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Federal Income Tax-Internal Revenue Code, Section 102-The Gift Exclusion-Divergence between the Tax and District Courts in Their Treatment of Similar Factual Patterns Arising under the Gift Exclusion Leads to the Reversal of the Tax Court

FEDERAL INCOME TAX—INTERNAL REVENUE CODE, SECTION 102—THE GIFT EXCLUSION—DIVERGENCE BETWEEN THE TAX AND DISTRICT COURTS IN THEIR TREATMENT OF SIMILAR FACTUAL PATTERNS ARISING UNDER THE GIFT EXCLUSION LEADS TO THE REVERSAL OF THE TAX COURT—*Carter v. Commissioner*, 453 F.2d 61 (2d Cir. 1971).

Whether payments to the widow by the decedent's corporate employer constitute compensation or gift[1] for the purposes of determining income is an issue frequently litigated.[2] Until recently, it was assumed that the factual considerations necessary for a resolution of the issue were only subject to a narrow latitude of appellate review.[3] In *Carter v. Commissioner*,[4] the United States Court of Appeals for the Second Circuit, in an opinion written by Judge Friendly, took an innovative approach to resolving the issue[5] which may have repercussions in the area of appellate review.[6]

In *Carter*, the taxpayer, Mrs. Carter, received payments from her deceased husband's employer. The amounts of these payments equaled what the decedent would have earned under an employment contract had he lived out the year.[7] The taxpayer failed to report these payments on her income tax return for that year and the Internal Revenue Commissioner assessed a deficiency against the taxpayer for such failure. The Tax Court sustained the Commissioner's determination[8] and the taxpayer appealed to the Second Circuit Court of Ap-

1. Section 102 of the INT. REV. CODE of 1954 excludes "gifts" among other items from consideration in computing the taxpayer's gross income under section 61. *See generally* Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift"*, 48 MINN. L. REV. 215 (1963).

2. Commissioner v. Duberstein, 363 U.S. 278, 280 (1960); Carter v. Commissioner, 453 F.2d 61 (2d Cir. 1971). *See* Note, *Payments to Widows of Corporate Executives and Employees—Gifts or Income?*, 49 VA. L. REV. 74 (1963) [hereinafter cited as *Payments*]. *See generally* J. CHOMMIE, FEDERAL INCOME TAXATION § 19 (1968).

3. *See* notes 20-21 *infra* and accompanying text.

4. 453 F.2d 61 (2d Cir. 1971).

5. Whereas the Fourth, Sixth and Eighth Circuits in reversing the Tax Court have based their opinions on determinations that the Tax Court was erroneous in its factual conclusions, (*See e.g.*, Estate of Olsen v. Commissioner, 302 F.2d 671 (8th Cir. 1962); Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962); Estate of Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962)). *Carter* inquired into the conflicting decisions of the Tax and district courts.

6. See text accompanying notes 9-11 *infra.*

7. Remaining salary payments would have amounted to $8,653.80 and the decedent's annual proportionate share under the firm's profit-sharing plan would have equaled $51,477.04. 453 F.2d at 62.

8. Estate of Carter, 29 CCH Tax Ct. Mem. 1407 (1970).

peals. Directing comment to what it determined to be divergent treatment of similar factual patterns under the gift exclusion by the Tax Court as contrasted with the federal district courts, the court of appeals determined that it could not support such a variance and reversed the findings of the Tax Court.[9] This decision appears to conflict with the relatively recent Supreme Court ruling in *Commissioner v. Duberstein*[10] emphasizing the role of the trier of fact and the limited scope of appellate review in this area of the law.[11]

Prior to *Duberstein* certain objective criteria were used by the Tax and district courts to determine whether payments to widows of corporate employees were intended as compensation and were therefore taxable income under section 61 of the Internal Revenue Code,[12] or as gifts and were thereby excluded from income by the operation of section 102.[13] These objective criteria were utilized by the courts to determine the dominant intent of the transferor, thereby establishing the taxable status of the property.[14] Since *Duberstein* these factors have been deemphasized by the Tax Court and replaced by others more inclusive.[15]

9. 453 F.2d at 70. The court also based its reversal on a finding that the judge was clearly erroneous on an evidentiary matter. But it is apparent from a reading of the case that the court placed primary emphasis on the divergence between the Tax and district courts in the gift exclusion area rather than the evidentiary concern. *Id.* at 70.

10. 363 U.S. 278 (1960).

11. *Id.* at 290. In *Duberstein,* the Court held that characterization of the receipt of an automobile as gift or income for federal income tax purposes was to be determined by the dominant motivation of the transferor. Moreover the court concluded that the trier of fact's assessment of the dominant motive was not to be reversed unless clearly erroneous.

12. INT. REV. CODE of 1954, § 61, which states in pertinent part, "[G]ross income means all income from whatever source derived. . . ."

13. *Id.* § 102, which states in pertinent part, "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

The formulated criteria were: whether the payments were made to the widow rather than the decedent's estate; whether there was an enforceable obligation against the corporation to make such payments to the decedent's widow; whether the widow had ever been employed by the corporation; whether the corporation realized any income benefit for making such payments; and whether prior to his death the decedent had been fully compensated for his services to the corporation. 453 F.2d at 64; *see* Estate of Luntz, 29 T.C. 647 (1958); Estate of Foote, 28 T.C. 547 (1957); Estate of Hellstrom, 24 T.C. 916 (1955).

14. Bogardus v. Commissioner, 302 U.S. 34 (1937). The *Bogardus* holding was two-pronged. First, the taxable status of transferred property depends upon the intent of the transferor. Second, intent is a question of law, or at least a mixed question of law and fact.

15. The post-*Duberstein* factors are decidedly more sophisticated. For example, whether the husband, the widow, or the family of either holds a controlling interest in the stock of the corporation; whether or not the corporation has followed a policy of

This has resulted in the establishment of a presumption by the Tax Court that, in the absence of unusual circumstances, all payments to survivors of deceased employees are considered compensation.[16]

In *Duberstein*, the Court reaffirmed the rule established in *Bogardus v. CIR*[17] that the dominant intent of the transferor was the standard for determining the taxable status of a transfer of property.[18] But the Court refused to follow the additional holding of *Bogardus* that the determination of whether the transaction was compensation or gift was a question of law subject to broad appellate review.[19] Rather, the Court held such a determination was solely a question of fact to be decided by the trier of fact,[20] thereby necessarily restricting the scope of appellate review.[21] Certain members of the Court recognized the deleterious effects of removing the opportunity for appellate review;[22] however, it was the opinion of the *Duberstein* majority that such effects should be remedied by the legislature.[23]

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declaring dividends; whether the corporation has sufficient surplus out of which to declare a dividend; whether the payments are related in amount to the husband's salary; whether the payments have been determined in deference to the widow's needs; the balance between the income of the widow and her necessary expenses. *See, e.g.*, Ivan Y. Nickerson, 19 CCH Tax Ct. Mem. 1508 (1960); Estate of Louis Rosen, 21 CCH Tax Ct. Mem. 316 (1962); *Payments, supra* note 2, at 97.

16. 453 F.2d at 66; *see Payments, supra* note 2, at 123.

17. 302 U.S. 34 (1937).

18. 363 U.S. at 285-86, *citing* Bogardus v. Commissioner, 302 U.S. 34 (1937).

19. 302 U.S. at 39.

20. 363 U.S. at 289, where the Court stated:

> Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that *primary weight in this area must be given to the conclusions of the trier of fact.* (Emphasis added).

21. 363 U.S. at 290-91, *citing* FED. R. CIV. P. 52(a), which provides: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." *See* United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948).

22. For example, Justices Douglas and Whittaker in their dissenting opinions would have reaffirmed the entire *Bogardus* decision, maintaining the broad purview of the appellate courts and thereby insuring a certain degree of consistency in the application of the tax laws within a particular circuit. 363 U.S. at 293. Justice Frankfurter in his concurring opinion cautioned against setting "fact-finding bodies to sail an illimitable ocean of individual beliefs and experiences" and, while recognizing the futility of an attempt to define precisely what constituted a gift, he formulated a "presumptive rule placing the burden upon the beneficiary to prove the payment wholly unrelated to . . . services to the enterprise." *Id.* at 297, 296.

23. The majority concluded: "If there is fear of undue uncertainty or overmuch

The *Duberstein* opinion operated to relieve the Tax Court, to some degree, of the watchful eye of the appellate courts. The Tax Court had interpreted the decision as an indication that it could utilize all relevant evidence and adopt a more restrictive notion of what constituted a gift.[24] It is this approach that the court rejected in *Carter*. The *Carter* court interpreted *Duberstein* as both reaffirming and reemphasizing, not restricting, the definition of "gift" previously developed by the courts.[25] It was the court's opinion that in applying the broader spectrum of factors allowable under *Duberstein*, the Tax Court had been utilizing a presumptive rule,[26] the practical effect of which was that "in the absence of unusual circumstances demonstrating compassion, all payments to survivors of deceased employees [were] considered to be compensation."[27] This, the court determined, was a trend[28] operating to the detriment of the taxpayer and causing an unacceptable disparity between the Tax Court and the district courts in their respective treat-

litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matter . . . ." *Id.* at 290.

24. 453 F.2d at 65.

25. *Id.*

26. *Id.* at 66.

27. *Id.*

28. *See, e.g.*, Joshel v. Commissioner, 296 F.2d 645 (10th Cir. 1961), *affirming* 19 CCH Tax Ct. Mem. 1349 (1960), wherein the court stated that in effect the Tax Court was attempting to institute the test proposed by the government in *Duberstein* that the Supreme Court had rejected, namely, that as an ordinary matter payments by a corporation cannot be a gift. The court nevertheless affirmed, stating:

> However, Duberstein lays down the rule that in a case such as this appellate review is "quite restricted." The findings of the Tax Court must be accepted unless clearly erroneous and we may not substitute our inferences for those of that court. . . . *As we read Duberstein, it is not within our power to change the result.* *Id.* at 648 (emphasis added).

See, e.g., Smith v. Commissioner, 305 F.2d 778 (3d Cir. 1962), *affirming* the Tax Court in a very close factual determination impliedly accepting the Tax Court's interpretation of *Duberstein*. The court stated: *"We cannot exceed the narrow function assigned to us, regardless of what others have done."* *Id.* at 782 (emphasis added). *But see* Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962), wherein the court did not feel as constrained by the "clearly erroneous" rule as the Tenth Circuit. The court said, "In every prior (pre-*Duberstein*) Tax Court case, essentially identical facts were held sufficient to support the conclusion that the dominant motive was sympathy for the taxpayer's widowed position . . . . The Supreme Court in Duberstein did not destroy the authority of the earlier Tax Court cases and the guides enunciated in them for discovering motivation." *Id.* at 291-92. In Estate of Olsen v. Commissioner, 302 F.2d 671 (8th Cir. 1962), the court of appeals cited *Bogardus* rather than *Duberstein*, impliedly in support of the proposition that Duberstein had not altered the substantive law of the area. *Id.* at 674; *see* Estate of Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962). The split of circuits seems to be based upon the various courts' interpretations of the scope of review allowed. With the Second Circuit lined up with the Fourth, Sixth and Eighth in opposition to the Third and Tenth, some clarification from the Supreme Court of the United States would seem appropriate.

ment of the gift exclusion.[29] That is, since the *Duberstein* decision, with a single partial exception, all such payments had been found by the Tax Court to be income,[30] whereas the trend of decision in the district courts had been to hold such payments to be gifts.[31] The court, although recognizing "forum shopping" to be inherent in the system of tax collection by the mere existence of more than one competent court, emphasized that:

> [T]he result should [not] depend on whether a widow could afford to pay the tax and sue for a refund [in the district court] rather than avail herself of the salutary remedy Congress intended to afford in establishing the Tax Court and permitting determination before payment.[32]

The problem of uniformity in the application of the tax laws was previously considered by the Second Circuit in *Bessenyey v. Commissioner*.[33] There, in a decision also written by Judge Friendly, the court confronted the issue of precisely what consideration should be

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29. 453 F.2d at 68-69. *But cf.* the dissenting opinion by Judge Davis where he referred to such variance but concluded that *Duberstein* left the cure to the legislature. *Id.* at 71; *see Payments, supra* note 2, at 123.

30. *Id.* at 66. *See generally* Hauser, *Voluntary Corporate Payments to Widows*, 44 TAXES 110 (1966).

31. 453 F.2d at 67, where the court stated:

> The course of decision in the district courts has been quite different from that in the Tax Court. Payments to a survivor, not specifically characterized as compensation, have been rather consistently held to be gifts. . . . Quite obviously, the Tax Court and the district courts have been traveling different paths.

See, e.g., Rice v. United States, 197 F. Supp. 223 (E.D. Wis. 1961), wherein the district court acknowledged the changed position of the Tax Court regarding the interpretation of the term "gift" but nevertheless reaffirmed its own position that *Duberstein* did not propose new substantive law. *Id.* at 226.

32. 453 F.2d at 69; *see* J. CHOMMIE, FEDERAL INCOME TAXATION § 253 (1968); Carey, *Choosing Tax Procedures for Tactical Advantage*, 40 NOTRE DAME LAWYER 363, 369 (1965); Hoffman & Davidson, *Payments to Widows of Deceased Employees—Gift or Compensation Under the Federal Income Tax*, 8 TAX COUNSELORS Q. 385 (1964); Note, 35 U. CIN. L. REV. 644 (1966).

33. 379 F.2d 252 (2d Cir. 1967). In *Bessenyey*, the court dealt with sections 162, 165 and 212 of the Internal Revenue Code which required a determination of the intent of the taxpayer in engaging in a particular transaction. The taxpayer in *Bessenyey* sought deduction for losses sustained in the operation of a horse breeding enterprise, but the Commissioner denied the deduction determining that the taxpayer's *intent* in entering into the transaction was for a recreational rather than a profitable purpose. Both the district court and the appellate court upheld the Commissioner. In the 1929 Tax Reform Act, Congress intervened to alleviate some of the litigation in this area. New section 183(d) applies a presumption that a profit motive exists if, in the case of an activity consisting of breeding, training, showing or racing of horses, there is a showing of profit in two or more of the taxable years in a period of seven consecutive taxable years preceding the taxable year in question. Similar legislation in the gift exclusion area would greatly alleviate the problems involved in *Carter*. *See* 363 U.S. at 286 n.8.

given to inconsistencies in the treatment of comparable factual patterns in the diverse forums available to the taxpayer. As the court then read *Duberstein*, "[s]uch a failure [was] not enough for reversal."[34] That is, such a finding did not render the lower court's decision "clearly erroneous."[35] Thus, the *Bessenyey* court, unlike the court in *Carter*, felt constrained by the "clearly erroneous" standard to uphold the trial judge and permit him freedom to "follow his bent" even though this would result in "the unfortunate consequence of lessening the predictability peculiarly essential in tax matters."[36]

This analysis of *Duberstein* by the Second Circuit in *Bessenyey* is difficult to reconcile with that of *Carter*. Ostensibly, *Carter* represents an expansion of appellate review in the area of the law of taxation, and necessarily an encroachment on the *Duberstein* principle. The court disapproved the judicial practice of allowing the taxable status of a particular transaction to be governed by the forum chosen. The court rejected the presumptive approach adopted by the Tax Court to resolve the gift exclusion problem and directed the trial court to remove this divergency by adhering to the pre-*Duberstein* guidelines.[37] Notably, these guidelines have been more favorable to the taxpayer and it can be expected that in the Second Circuit the Tax Court will be forced to apply these factors to reach a like result.

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34. 379 F.2d at 257.

35. *See* note 21 *supra*.

36. 379 F.2d at 257. The court also stated that if their objective were uniformity or were they at liberty to reweigh the evidence, they would reverse.

> But we have been instructed that these are not the proper criteria for an appellate court when a tax case turns on an issue of intent. . . . "[A]ppellate review of determinations in this field must be quite restricted," and the findings of a trial judge . . . are not to be upset unless "clearly erroneous". . . . While we do have "a definite and firm conviction" that the judge here did not make good on the (*Duberstein*) Court's prophecy of a "natural tendency of professional triers of fact to follow one another's determinations, even as to factual matters", . . . as we read Duberstein such a failure is not enough for reversal. *Id.* at 256-57.

37. The court did not insist that the pre-*Duberstein* guidelines were the only factors the trial court should consider. Rather, it concluded:

> [W]hen the Supreme Court wrote as it did in *Duberstein*, it could reasonably have expected the Tax Court to continue to observe the sensible guidelines last enunciated in *Luntz* . . . supplemented by such others as experience should prove to be relevant. . . . 453 F.2d at 69.