2016

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Recommended Citation
ACTEC Law Journal, Vol. 42, Issue 1 (Spring 2016), pp. 17-22

Irwin v. Gavit: Income is (Sometimes) in the Eye of the Beholder

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To contemporary tax and trusts and estates practitioners this is a simple case: the will of X devises property to T as trustee to pay the income from the trust property to A for fifteen years and at the end of such time or on A's sooner death, the trust terminates and the trust property is to be paid to B free of trust. We all understand that as far as the trustee is concerned, the "income" to be paid to A is defined by state law of principal and income but that the federal income tax consequences to A of the receipt of the income are governed by the rules of Subchapter J.[1] Were A to argue that what A receives in satisfaction of the right to income from the trust property is not part of A's taxable income because it was received as a devise and "the value of property acquired by gift, bequest, devise, or inheritance" is excluded by Code section 102(a) from the definition of "gross income" the response would be an incredulous, "Are you kidding me?" After all, Code section 102(b)(2) excludes from the section 102(a) exclusion from gross income any income from property that is the subject of a "gift, bequest, devise, or inheritance" and the income earned on any section 102(a) property. And just in case any doubts remain about the coordination of these rules with the rules of Subchapter J, the flush language that follows Code section 102(b)(2) states that any amount included in the income of a beneficiary under Subchapter J "shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property" and thus included in gross income. What is now Code section 102(b) was added to the statute in 1942.[2] Prior to that amendment the statute included only the ancestor of Code section 102(a). The amendment, however, was not new law. It codified the holding in *Irwin v. Gavit*,[3] to which we now turn.

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1 I.R.C. § 102(b)(2).

2 Revenue Act of 1942, Pub. L. No. 753, ch. 619, § 111, 56 Stat. 798, 809 (1943).

3 268 U.S. 161, 167 (1925).

Anthony N. Brady died leaving a will that, among other provisions, created a trust for his granddaughter, Marcia Ann Gavit. The trustees were to pay so much of the "net rents, income and profits" from the trust property as they determined, in their absolute discretion, should be "proper" for the "maintenance, education, and support" of his granddaughter during her minority.[4] Any income in excess of that distributed for the maintenance, education and support of the testator's granddaughter was to be divided into two parts, one to be accumulated for her benefit and the other to be distributed to her father, Erastus Palmer Gavit. Mr. Gavit paid income tax on the income he received from the trust in 1913, 1914, and 1915 totaling $21,602 (including penalties). He then sued to recover that sum.[5]

Mr. Gavit was successful both in the United States District Court for the Northern District of New York[6] and in the Second Circuit.[7] The reasoning of both courts was the same. The trust income paid to Mr. Gavit was a bequest. Therefore, it is excluded from gross income by statute.[8] In the view of both the District Court and the Circuit Court of Appeals, the result would be different if Mr. Gavit had been given an interest in the corpus of the trust. In that case the payments would be characterized as income from property acquired by gift, bequest, devise or descent and therefore taxable under the statute, both then and now.

Both courts also relied on the definition of income set forth in *Eisner v. Macomber*,[9] where a divided Supreme Court held that stock dividends received by a shareholder were not "income" as that term is used in the Sixteenth Amendment and therefore could not be directly taxed without apportionment of the tax among the states as required by the Constitution in Article 1, sections 2 and 9. The court's holding rested on the distinction between capital and income which, at least according to the majority, is quite clear and fundamental.[10] Income comes from capital and is distinct from it. For both the District Court and the Circuit Court of Appeals, Mr. Gavit had no interest in the capital from which the "income" paid to him under the terms of the trust was derived. Therefore, not only was the income a "gift or bequest" but it wasn't

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4 *Id.* at 166.

5 This would be $528,000 measured in today's dollars. *See Seven Ways to Compute the Relative Value of a U.S. Dollar Amount – 1774 to Present*, MEASURINGWORTH.COM, https://www.measuringworth.com/uscompare/ (last visited Nov. 30, 2016).

6 Gavit v. Irwin, 275 F. 643, 648 (N.D.N.Y. 1921).

7 Irwin v. Gavit, 295 F. 84, 89 (2d Cir. 1923).

8 Revenue Act of 1913, ch. 16, § 2(B), 38 Stat. 114, 167 (1913) (including in net income "the income from but not the value of property acquired by gift, bequest, devise or descent . . . . ").

9 252 U.S. 189, 207.

10 *Id.* at 206-07.

even "income" as that term is used in the Sixteenth Amendment and the Revenue Act of 1913.

The government appealed for obvious reasons and for one not so obvious. Under the 1913 Act, income tax was not levied on the income received by executors and trustees unless it was distributed to beneficiaries.[11] The Revenue Act of 1916 changed that arrangement by taxing to such fiduciaries as individuals the income received by fiduciaries to the extent it was not distributed to beneficiaries, with the tax to be paid from the property held as fiduciary.[12] In other words, unless Mr. Gavit were taxed on the income received from the testamentary trust for the primary benefit of his daughter, the income would not be taxed at all.

The government prevailed in the Supreme Court in an opinion written by Justice Holmes.[13] Holmes relied on a provision of the 1913 Act providing that fiduciaries are to "make and render a return of the net income of the person for whom they act, subject to this tax" and are under the following provision authorized to withhold the amount of the tax required to be paid.[14] That provision, according to the Court, left no doubt "that if a fund were given to trustees for A for life with remainder over, the income received by the trustees and paid over to A would be income of A under the statute."[15] "It seems hardly less clear," Justice Holmes wrote, that even if the governing instrument expressly provided that A should have no interest in the corpus, "the payments would be income none the less, within the meaning of the statute and the Constitution, and by popular speech."[16] The opinion acknowledges that the provisions of the statute draw a distinction between the gift of "a corpus," which is not included in gross income, and the income arising from that corpus, which expressly is included. That distinction, however, is not viewed by the Court as intended "to exempt income property so called simply because of a severance between it and the principal fund" nor is there anything in the opinion in *Eisner v. Macomber* that leads to that conclusion.[17]

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11 Irwin v. Gavit, 295 F. at 88.

12 Revenue Act of 1916, ch. 463, § 2(b), 39 Stat. 756, 757-58 (1916). The Act also indemnified fiduciaries for all tax payments as expressly stated that such payments were to be treated as a credit against the beneficiary in any accounting.

13 Irwin v. Gavit, 268 U.S. 161, 165 (1925).

14 *Id.* at 167; *see* Revenue Act of 1913 ch. 16, § 2(D)-(E), 38 Stat. 114, 168-70 (1913). The amount of tax required to be withheld was the "normal" tax of 1%; the Act also levied a graduated additional tax that reached a maximum of 6% on taxable incomes for $500,000 or more, for a total tax in the highest income bracket of 7%.

15 *Irwin*, 268 U.S. at 167.

16 *Id.*

17 *Id.*

Justice Sutherland dissented, joined by Justice Butler, in a brief opinion asserting that the income received by Mr. Gavit was a gift, "the legacy itself," and therefore was exempt from tax under the statute.[18] There was no warrant for going beyond "the strict letter of the statute" because "there is no latitude" in a tax statute and "you must adhere to the very words."[19]

The decision in *Irwin v. Gavit* is in many ways an historical curiosity whose importance as a source of law ended with the 1942 Revenue Act described above. The opinion plays a part in the story of the struggle to find a legally acceptable and practical scheme for taxing the income of trusts and estates, a story whose latest chapter is the enactment of the Internal Revenue Code of 1954 and its system of taxing of trusts and estates based on the concept of distributable net income.[20]

But there is more to *Irwin v. Gavit*. It makes sense for Justice Holmes to have written the opinion. His dissent in *Eisner v. Macomber* was a single paragraph stating that the word "incomes" in the Sixteenth Amendment should mean what it meant in "common understanding" at the time of the amendment's adoption and in light of the "known purpose" of the amendment: "to get rid of nice questions as to what might be direct taxes . . . ."[21] "I cannot doubt," Holmes added, "that most people not lawyers would suppose when they voted for it that they put a question like the present to rest."[22] In both cases, Holmes advocated a common sense approach to the meaning of income and dismissed as immaterial, or at least unnecessary to the decision in *Irwin v. Gavit*, the principle that the gift of the income of a fund is treated in equity as an interest in the fund itself.[23] Holmes's approach to the question of the meaning of income is at heart the same that led to his statement in *New York Trust Co. v. Eisner*:[24] the question of whether the estate tax enacted in the Revenue Act of 1916 was a direct tax or an excise tax that

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18 *Id.* at 168-69 (Sutherland, J., dissenting).

19 *Id.* at 169.

20 *See generally* JASPER L. CUMMINGS, JR., TAX PRINCIPLES ADDRESSED AND THE INTERPRETIVE CONTEXT 7 (2010) (discussing Justice Holmes's opinion in *Irwin v. Gavit* where he ruled the income beneficiary of a testamentary trust had received taxable income)?.

21 Eisner v. Macomber, 252 U.S 189, 219-20 (1920) (Holmes, J., dissenting).

22 *Id.* at 220. Justice Day concurred in Holmes's dissent. It must be noted that Justice Brandeis also dissented, but in a lengthy opinion, joined by Justice Clarke, in which he spent seventeen pages of the United States Reports analyzing the question of the income tax treatment of stock dividends in corporate practice and theory and in Anglo-American law before stating that in adopting the Sixteenth Amendment the people of the United States "intended to include . . . everything which by reasonable understanding can fairly be regarded as income." *Id.* at 227.

23 Irwin v. Gavit, 268 U.S. 161, 167 (1925).

24 256 U.S. 345, 349 (1921).

did not need to be apportioned was long settled, and in answering the question "a page of history is worth a volume of logic."[25]

Today, the transfer taxes are far from popular and, once again, courts could be described as analyzing certain questions in narrow and formalistic ways. Perhaps the most obvious example is the deference many courts have given to the legal form of family limited partnerships in determining that the creation of such vehicles leads to valuation discounts. Of course, that deference is related to the unwillingness of the courts to allow family attribution in questions of control premiums and minority discounts, an opposition so strong that the Treasury finally surrendered more than twenty years ago.[26] Whether or not Holmes or any of the other Justices in the majority in *Irwin v. Gavit* would have opposed the effects on valuation of family limited partnerships or have supported family attribution in determining control premiums and minority discounts is both not knowable and not the point. The spirit of their approach is what we should consider.

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25 *Id.*

26 Rev. Rul. 93-12, 1993-1 C.B. 202.