Presentation:

Federal Income Taxation
Chapter 7 Assignment of Income Issues
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Fundamental inquiries in this chapter:

**Who** is the taxpayer?

whose income?
whose deductions?

How take advantage of “multiple runs up the bracket ladder”?

How can income or deductions be attributed to another taxpayer?
Choices for Identifying the Taxpayer Unit

Choices for possible income/deduction shifting:
1) spouses;
2) children;
3) other family members;
4) family entities (trusts, corporations & partnerships)

Alternative: the entire family (how defined?)

Cf., perspective of other cultures
Comparing Income Tax Rates

Rate Brackets and Marginal Rates for individuals - Code §§1(a)-(d) & (h)

Marginal rates - tax rate applicable to the last taxable dollar.

Cf., effective rate (or average rate).

Tax rates for corporations: Code §11.
Tax planning objective: Deflect income to a lower bracket taxpayer.

Lucas vs. Earl, p. 554 - A contractual agreement concerning allocation of wages of spouses after their marriage.

Held: income is taxable to the person earning the wages (not the “legal” owner). Note: the “fruit and tree” doctrine.
Contract to share with his father his sign-on bonus for his baseball career.

Held: Reasonable amount was paid to father – for coaching and for acting as agent for player son.

Not an assignment of income.
Facts: The Seaborns lived in Washington, which was a community property state. Mrs. Seaborn reported on her tax return half of the community income, including half of Mr. Seaborn’s salary. The Commissioner took the position that all of the income must be reported by Mr. Seaborn.

Held: The Commissioner’s determination is rejected. Mrs. Seaborn, under Washington law, had a “vested right in the community property . . . including salaries.” Lucas v. Earl is distinguished by stating, “The very assignment in that case 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,” whereas here “by law, the earnings are never the property of the husband, but that of the community.”
Chief Counsel Advisory 200608038: The California Domestic Partner law gave registered domestic partners the same rights as those enjoyed by married couples. However, California did not permit domestic partners to split their earned income.

Advice: California domestic partners are not allowed to split their earned income for federal income tax purposes. Poe v. Seaborn and related cases apply only to husbands and wives.

Chief Counsel Advisory 201021050: Subsequent to CCA 200608038, California law was changed to provide for splitting of earned income--that is, to treat same-sex couples the same as married couples. So, income could now be split.
Effect of joint return income tax status – twice the tax on 1/2 of combined income.

Objective: To enable equality with community property jurisdictions – where an automatic split of the income occurs under state law.
Marriage Penalty/Bonus Options  Code §1 - 2012 Rates

**Bonus (only one earner):** Single taxpayer & married taxpayer have taxable income of $388,350 – 112,684 tax (single) vs. 105,062 (married); 7,662+ benefit for married.

**Penalty (two equal earners):** Two single taxpayers & each married taxpayer has income of $194,175 – single taxpayers have 48,606 tax each (total – 97,212); married have 105,062 tax; 7,850+ penalty for marrieds.
Edward Blair as the owner of a life interest under trust, but not the remainder interest (presumably for benefit of children).

He transferred percentage interests in that life interest to his children.

Assignments were valid under state law.

Held: Assignment was valid and income attributed to the children and not to the assignor father.
Assignment of bond interest coupons to child shortly before interest due date.

“The power to dispose of income is equivalent to the ownership of the income.”

The anticipatory assignment of income is not permitted for income tax purposes.

Cf., registered bonds & coupon bonds.
Assign any tax basis from a bond to stripped interest coupons? Code §1286 provides that original basis in the instrument must be allocated between (i) the retained stripped bond and (ii) the stripped coupon.

Allocation based on relative FMVs at the time of the stripping transaction. OID to accrue on each instrument (for both seller’s purchase and buyer’s retained interest).
Facts: Eubank, an insurance agent, assigned renewal commissions (presumably as gifts).

Held: The commissions are taxable to Eubank, when paid, not to the assignees.
Heim v. Fitzpatrick, p.579

Assignment of patent license royalties to wife and children.

Were royalties received by wife & children taxable to inventor/husband/parent?

Held: gifts of income producing property – and not merely gifts of income.
Summary of Assignment of Income

Personal Services Income

- Assignment of Present (Lucas v. Earl) or Deferred Compensation (Helvering v. Eubank)
- Patents/copyrights/art produced from personal effort (Heim)

Gifts of Income Producing Property

- Donor retains underlying property and carves-out income (horizontal slice) or retains right to get the income producing property back. See Helvering v. Horst.
- Donor gives the underlying property (vertical slice). Taft v. Bowers. Income follows the property itself.
- Donor gives all that Donor has (even if donor only has a life interest). Income follows the property itself.
Tax either to (1) trust or (2) beneficiary.

§§651-652 – simple trusts – merely a conduit (p. 593).

§§661-662 – complex trusts – taxation to the trust if income retained by the trust; or, tax to beneficiaries to receive income distributions (p. 584).

Very steep income tax brackets for trust income taxation. §1(e).
§671 provides for grantor trust (i.e., ownership) status, where:

§673 – reversionary interest of grantor

§674 – certain beneficial powers

§675 – administrative powers

§676 – revocation power

§677 – subsequent distribution to grantor or spouse (or to satisfy support obligation)
Partnerships are conduit entities, not subject to federal income taxation.

Each partner is allocated his share of each income and deduction item.

Informational tax return to be filed, including K-1s (a W-2 or 1099 equivalent).

Tax basis in the partnership interest enables loss flow through; tax basis includes debt (note the Tufts case) & allocated income.
Can a parent make his children “partners” in a partnership and deflect income to them through the partnership arrangement?

Cf., a service partnership vs. a capital investment partnership.

§704(e) permits recognition of those partners who have a capital interest in the partnership where capital is a “material income-producing factor.”
Subchapter S corporation - a corporation taxed under a pass-through regime.

Limitations apply concerning (1) who can be shareholders and (2) the number of shareholders.

Limited liability companies (LLC) – partnership equivalent treatment; organized under local law; no liability for any “member.”
Facts: The taxpayer was a doctor with six minor children. As a gift he deeded to his children real estate which was improved by a pharmacy, a rental apartment, and the offices of his medical practice. He had himself appointed guardian of the children. He collected rents from the pharmacy and the rental apartment and from himself. He used the money to pay for private school tuition, musical instruments, swimming lessons, etc. The Commissioner challenged the taxation of the children rather than their father and the father’s rental deduction.

Held: Dr. Brooke wins. The transfer by gift was not a sham and there were nontax motives.
Final Thoughts: Income From Property

Income from property is taxed to its owner.

Gift of the property itself shifts the income from the property to the transferee.

Gift only of income from the property (while retaining a remainder interest) will not shift the income to the recipient of that income.
Examples:

1) Gift of dividends stream (for several years?) from corporate stock, but retaining the stock itself.

2) Gift of rent from a “rent house,” but not a gift of a remainder interest (or portion) in the house.

Extend Code §1286 to these situations?
§102(b)(1) - the income exclusion does not extend to the income received from the gifted property.

Consider several trust interests:
1) the life tenant’s portion; and
2) the remainderman’s portion.

Trust income is entirely taxed to the life tenant. E.g., gift of “income only” is not excluded from gross income; the entire benefit of the §102 exclusion is for the remainderman (when eventually receiving the remainder interest).
Corporations – an entity separate from its shareholders for federal tax purposes. Subject to tax up to 35% on taxable income. §11.

Distributions of profits from a (regular “C”) corporation as “dividends” – and, then (1) a return of capital investment (recovery of tax basis) and (2) capital gain. The “classical system.”

Dividends subject to a 15% tax rate (through the year 2012 and then?). Note possibility of a “stock redemption” as a dividend distribution.
§482 – (p. 514) a tax accounting provision – enabling IRS to reallocate income, deductions, credits, etc., to “clearly reflect income.”

§269A – (p. 515) authority to allocate income, etc., between a personal service corporation and its employee-owners when availed of to avoid federal income tax.
Facts: Kaiser, one of the first of the big HMOs, entered into an agreement with Permanente, the medical partnership that provided Kaiser with doctor services. The agreement provided for a basic level of compensation plus additional payments into a trust fund to provide retirement benefits. The benefits were allocated among the partners and the employee doctors but were forfeitible.

Held: The income is taxable to the partnership, and allocable to the partners, when paid into the trust by Kaiser. For the partnership there was no risk of forfeiture. The Court relies on Lucas v. Earl without making clear who assigned what to whom. Presumably Permanente assigned its income to the trust.