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Teschner v. Commissioner, 38 T.C. ... no. 101 (1962)

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employee to sue his employer under section 301 when the collective bargaining agreement contains no grievance arbitration procedure. Furthermore, by impliedly refusing to determine the right of an employee to sue his employer under section 301 for breach of an agreement containing grievance arbitration procedure, the Court has indicated that it has not abandoned its view that industrial peace is best obtained by the enforcement of collective bargaining agreements.

KEMP J. WILSON

TAXPAYER WHO GENERATES INCOME AND DESIGNATES ITS RECIPIENT HELD NOT TAXABLE THEREON WHEN HE HAS NO RIGHT TO RECEIVE IT.—Taxpayer entered a contest under rules which required contestants over the age of seventeen years and one month to designate persons under that age as recipients of any prizes won. Taxpayer, an adult, designated his daughter and his entry subsequently won. The daughter received an annuity policy payable to her at age eighteen without restriction as to the use of the proceeds. Taxpayer did not include the amount of the prize in his income tax return and the Commissioner determined a deficiency for the amount excluded. The United States Tax Court held that a taxpayer who generates income and designates its recipient is not taxable thereon when he has no right to receive it. *Teschner v. Commissioner,* 38 T.C. ....no. 101 (1962) (two justices concurring) (seven justices dissenting).

Prior to 1954 the courts expressed divergent views as to who should be taxed on prizes and awards.[1] With the enactment of section 74 of the 1954 Internal Revenue Code "amounts received as prizes and awards" were expressly included in the gross income of the recipient.[2] In the instant case the question before the court was whether a taxpayer who entered a contest and won a prize could be taxed upon it even though, under the rules of the contest, he could not receive the prize.[3]

[1]Compare Pauline C. Washburn, 5 T.C. 1333 (1945) ("Pot O' Gold" case); McDermott v. Comm'r, 150 F.2d 585 (D.C. Cir. 1945) (Ross Essay contest); Glenn v. Bates, 217 F.2d 535 (6th Cir. 1954) (car giveaway); *with* Herbert Stein, 14 T.C. 494 (1950) *and* Robertson v. United States, 343 U.S. 711 (1952).

[2]INT. REV. CODE, § 74: Prizes and Awards.

"(a) General Rule.—Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

"(b) Exception.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—

"(1) the recipient was selected without any action on his part to enter the contest or proceeding; and

"(2) the recipient is not required to render substantial future services as a condition to receiving the prize or award."

[3]There was no question in the instant case as to whether the prize constituted taxable income. The sole question was whether taxpayer should be taxed upon it. Instant case at 3. Under section 74 of the INT. REV. CODE the recipient of the prize is taxed. From the facts in the instant case it would seem that the daughter should be taxed. Instant case at 7. See *infra* note 33.

The courts, in determining to whom income should be taxed, have not formulated a broad standard which can be applied to every situation. Various factors are considered controlling, dependent upon the situation before the court.[4] In the instant case three factors controlled the court's determination: (1) the source of the income; (2) the control of the taxpayer over the source of the income (primarily, the taxpayer's right to receive the income);[5] and (3) the benefit and enjoyment which taxpayer receives from the use of the income.

The difficulty in determining the source of income is illustrated by *Helvering v. Horst.*[6] In that case the taxpayer, an owner of negotiable bonds, detached from them negotiable interest coupons and gave them to his son who in the same year collected on them at maturity. The majority of the Court held that the source of the income was the investment in the bonds, whereas the dissent contended that it was the coupons themselves. The majority looked to the act which generated or produced the income rather than to the instrument with which it was produced. This position is consistent with the established rule that income is taxable to the one who earns it.[7] "To earn" in its broadest sense means to generate or produce income,[8] and the act generating or producing the income is its source. However, generation of income, by itself, is not sufficient to establish the liability of a taxpayer for the tax upon it.[9]

Control over the source of income must also be considered in determining to whom it is taxable. Control presupposes that the taxpayer at one time was entitled to receive the income or was able to designate himself as the recipient.[10] In the *Marion Stone Burt Lansill* case the United States Tax Court said that:[11]

> The right in the taxpayer to receive the income at the time it is attributed and taxed to him is likewise not essential, where . . . the taxpayer has by his own volition chosen to dispose of the right to receive income while retaining that from which the income is derived. The volition in disposing of the right is important, *for while all will agree that one who has never received or had a right to receive or who has involuntarily lost it should not be taxed,* it is also plain that his voluntary exercise of the right to dispose of the income before receipt may be just as valuable and important practically as its exercise after receipt. (Emphasis supplied.)

[4]If a taxpayer is liable for the tax on income, hereinafter such income is referred to as "taxable income." For a discussion of all the terms used in determining the liability of a taxpayer for the tax on income see Williamson, *Fruition of Potential Income—Contingent or Realized,* TAXES, Vol. 40, No. 8.

[5]Instant case at 3, 4, 5, 6, 7, and 8.

[6]311 U.S. 112 (1940).

[7]Compare Rev. Rule 58-127 with instant case at 4.

[8]Instant case at 4. The majority in the instant case preferred two other definitions of "to earn", both of which came from WEBSTER'S NEW INTERNATIONAL DICTIONARY: (1) "to acquire by labor, service, or performance"; (2) "to deserve or receive compensation." A discussion of the applicability of these definitions appears later.

[9]The *Horst* case, *supra* note 6, recognized that control over the income, benefit and enjoyment received are also important and did not divorce the question of the source of income from the other two factors. However, for the purpose of clarification, the factors shall be distinguished in this discussion.

[10]Marion Stone Burt Lansill, 17 B.T.A. 413 (1929) *aff'd* 58 F.2d 512 (D.C. Cir. 1932); Poe v. Seaborn, 282 U.S. 101, 117 (1930); United States v. Pierce, 137 F.2d 428, 431 (8th Cir. 1943); Harrison v. Shaffner, 312 U.S. 579, 580, 582 (1941).

[11]17 B.T.A. 413, 423 (1929).

While control over the source of income further presupposes that the taxpayer has the power to dispose of it, his exercise of this power, standing alone, will not justify taxing him on the income.[12] For example, if a taxpayer assigns the source of income to another and retains no control over it, the assignment will relieve him of the tax upon income thereafter generating from the source.[13] However, if his continued control over the source is necessary to maintain the flow of income to the assignee, a valid assignment will not relieve him of the tax.[14]

The benefit and enjoyment which a taxpayer receives from the use of income is a factor in determining whether the income is taxed to him when he does not actually receive it. The Supreme Court recognized this principle when it stated:[15]

> The rule that income is not taxable until realized . . . 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. *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.* (Emphasis supplied.)

The term "satisfaction" has been used in at least three different situations involving the taxation of income: (1) where a taxpayer exercises his power to dispose of income in such a way as to receive personal satisfaction from it;[16] (2) where a taxpayer uses income which he would otherwise receive to satisfy an obligation which he owes to another;[17] and (3) where another person pays a debt for the taxpayer's benefit.[18] In all three instances it has been held that the taxpayer has received economic worth or "satisfaction" and that he should be taxed on the income.

In the instant case all of the judges agreed that the taxpayer's entry in the contest was the act that produced the income which subsequently was received by his daughter.[19] However, the majority refused to apply, in its broadest sense, the rule that income is taxable to the one who earns it.[20] It instead defined the phrase "to earn," as meaning "to acquire by labor, service, or performance" or "to deserve or receive compensation."[21] Wheth-

[12]For a discussion of the principle that the power to dispose of income does not create liability for the tax upon it see 1946-1 CUM. BULL. at 19-21, T.D. 5488. Compare Nicholas A. Stavroudes, 27 T.C. 583, 590 (1956).

[13]Helvering v. Seatree, 72 F.2d 67 (D.C. Cir. 1934); Comm'r v. Ross, 83 F.2d 18 (6th Cir. 1936); Mitchell v. Comm'r, 27 B.T.A. 101 (1932), *Contra,* Stack v. Comm'r, 22 B.T.A. 707 (1931).

[14]Rossmore v. Comm'r, 76 F.2d 520 (2d Cir. 1935); Daugherty v. Comm'r, 63 F.2d 77 (9th Cir. 1933).

[15]*Supra* note 6 at 116.

[16]*E.g.*, taxpayers creates a revocable trust with income to objects of his bounty. See Corliss v. Bowers, 281 U.S. 376 (1930).

[17]*E.g.*, payment of the income to satisfy an alimony obligation. See Douglas v. Willcuts, 296 U.S. 1 (1935).

[18]Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929); United States v. Boston & Maine R.R., 279 U.S. 732 (1929).

[19]Instant case at 4, 8.

[20]*Id.* at 4.

[21]*Id.* at 4, 5.

er "to earn" is used in its broadest sense or is given the definition used by the majority, the underlying assumption is that income can only be taxed to a taxpayer who at one time was entitled to receive it.[22] Under this rationale the taxpayer in the instant case would not be taxable on the income regardless of how "to earn" is defined.

All of the judges in the instant case further agreed that the taxpayer's designation of his daughter was not in discharge of an obligation to support.[23] Satisfaction of such an obligation renders a taxpayer taxable because he receives economic worth from the use of the income.[24] By designating his daughter as recipient of the income, the taxpayer in the instant case did not receive economic worth since the designation was not made to satisfy an obligation.

The minority and majority of the court in the instant case disagreed as to whether the taxpayer had sufficient control over the income to be taxed upon it. The majority correctly recognized that control over the source of the income necessarily involves the right in the taxpayer to receive the income.[25] The minority, on the other hand, contended that the right to receive the income is not necessary[26] and relied heavily upon the doctrine announced in *Lucas v. Earl*[27] that an anticipatory assignment of income to be earned does not relieve the taxpayer of the tax upon it.

In the *Earl* case a husband and wife contracted to place into joint tenancy all of their property then owned or that was subsequently acquired. Assuming the contract to be valid, the court held that income thereafter earned by the husband was attributable to him for income tax purposes notwithstanding the contract because, as Mr. Justice Holmes stated; "no distinction can be taken according to the motive leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."[28] Consequently, if a taxpayer, by any anticipatory arrangement, channels income earned or to be earned to another, he does not escape the tax upon it.

In the instant case the dissent recognized the rule of the *Earl* case that an anticipatory assignment of income to be earned does not relieve the taxpayer of the tax upon it. However, it sought to extend the application of this rule to situations where a taxpayer had no right to receive the income. The minority contended that a taxpayer's receipt of economic worth does not depend upon his right to receive income. Therefore, when he generates income and disposes of it in such a way as to receive economic worth, he is taxable on it.[29]

[22]*Supra* note 10.
[23]Instant case at 4.
[24]Payment in satisfaction of an obligation is recognized as amounting to taxable income. See *supra* notes 16, 17. In Douglas v. Willcuts, 296 U.S. 1, 9 (1935), the court stated: "We have held that income was received by a taxpayer, when, pursuant to a contract, a debt or other obligation was discharged by another for his benefit. The transaction was regarded as being the same in substance as if the money had been paid to the taxpayer and he had transmitted it to his creditor." The same result and reasoning follows when a taxpayer channels income to satisfy an obligation owed by the taxpayer to another.
[25]Instant case at 5, 6, 7.
[26]*Id.* at 8.
[27]281 U.S. 111 (1930).
[28]*Id.* at 115.
[29]Instant case at 8.

In the instant case, under the rationale of the dissent, it would appear that the three factors considered heretofore are present. The source of the income, *i.e.*, the act which generates it, was the entry of the taxpayer into the contest. Control over the source of the income is found in the taxpayer's designation of income to his daughter. Finally, the taxpayer received economic worth by designating his daughter as the person to receive the income.

However, the rationale of the dissent fails when the *Horst* case is read in connection with *Poe v. Seaborn.*[30] In the *Seaborn* case Mr. Justice Roberts stated that "The very assignment in that case (referring to the *Earl* decision) was bottomed on the fact that the earnings would be the husband's property else there would have been nothing on which it could operate."[31] This qualification of the *Earl* case was more explicitly stated in *Helvering v. Horst* where Mr. Justice Stone, writing for the majority, said that:[32]

> [T]he rule that income is not taxable until realized has never been taken to mean that the taxpayer . . . *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. (Emphasis supplied.)

It is submitted that the majority is correct in its conclusion that a taxpayer must have a right to receive income which he generates before he can be taxed upon it. If a taxpayer has no right to receive the income, he does not have sufficient control over it to justify taxing him. He could in no way use the income for his own economic benefit. Further, this position will not deprive the United States of revenue inasmuch as someone will be taxed upon the income in such situations. Under the facts in the instant case, it would appear that the daughter is taxable on the income which she received.[33]

HARRY A. HAINES

FAILURE TO APPEAL FROM REVERSAL OF VARIANCE GRANTED FOR NONCONFORMING USE UNDER ZONING ACT PRECLUDES CLAIM OF AGRICULTURAL EXEMPTION.—Pursuant to the Montana County Planning and Zoning Act,[1] defendant and other landowners signed a zoning petition giving the Board of County Commissioners authority to creat a zoning district. The district

[30]*Supra* note 10.
[31]Poe v. Seaborn, 282 U.S. 101, 117 (1930).
[32]*Supra* note 6 at 116.
[33]The daughter does not come within the exception of section 74 of the INT. REV. CODE. The exception in that section allows Nobel prize winners and Pulitzer prize winners tax free income. See, H. Rept., No. 1337, 83d Cong., 2d Sess., pp. 11, A27 (1954); S. Rept., No. 1622, 83d Cong., 2d Sess., pp. 13, 179 (1954). Although the daughter falls within a different income bracket than another with higher income, in theory the United States is not deprived of the revenue.

[1]REVISED CODES OF MONTANA, 1947, §§ 16-4101 to 4107. Hereinafter REVISED CODES OF MONTANA are cited R.C.M.