each spouse under local law.

A more logical solution perhaps would extend the splitting plan to the estate and gift tax field, with appropriate rate adjustments and allowances for single taxpayers. Only in such a manner—or by retention of the present amendment with slight modifications—could complete geographical equity be obtained under the estate and gift taxes.

77. See note 71 *supra*. 
APPENDIX A

COMPARISON OF TAX LIABILITIES OF MARRIED COUPLES WITH NO DEPENDENTS IN COMMUNITY PROPERTY AND IN NON-COMMUNITY PROPERTY STATES

<table>
<thead>
<tr>
<th>Total Tax on Married Couples</th>
<th>Tax Saving in Community Property States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income Before Exemption</td>
<td>Non-Community Property State (Only One Spouse)</td>
</tr>
<tr>
<td>$3,000</td>
<td>$380</td>
</tr>
<tr>
<td>4,000</td>
<td>589</td>
</tr>
<tr>
<td>5,000</td>
<td>798</td>
</tr>
<tr>
<td>10,000</td>
<td>2,185</td>
</tr>
<tr>
<td>15,000</td>
<td>4,047</td>
</tr>
<tr>
<td>25,000</td>
<td>9,082</td>
</tr>
<tr>
<td>50,000</td>
<td>24,795</td>
</tr>
<tr>
<td>100,000</td>
<td>63,128</td>
</tr>
<tr>
<td>500,000</td>
<td>407,465</td>
</tr>
<tr>
<td>1,000,000</td>
<td>839,715</td>
</tr>
</tbody>
</table>

Treasury Department, Division of Tax Research, May 1947. (Figures based on Int. Rev. Code, as amended by Revenue Act of 1945.)

APPENDIX B

TAX LIABILITIES UNDER PRESENT LAW FOR MARRIED COUPLES WITH ONE AND TWO CHILDREN FOR SPECIFIED LEVELS OF NET INCOME, ASSUMING VARIOUS DISTRIBUTIONS OF INCOME BETWEEN FAMILY MEMBERS

<table>
<thead>
<tr>
<th>Combined Net Income</th>
<th>$50,000</th>
<th>$100,000</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Assumed percentage distribution of income among three family members</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100: 0: 0</td>
<td>$24,453</td>
<td>$62,714</td>
<td>$407,032</td>
</tr>
<tr>
<td>50: 50: 0</td>
<td>18,444</td>
<td>49,932</td>
<td>383,111</td>
</tr>
<tr>
<td>80: 10: 10</td>
<td>20,268</td>
<td>52,017</td>
<td>371,720</td>
</tr>
<tr>
<td>60: 30: 10</td>
<td>17,456</td>
<td>46,859</td>
<td>365,940</td>
</tr>
<tr>
<td>50: 25: 25</td>
<td>15,822</td>
<td>43,862</td>
<td>361,109</td>
</tr>
<tr>
<td>40: 40: 20</td>
<td>15,637</td>
<td>43,496</td>
<td>360,644</td>
</tr>
<tr>
<td>33(\frac{1}{3}): 33(\frac{1}{3}): 33(\frac{1}{3})</td>
<td>15,058</td>
<td>42,754</td>
<td>360,155</td>
</tr>
<tr>
<td>II. Assumed percentage distribution of income among four family members</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100: 0: 0: 0</td>
<td>$24,111</td>
<td>$62,301</td>
<td>$406,600</td>
</tr>
<tr>
<td>50: 50: 0: 0</td>
<td>18,164</td>
<td>49,590</td>
<td>382,679</td>
</tr>
<tr>
<td>80: 10: 5: 5</td>
<td>20,107</td>
<td>51,514</td>
<td>365,308</td>
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<td>70: 10: 10: 10</td>
<td>18,045</td>
<td>46,683</td>
<td>353,633</td>
</tr>
<tr>
<td>50: 20: 15: 15</td>
<td>14,862</td>
<td>40,323</td>
<td>342,266</td>
</tr>
<tr>
<td>30: 30: 20: 20</td>
<td>13,234</td>
<td>37,820</td>
<td>338,694</td>
</tr>
<tr>
<td>25: 25: 25: 25</td>
<td>12,920</td>
<td>37,449</td>
<td>338,675</td>
</tr>
</tbody>
</table>

Treasury Department, Division of Tax Research, May 1947. (Figures based on Int. Rev. Code, as amended by Revenue Act of 1945.)