PRESIDENT'S 1963 TAX MESSAGE

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HEARINGS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
EIGHTY-EIGHTH CONGRESS
FIRST SESSION
ON
THE TAX RECOMMENDATIONS OF THE PRESIDENT CONTAINED IN HIS MESSAGE TRANSMITTED TO THE CONGRESS JANUARY 24, 1963

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PART 1

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Secretary Dillon. Certainly.

Mr. Byrnes. And those you are going to penalize, are you not?

Secretary Dillon. We point out that it would require anywhere between 70 and 85 percent of income in itemized deductions and exemptions to actually be penalized.

Mr. Byrnes. Take two people who both get a rate reduction. Let us say they both have $8,000 of adjusted gross income. One who takes the standard deduction—he does not have these deductions in excess of $800—he gets the full benefit of the rate reduction, does he not?

Secretary Dillon. That is right.

Mr. Byrnes. But the other taxpayer who happened to have a major medical expense, or paid interest on a home mortgage, and real estate taxes, has deductions of $1,200. He loses $400 of deductions. does he not?

Secretary Dillon. That is correct.

Mr. Byrnes. So that the person who is contributing to charity, the person who has interest payments, the person who does buy his home, has the potential of being penalized as against the person who does not because they both get the same rate reduction, but one gets his tax base enlarged, whereas the other person does not.

Secretary Dillon. I would say that the answer to that is that right in that area there are certain people who get a greater rate reduction than others. I think you are correct in that.

Mr. Byrnes. How do they get a greater rate reduction? The rate reduction is the same.

Secretary Dillon. I do not mean the rate reduction. I mean greater effective rate reduction, greater overall tax reduction.

Mr. Byrnes. It is a question of who you are going to favor or who you are going to penalize, as I see it, in this 5-percent floor. You are going to favor the person that does not own his own home, who does not pay local real estate taxes, who does not contribute to his community chest and his charities, who does not do the things we rely on for people to do if we are going to sustain them on a voluntary private basis. We favor the people who do not; or you can put it the other way around and say you penalize those who do. That is the inequity here. I think you conceal it when you constantly refer back to the rate reduction because everybody gets the rate reduction. Your tables refer to averages. I do not like to rely completely on averages because we are dealing with individual people and they do not operate on the basis of an average.

Before I yield, Mr. Secretary, there is another area I would like to go into. Do you have a legal opinion as to the constitutionality of taxing unrealized gain on death?

Secretary Dillon. Yes; I can submit that for the record.

Mr. Byrnes. This is the first time I knew a person made income by dying. Will you put your opinion in the record at this point?

Secretary Dillon. Yes; I would be glad to put it in. It is a formal constitutional opinion which I would be glad to put in the record.

Mr. Byrnes. Fine.
(The opinion referred to follows:)

TO: Secretary Dillon.
From: G. d'Andolot Bellin.
Subject: Constitutionality of proposed legislation to tax capital gains from property transferred by donation or death.

My opinion has been asked on the question whether Congress may constitutionally amend the provisions of the statutes taxing capital gains as income to provide that upon the transfer of property by donation or death the appreciated value of the property over the cost basis may be taxed as a capital gain to the donor or decedent.

I. PRESENT STATUTORY FRAMEWORK

At the outset, I will outline briefly the present relevant congressional definition of income and the applicable statutory framework. Congress has provided the basic definition of income in the Internal Revenue Code of 1954, 26 U.S.C., in section 61(a). This section states that "gross income means all income from whatever source derived, including (but not limited to) the following items: * * * (5) gains derived from dealings in property; * * *." The determination of the amount, and the recognition, of gains derived from the disposition of property are provided for in subchapter O, sections 1001 et seq. In brief, a gain occurs on the sale or other disposition of property when the amount realized is in excess of the cost, sections 1001(a) and 1012. The amount realized is "the money received plus the fair market value of the property (other than money) received," section 1001(b). Congress has accorded, in subchapter P, a reduced tax treatment to those gains from the disposition of property which meet the definition of net long-term capital gains, sections 1201 et seq. A net long-term capital gain is the gain from the sale or exchange of a "capital asset," which term is defined as property held by a taxpayer, with certain specific exceptions, in section 1221.

The present law does not provide for taxation of gains (or the comparable treatment of losses) from the disposition of property by donation or at death. The basis of property passing to a recipient in these events is, however, provided in sections 1014 and 1015. In the event of a gift, the donee takes the property on the cost basis of the last owner who has not received the property by gift, section 1015(a). Therefore, the donee may be taxed on the appreciation of value, including that which occurred while held by the donor, when the donee sells or disposes of the property. The proposed amendment would alter this arrangement by taxing the donor on the appreciation of the property up to the time of his gift, and the donee would, consequently, receive the property with the cost basis being the market value as obtained from the donor. At present, in the event of death, the beneficiary receives the property of the decedent at the fair market value at the time of the death or at the optional alternate valuation date, section 1014. Consequently, the appreciation of value of the property while held by the decedent is lost to income taxation.

II. CONSTITUTIONAL POWER OF CONGRESS

I turn now to the question whether there is any constitutional limitation on Congress which would prevent it from providing for recognition of a taxable gain or loss under the income tax law on the disposition of property by donation or death.

The first power given to Congress by Article I, section 8, of the Constitution, is the "Power To lay and collect Taxes." The 16th amendment, adopted in 1913, provides that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

In the 50 years since this amendment was adopted, Congress has defined and redefined income subject to tax, often as a result of restrictive court rulings. The Federal courts, in dealing with the concept of income, have come to recognize that Congress intended, in 26 U.S.C. 61(a) and its predecessor sections, to use its full taxing power and that the courts should give a liberal construction to that power, recognizing broad discretion in Congress to define income. See,

III. TAXABILITY OF APPRECIATION OF CAPITAL

Since 1920, definitions of income have often referred to the Supreme Court's dicta in the case of Elsner v. Macomber, 252 U.S. 189, concerning the taxation of gains accruing to capital. In this case the Supreme Court held that a common stock dividend distributed to a common stockholder of the corporation which did not alter his ownership interest in the corporation was not income but the evidence of capital ownership. The Court's definition of income was as follows:

"** Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however, invested or employed, and coming in, being 'derived,' that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description." [Italics omitted.]

This opinion will demonstrate that the foregoing definition is not an obstacle to the proposed legislation for at least the following two reasons: (1) later Supreme Court cases have so modified and qualified its concepts that there is every probability that the Supreme Court will now recognize power in Congress to tax appreciation in value as income at appropriate times; specifically, the Supreme Court has held taxable as income at an appropriate ocassion appreciation in value which had not been severed from the capital asset and such appreciation which, by virtue of the control over it exercised by the taxpayer, had been received or held by another than the taxpayer; and (2) the proposed legislation is not inconsistent with the foregoing definition as it proposes to tax as income "something of exchangeable value" that is "drawn by" the taxpayer for his "disposal." The increase in value, having exchangeable value, would be disposed of by the taxpayer according to his wishes to accomplish his economic objectives. Under modern court rulings this disposition may be said to be a realization of income, as will be demonstrated in part IV of this opinion.

Point (1) was fully developed in the Opinion of my predecessor, No. 748, dated June 12, 1901, supporting the constitutionality of section 13 of H.R. 10630, placing a tax on the undistributed profits of certain foreign corporations controlled by U.S. citizens. This tax was enacted as section 12 of Public Law 87-884, October 16, 1902, 38 Stat. 371, 375.

Suffice it to point out here that succeeding Supreme Court cases have greatly eroded both the holding and the dicta of Macomber. With respect to stock dividends in particular, the case has been clearly limited by subsequent decisions to the precise holding of a distribution of capital by a particular corporation to its stockholders which did not alter the interest of those stockholders in the identical corporation. United States v. Phellis (1921), 257 U.S. 156; Rockefeller v. United States (1921), 257 U.S. 176; Mapp v. United States (1925), 288 U.S. 536; Koshland v. Helvering (1936), 298 U.S. 441; Helvering v. Gowran (1937), 302 U.S. 228; and see Helvering v. Griffiths (1943), 318 U.S. 371, 375.

Moreover, the Supreme Court has refused to be hobbled by that definition in determining other gross income questions not involving stock dividends. United States v. Kirby Lumber Co. (1931), 284 U.S. 1; Helvering v. Brunn (1940), 309 U.S. 461; Commissioner v. Glenshaw Glass Co. (1935), 358 U.S. 536, and General American Investors Co. v. Commissioner (C.A. 2d 1954), 211 F. 2d 522, aff'd (1955), 348 U.S. 434. In the Glenshaw Glass Co. case the court said "** ... [Elsner v. Macomber] was not meant to provide a touchstone to all future gross income questions" (p. 431). These and other recent Supreme Court cases have led many tax authorities to conclude that the doctrine of realization as formulated in 1920 is not a constitutional requirement and that any economic accretion to wealth may be taxable when it may be conveniently measured.

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*See, e.g., Rittker, "Federal Income Taxation of Corporations and Shareholders" (1939) at p. 189; Griswold, "Cases and Materials on Federal Taxation" (5th ed. 1959) at p. 162; Mintz, "Basic Concepts of Taxable Income," an article contained in "Practical Aspects of Federal Taxation" (1948) at p. 17; Rabkin and Johnson, "Federal Income, Gift and Estate Taxation" (1956 ed.) sec. 1.02(2); and Wright, "The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts," 8 Stanford L. Rev. 164, at pp. 201, 209 (March 1956).
In analyzing the present question, it is important to emphasize that the proposal is not to tax appreciation in value of property held by an owner, either periodically or as it accumulates, but when it is transferred. The courts do generally deny taxation of mere appreciation when it appears to them that this has been undertaken by the Internal Revenue Service without congressional direction. See Campbell v. Prothro (C.A. 5th 1954) 200 F. 2d 531, 535. However, in the Brown case, supra, the Supreme Court upheld the assessment by the Internal Revenue Service against a landlord of an income tax on the value added to the real estate by a building erected by a tenant, the value being determined at the time of the forfeiture of the lease. Against the contention of the taxpayer that this taxation was unconstitutional under the Supreme Court's definition of income as gain "severed from capital" for the taxpayer's "separate use, benefit, and disposal," the Court explained that that definition was meant to clarify the distinction between an ordinary dividend and a stock dividend, that "the realization of gain need not be in cash derived from the sale of an asset," and that it was "not necessary to recognition of taxable gain" that the taxpayer should be able to sever the gain from the capital (p. 469).

The extent to which the Supreme and Circuit Courts have gone in allowing a taxpayer to be taxed on income not "realized" or received by him in the traditional sense, point (2), will be discussed in part IV, below. Most important for present purposes, however, is the fact that the concept of realization of income has been broadened in recent years, particularly in the area of the taxation of capital gains and gifts of income.

Moreover, Congress has, in fact, taxed appreciation of property not received by the taxpayer when it was under his control and direction, as in the Foreign Personal Holding Company Act, enacted in 1937, now 26 U.S.C. 551 et seq. The constitutionality of this enactment was upheld in Edler v. Commisstoner (C.A. 2d 1943), 183 F. 2d 27, and acceptance of the act was indicated in Helvering v. National Grocery Co. (1938), 304 U.S. 282 fn. 4 at p. 288.

IV. REALIZATION OF INCOME BY DISPOSITION ON DONATION OR DEATH

In my opinion, the proposed legislation is primarily an extension and elaboration of the concept of the capital gains tax itself, namely, that the appreciation in value of a capital asset may be taxed as income upon its transfer; the transfer being the taxable event at the time of which the appreciation in the value may be measured and taxed as income. The Supreme Court quickly rejected a taxpayer's contention that the doctrine of Eisner v. Macomber prevented the taxation of the increase in value of stock determined upon the occasion of its sale. The Court pointed to its definition in that case as including profits gained from the sale or conversion of capital assets. Merchants Loan and Trust Co. v. Smeltanka (1921), 256 U.S. 509.

The income tax now falls upon the occasion of a "sale or other disposition" of property, and the capital gains rate is applied upon the occasion of a "sale or exchange" of a capital asset. The taxable event may be the voluntary act of the taxpayer or the happening of an event not the will of the taxpayer, such as the taking of property in a condemnation proceeding (Commissioner v. Kieselbach (C.A. 8d 1942), 127 F. 2d 359, aff'd (1943) 317 U.S. 399) or for nonpayment of taxes (Helvering v. Nebraska Bridge Supply & Lumber Co. (1941), 312 U.S. 668, reversing (C.A. 8th 1941) 116 F. 2d 288). The proposed legislation would include as taxable events the act of the taxpayer in making a donation and the death of the taxpayer, on which events his property is measured, including the increase in value during his period of holding.

If these two events, upon both of which property is transferred, are appropriate occasions for measuring the increase in value of property held by the taxpayer, as I believe they are, the next question is whether Congress is prevented by the Constitution from so designating them because the taxpayer may receive only the intangible benefits which cause and accompany beneficial effects, including the accumulation of property for the benefit of the taxpayer's heirs. The courts have already foreshadowed, without the benefit of statute, the possibility of recognizing a separate income subject to capital gains tax, the appreciation of property disposed of for which a value is received which cannot readily be described as having a "fair market value" under section 1001(b). The accomplishment of an economic objective of an intangible nature, the value of which can be measured only approximately by the amount of the appreciation of the property disposed of, has been held sufficient to justify the taxation of this appreciation to the taxpayer.
The outstanding example of this recognition of capital gain is the recent Supreme Court decision in United States v. Davis (1962) 370 U.S. 65. Here the Supreme Court reversed the Court of Claims’ decision, Davis v. United States (1961) 287 F. 2d 168, which held that there was no taxable gain to the husband on the transfer of appreciated stock to his divorced wife in settlement of the wife’s interest in his property. The Court of Claims believed that the provisions of the capital gains tax could not apply as the amount realized by the husband was not determinable. It had concluded that the value of the rights of the wife in the husband’s property could not be estimated. In this holding it followed the opinion of the 6th Circuit Court in 1960, in C.I.R. v. Marshman 279 F. 2d 27, cert. den. (1960) 364 U.S. 918. The Supreme Court, however, reversed the Court of Claims and reestablished the holdings of the 3d and 2d Circuit Courts, Commissioner v. Meola (O.C.A. 3d 1941) 123 F. 2d 980, cert. den. (1941) 310 U.S. 695, and Commissioner v. Halliwell (O.C.A. 2d 1942) 131 F. 2d 042, cert. den. (1942) 319 U.S. 741, which conflicted with the Marshman case. Furthermore, it cited with approval two other important holdings under the capital gains statute, United States v. General Shoe Corp. (O.A. 6th 1960) 282 F. 2d 9, cert. den. (1961) 365 U.S. 843, and International Freight Corp. v. Commissioner (O.A. 2d 1943) 185 F. 2d 810.

The rationale of the Supreme Court in this case is important for our purposes. It argued that the income tax consequences of the stock transfer required a two-step analysis: first, “Was the transaction a taxable event?” and, second, “If so, how much taxable gain resulted therefrom?” (p. 67). In deciding that the transfer was “an appropriate occasion for taxing the accretion to the stock” (p. 68), the Court stated that there was no doubt that Congress by its inclusive definition of income subject to taxation as “all income from whatever source derived, including * * * gains derived from dealings in property” intended that the economic growth of this stock be taxed. “The problem confronting us is simply when is such accretion to be taxed. Should the economic growth be presently assessed against the taxpayer or should this assessment await a subsequent transfer of the property by the wife? The controlling statutory language, which provides that gains from dealings in property are to be taxed upon ‘sale or other disposition’ is too general to include or exclude conclusively the transaction presently in issue” (pp. 68, 69). The Court decided that the transfer was similar to a taxable transfer of property in exchange for the release of an independent legal obligation and that the transfer was therefore a taxable event. It pointed out that the Court of Claims recognized this to be true but had “balked” at the “measurement” of the taxable gain realized by the taxpayer (p. 71). The Supreme Court recognized that the measurement of the wife’s rights, complicated by the emotion, tension, and practical necessities of divorce negotiations, could not be exact. However, it concluded that “once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences” (pp. 72, 73). It, therefore, held that the husband had realized the appreciation in the value of the stock from its cost basis to the time of the transfer to his wife and that this was taxable as a capital gain.

The conclusions to be drawn from this Davis decision are, therefore, that appreciation in capital may be recognized as taxable upon the event of the disposition of the capital and that the gain may be measured by the amount of the appreciation itself where intangible subjective factors account for the disposition of the property.

It is significant that the Supreme Court in the Davis case referred not only to the Meola and Halliwell cases, supra, as precedent, they being marital obligation cases, but also to the General Shoe and the International Freight Corp. cases, supra, which involved an economic realization by the taxpayer not consisting of either money or the fair market value of property. In the General Shoe case, the Corporation made a contribution to its employees’ retirement fund of property which had appreciated in value and deducted from its income tax as a contribution the current market value of that property. The Court held that the Corporation had realized capital gains on this transfer of appreciated property to the same extent as if it had sold the property and donated the proceeds to the retirement fund. The Court found support in the reasoning of the Supreme Court in Helvering v. Horst (1940) 311 U.S. 112, 115 (discussed further below), in which the Court said “where the taxpayer does not receive payment of income in money or property realization
may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." The 6th Circuit Court went on to say in the General Shoe case:

"* * * To argue, as the taxpayer does here, that there can be no gain because nothing is realized, is unrealistic. Literally the taxpayer is correct in its contention that it did not receive a tangible benefit * * * however, we do not conceive that in this day and age we are restricted to tangibles in tax matters where there is actual recognizable benefits, albeit intangible, the taxation of which is implicit in the statutory scheme, and where such benefit is clearly capable of being evaluated on an objective basis."

The opinion in the General Shoe Corp. case was also built upon the International Freight Corp. case (C.A. 2d 1943) 135 F. 2d 310. In that case the Circuit Court held that the Corporation realized taxable gain in the appreciation of the shares of stock which it owned and transferred to its employees as a bonus, deducting the fair market value of these shares as a business expense. The Court recognized that the transfer was an appropriate business expense, not a gift, but that no money or property having a fair market value had been realized on the transfer of the shares. However, the Court said, "In similar circumstances, it has been held that 'money's worth' is received and that such a receipt comes within section 111(b) [presently section 1001(b)].," citing the Mesta and Hallwell decisions.

From the foregoing cases it appears that a taxable capital gain will be recognized by the court although the taxpayer has achieved some economic objective other than receipt of money or property having a fair market value, as specified by the statute. It is sufficient, if, as said in the Horst case, he has "the fruition of the economic gain which has already accrued to him." The fact that a taxable gain is not recognized from a gift of appreciated property is due solely to the absence of statutory definition. This was recognized by the court in Campbell v. Prothro (C.A. 5th 1954) 209 F. 2d 331, in declining to recognize a taxable gain from a gift to a farmer of calves to the Y.M.C.A. The court said that Congress had not so far adopted the rule that a gift of appreciated property makes the donor taxable on the appreciation and that under the statutes "as they exist" the court may not do so (p. 336). The court concluded that a gift of farm products was a gift of capital assets and not of ordinary income to which the doctrine of Helvering v. Horst, supra, would apply, as contended by the Commissioner. See note (1954) 22 G.W.L. Rev. 789, analyzing tax problems in gifts of farm products in the absence of the kind of statute now proposed.

It would appear likely, therefore, that the courts would recognize any transfer of appreciated property as a taxable event if Congress broadens the statutory definition of the amount realized upon such a transfer to include the intangible economic values obtained from the making of a gift or bequest or devise or a "receipt of intestacy."

With respect to income other than capital gains, it has been established that a taxpayer who gives away such income over which he had control nevertheless realizes this income and may be taxed upon it. This was the decision of the Supreme Court in Helvering v. Horst (1940) 311 U.S. 112, in which a father who was the owner of a bond was held taxable on the interest received by the son after the gift to the son of the coupon which mature later in the same year. The reasoning by Justice Stone in this case on what constitutes realization of income and on the purpose of the revenue laws has been widely quoted and followed by the Supreme Court and the Circuit Courts generally. This reasoning, because of its importance, is set forth in the following quotations:

"* * * Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.

"Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not defined to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income
in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him" (p. 115).

"* * * But the rule that income is not taxable until realized has never been taken to mean that the taxpayer even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. Aluminum Castings Co. v. Routzahn, 282 U.S. 92, 98. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth" (p. 118).

"* * * Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son" (p. 117).

"The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it" (p. 118).

"The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, Cortes v. Bowers, supra, 375; Burnet v. Guggenhem, 288 U.S. 290, 293. The tax laid by the 1934 Revenue Act upon income derived from wages, or compensation for personal service, of whatever kind and in whatever form paid, * * *; also from interest * * * therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received" (p. 119).

By comprehending "capital gain" within the term "income" or by substituting "capital gain" for "income" in the appropriate places in the foregoing quotations one may see how readily the Court's thinking in this 1940 case could accommodate the concept of taxing capital gains upon such an event as death or gift, despite the fact that these gains were not paid to or received by the taxpayer in the ordinary sense of the word.

The Horst decision was a development of the holding in Lucas v. Earl (1930), 281 U.S. 111, in which a husband was held taxable on all his income although he had made a valid contract with his wife that all his future income should be held by them jointly. In that case Justice Holmes interpreted the federal income tax law as allowing for no "arrangement by which the fruits are attributed to a different tree from that on which they grew" (p. 115). This metaphor has provided the rationale in many later income tax cases.

The Horst decision was followed in the companion case of Helvering v. Eubank (1940) 311 U.S. 122, holding a life insurance agent taxable on commissions paid in 1933 to persons to whom he assigned these commissions in 1924 and 1928. Horst was also followed in Harrison v. Schaffer (1941) 312 U.S. 570 to hold taxable the donor of certain dollar amounts of income from a life estate. Besides extensive quotations from the Horst opinion, the Court said that the exercise of power to procure payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever" (p. 589). In both Commissioner v. Tower (1946) 327 U.S. 280 and Lusithaus v. Commissioner (1946) 327 U.S. 203, the husband was held taxable on income received by the wife from the corpus of property which he had previously given to her, indicating that the rule may be applied where the underlying income-producing property is disposed of. In Commissioner v. Summen (1948) 333 U.S. 591, the Horst rule was applied to a taxpayer who had assigned royalty agreements, and in Commissioner v. Lester (1961) 306 U.S. 269, the rule of the Horst case that "the power to dispose of income is the equivalent of ownership of it" was applied to determine the appropriate taxpayer.
The principles of the Horst case have been followed in a number of circuit court cases which look behind various business arrangements to tax the income to the true owner and to place the income tax on the person who created and had control of the income even though he did not receive it. See, e.g., Home Furniture Company v. O.I.R. (C.A. 4th 1948) 168 F. 2d 312; Paster v. O.I.R. (C.A. 8th 1957) 245 F. 2d 381; Factor v. O.I.R. (C.A. 9th 1960) 281 F. 2d 100.

The Horst case, its precursors and its successors demonstrates that a taxpayer realizes taxable income when he exercises control over income that is compensation for services or derived from business or royalties or other interests by giving it away. There is thus no logical reason why Congress could not provide that this same principle shall apply to the exercise of control over income from gains from dealings in property when this control is exercised through donation, devise, bequest, or intestacy.

The making of a donation, devise, or bequest is an affirmative act of control over property to obtain certain objectives of the taxpayer. In either case the taxpayer has control of the appreciation in value and it is transferred in accordance with his decision. In many cases the acceptance of intestacy is also a decision of the taxpayer which exercises control over the property by permitting its distribution in accordance with laws which would accomplish his own objectives. To be sure, in some cases the “decision” of the taxpayer may be theoretical or nonexistent or may even have been contrary to his unexpressed wishes. His will may even have been invalidated as the result of a contest. Nonetheless, there seems no great conceptual difficulty in including intestate transfers along with those made by will as appropriate events upon which to measure and tax the gains which are by law distributable to the decedent’s spouse and next of kin or heirs.

V. SUMMARY

To recapitulate, it is my opinion that Eisner v. Macomber has limited, if any, application and does not stand in the way of the present proposals; that the transfers of appreciated property by gift or by death present appropriate occasions to measure the increase in the value of the property and to tax the capital gain to the donor or decedent, and that such a tax would be constitutional. The constitutionality of the tax can be supported by the conclusions that an appreciation in property may be taxed upon the occurrence of an appropriate taxable event, which event is for Congress to determine, and that the taxpayer has realized the appreciation in value by his exercise of control over it and by his accomplishment of his economic objective with respect to that income.

Mr. Byrne. I yield.

The Chairman. Mr. King will inquire, Mr. Secretary.

Mr. King. Mr. Secretary, I am going to ask a few questions dealing with civil service annuities and the effects upon them by the President’s recommendation.

It has been reported that in addition to removing the sick-pay tax exclusion, the new plan would abolish the $1,524 annual deduction retired Government workers now get at age 65, as well as the extra $600 exemption each former employee and his spouse now receive at age 65. Would this elderly group be required to carry an extra tax burden under the President’s plan that they do not now carry?

Secretary Dillon. No. Of course, the $1,524 retirement income exemption is worth, under the new proposals with a 14-percent bottom bracket income tax, only some $215 as a credit. The $600 exemption is worth something like $84. So if you add these two together, the total is about the $300 total that we have recommended.

The maximum amount of additional tax that anyone could pay under this would be, I think, $22, or possibly $44 in a few cases. The best information we have is that there are approximately 6,000 individuals and 2,000 families or a total of 10,000 people that might be in this category, most of them not up to the full amount. They might pay $10 to $15 more, and this compares to the roughly 3.5