Indiana Law Journal

Volume 14 | Issue 3 Article 9

2-1939

Taxation-Tax Status of Will Contestants-Influence of State Law on the Interpretation of Federal Tax Statutes

TAXATION—TAX STATUS OF WILL CONTESTANTS—INFLUENCE OF STATE LAW ON THE INTERPRETATION OF FEDERAL TAX STATUTES.—Petitioner, the grandson of testatrix, who bequeathed certain small legacies to her heirs and the entire residuary estate to a trustee for an endowment trust for a charity, began a will contest which ended in a compromise agreement. Suit was brought to recover income tax, assessed on amount obtained by the compromise. Petitioner contended that it was not income under the Sixteenth Amendment, and if income under the amendment was exempt under the exemption of property received by "inheritance." Held: that such property comes under exemption of "inheritance." *Lyeth v. Hoey* (1938), 59 S. Ct. 155.

The Supreme Court after the passage of the Sixteenth Amendment defined taxable income as that "gain derived from capital, from labor, or from both

---

16 Updike v. Commissioner of Internal Revenue (1937), 88 F. (2d) 807; United States v. Wells (1931), 283 U. S. 102, 51 S. Ct. 446.

17 26 U. S. C. A. § 411 (c). The statutory presumption was overcome in the Wells case because the motive was to carry out a policy long followed of making liberal gifts to his children during his lifetime. 283 U. S. 102, 119; 51 S. Ct. 446. But where the donor transferred $670,000 in trust and the same day disposed of the remaining $13,000 of his property by will the Supreme Court held that being 78 years old, unusually vigorous and clear minded, and in good health was not enough to overcome the presumption and held that the estate was taxable. McCaughin v. Real Estate Land Title and Trust Co. (1936), 197 U. S. 606, 56 S. Ct. 604.

18 Oliver v. Bell (1938), 23 F. Supp. 30. Deceased was 99 years, 11 months, 11 days old at his death. He had divided his property among his children two and one-half years before and made his will two days later. The same persons witnessed both the will and the gift instrument. The same persons were beneficiaries and received the same proportions under both instruments.

19 Milliken v. United States (1931), 283 U. S. 15, 51 S. Ct. 324.

20 Helvering v. Bullard (1938), 303 U. S. 297, 58 S. Ct. 565, indicates that such a classification would be valid.

combined, provided it be understood to include profit gained through a sale or conversion of capital assets."[1] It is difficult to include a compromise settlement of a will contest within this definition since there has been no capital invested, gain from labor, nor actual exchange of capital assets, unless the claim of the contestant, even if only a nuisance value, is considered to constitute an asset of exchangeable value.[2] It was expected that the Supreme Court would determine in the case at bar whether or not these receipts came under this definition of income and thereby settle the conflicting decisions prevailing in the lower federal courts;[3] but the Supreme Court avoided the issue by finding such acquisition of property was not taxable because of the exemption of "property acquired by gift, bequest, devise or inheritance."[4]

Because of the presence of a bargain there is sufficient indication of the lack of a pure gratuity to preclude application of the gift exemption. The words "bequest" and "devise" are limited to the passing of property (personalty and realty respectively) to a person named by the decedent in his will, and thus a will contest settlement cannot come under these terms. "Inheritance" however, is not so readily defined and, although most times used to mean intestate succession has also been commmonly used to cover both "bequest" and "devise".[5] The present case necessitates a determination of whether or not "inheritance" includes property receivd in a compromise settlement of a will contest. On this question, the state courts have differed in the interpretation of their own tax laws. In some states, including Massachusetts, the rule has been stated that such property is derived by contract and not intestacy;[6] others have considered such property to be received by inheritance.[7] This raises the inquiry of whether the term so used in the Revenue Act has reference to some uniform meaning in common throughout the United States, or whether its meaning is a matter dependent upon the local law of the state or domicil of decedent. In other words, shall local law be used in the interpretation of this exemption in our Federal Revenue Act?[8]

---

[1] Eisner v. Macomber (1920), 252 U. S. 189, 207; Doyle v. Mitchell Bros. Co. (1918), 247 U. S. 179; Stratton's Independence v. Howbert (1913), 231 U. S. 399. Also see 1 Paul & Mertens, Law of Federal Income Taxation (1934) Ch. 5.

[2] The right to inherit is not a natural or absolute right, but the creation of statute law, Jones v. Jones (1914), 234 U. S. 615.

[3] Sterling v. Comm'r. (1937), 93 F. (2d) 304, holding entire sum received under the compromise as taxable income. Magruder v. Segebade (1938), 94 F. (2d) 177, to the effect that distributees under a prior will who compromised their objections to the probate of a later will for a sum paid, did not thereby receive income within the Sixteenth Amendment. Also see Lyeth v. Hoey (1937), 20 F. Supp. 619, and reversal in (1937) 96 F. (2d) 141.

[4] Revenue Act of 1938, Sec. 22 (3).

[5] Bouvier's Law Dictionary, 3rd Revision (1914): "A perpetuity in lands to a man and his heirs; the right to succeed to the estate of a person who dies intestate." Black's Law Dictionary: "An estate which has descended to the heir and has been cast upon him by the single operation of law."

[6] Ellis v. Hunt (1917), 228 Mass. 39, 43, 116 N. E. 956; Matter of Cook (1907), 187 N. Y. 253, 79 N. E. 991, MacKenzie v. Wright (1927), 31 Ariz. 272, 252 P. 521.

[7] Taylor v. State (1929), 40 Ga. App. 295, 149 S. E. 321, Pepper's Estate (1894), 159 Pa. 508, 28 A. 353.

[8] Note that this involves the interpretation of a Federal Statute and not the application of state rules in Federal Courts as was the problem in Erie

Although there has been no Supreme Court decision prior to the instant case interpreting "inheritance" under the federal income tax act, the applicability of state laws to the construction of federal tax statutes has been involved in many cases. The cases may be classified into three categories. In the first are those in which state laws control because the federal taxing act by express language makes its operations dependent upon state law.[9] In the second class are those in which the statute expressly defines its meaning.[10] Then, in the third group, are the cases such as the one at bar, in which the statute is in need of interpretation without any specific intention stated by Congress.

The cases in this latter group superficially appear to be divided, but upon close scrutiny can be distinguished. Among those cases that seem to hold that state law should be used are the cases involving the income of husband and wife in community property states. In taxing this income, the Supreme Court has looked to the law of the state to determine the interest of the wife with resulting differences because of the divergencies in the legal doctrine of the community property states.[11] But these cases may be explained in that the reference to local law is to determine ownership of the income and not strictly an interpretation of the federal act. In determining the meaning of "insurance company" and "building and loan association" in the Revenue Act, the Supreme Court, in *United States v. Cambridge Loan and Bldg. Co.*,[12] held that if a corporation was a building and loan association under the laws of the state of incorporation, it was also under the Revenue Act, but then limited this broad statement by adding, "unless a gross misuse of the name." In apparent conflict is the court's later opinion in *Bowers v. Lawyers Mortg. Co.*,[13] holding that although the petitioner was organized under the New York Insurance Law it will not come under the class taxed as "insurance companies" under the Revenue Act, for too much of the companies' business was not properly pertaining to that of an insurance company.[14] The court distinguished the Cambridge Loan & Bldg. Co. case in that there was no gross abuse of the name "building and loan association"; however, it may also be distinguished in that the act used the word "domestic" and also because the court actually inquired into the business of the loan company and in reality did not apply the state rule.

On the other hand, there are many cases which emphatically hold that words used in the federal acts are to be interpreted solely in the light of

---

R. R. Co. v. Tompkins (1938), 302 U. S. 671, 58 S. Ct. 817. Also see Kightlinger, Swift v. Tyson Overruled, 13 Indiana L. J. 564.

[9] An example of this is Sec. 112 (g) of the Revenue Act of 1938, which in defining reorganization refers to "a statutory merger or consolidation," meaning consolidation accomplished pursuant to the provision of state law. Such variations in application do not infringe the constitutional prohibitions against delegation of taxing power or the requirement of geographical uniformity. Florida v. Mellon (1927), 273 U. S. 12, 47 S. Ct. 265.

[10] See Sec. 115 (a) of the Revenue Act of 1938 defining "dividend".

[11] See Poe v. Seaborn (1930), 282 U. S. 101, 51 S. Ct. 58; United States v. Robbins (1925), 269 U. S. 315, 46 S. Ct.; United States v. Malcolm (1930), 282, U. S. 792, 51 S. Ct. 184.

[12] (1928), 278 U. S. 55, 49 S. Ct. 39.

[13] (1932), 285 U. S. 182, 52 S. Ct. 350.

[14] See United States v. Home Title Ins. Co. (1932), 285 U. S. 191, 52 S. Ct. 319.

congressional intent of the ordinary meaning, and be given a construction which will be applicable uniformly throughout the country, irrespective of the particular local meaning. As the court stated in refusing a tax deduction, "It does not matter that in Ohio where the property lies, these long leases are treated as in many respects like a conveyance of the fee. The Act of Congress has its own criteria, irrespective of local law."[15] An example of the court's refusal to accept the local classification of a business entity was its upholding of corporate taxes upon businesses that the state classified as partnerships.[16] The necessity for interpretation of our tax laws in the absence of language evidencing a different purpose so as to give an uniform application to a nation-wide scheme of taxation was also brought out by the Supreme Court in *Burnet v. Harmel*,[17] limiting the application of state law to the federal taxing acts when by express language or necessary implication the act makes its own operation dependent upon state law. In the same decision the court epitomized the law by stating, "The state law creates legal interests but the federal statutes determine when and how they shall be taxed." Or stated otherwise, the state decisions fixing title and legal right to property are controlling upon the Federal Courts,[18] but state decisions as to the character of devolution of a decedent's estate, or determining whether property received is income or capital, are not controlling on the Federal Courts in the administration of the Federal Revenue Laws.[19]

The considerations favoring uniformity of construction, in so far as constitutionally possible are numerous and overpowering. The inherent injustice of permitting taxpayers in the same economic stratum to be affected differently by the same federal statute is evident in itself. In the noted case, the Supreme Court, realizing this need for uniformity, has rightfully refused to consider the local law by interpreting the exemption of "inheritance" in the Federal Income Tax to include property acquired by compromise of a will contest, and thereby establishing a construction which will be applicable uniformly throughout the country. I. K.

TORT LIABILITY WITHOUT PRIVITY—INSTALLATION OF IMMINENTLY DANGEROUS INSTRUMENTALITY.—The defendant negligently installed a furnace in the plaintiff's dance hall under a contract with the tenant in possession. The installation was completed and the work was accepted by the tenant. Some time later when the first fire was built in the furnace the building caught fire and considerable damage was sustained. For the negligent installation the landlord sued the defendant who contended there was no liability without privity. Held, the furnace was so negligently installed as to be imminently dangerous to third persons and thus the defendant is liable for the damage to the plaintiff's property. *Nauracaj v. Holland Furnace Co.* (Ind. 1938), 14 N. E. (2d) 339.

---

[15] Weiss v. Wiener (1928), 279 U. S. 333, 337, 49 S. Ct. 337.

[16] Burk-Waggoner Oil Assoc. v. Hopkins (1925), 269 U. S. 110, 46 S. Ct. 48.

[17] (1932), 287 U. S. 103, 53 S. Ct. 74.

[18] See cases cited in note 11, *supra*.

[19] See Paul, Selected Studies in Federal Taxation (1938) Ch. 1. Also Barton, Effect of State Laws on Federal Tax Laws (1931), 10 Tax Mag. 11.