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A BUNDLE OF CONFUSION FOR THE INCOME TAX: WHAT IT MEANS TO OWN SOMETHING

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ABSTRACT—Conceptions of property exist on a spectrum between the Blackstonian absolute dominion over an object to a bundle of rights and obligations that recognizes, if not encourages, the splitting of property interests among different people. The development of the bundle of rights conception of property occurred in roughly the same era as the enactment of the modern federal income tax. Nevertheless, when Congress enacted the tax in 1913, it did not consider how the nuances of property, and the possible splitting of the property interests in an income-producing item, might affect application of the tax. Soon after the tax's enactment, the Treasury Department and the courts were confronted with questions of who owned, and could be taxed on, what income. As shown by an examination of family partnerships and synthetic leases, the government continues to struggle with determining who owns a sufficient property interest to be taxed because Congress has yet to define ownership for tax purposes.

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I. FROM BLACKSTONE TO BUNDLES

Sir William Blackstone made famous the conception of property as "that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe."[1] This vision of property attributes to the owner almost total control. Despite the resonance of this Blackstonian ideal, truly despotic ownership over property has never been possible. Society demands constraints on what owners are allowed to do with their property; and many owners sell or give away some, but not all, rights to their property. Today Blackstone's view of property as a solitary thing—owned and controlled by one—is a fiction, although one that continues to have political power. Instead, we divide some attributes of ownership here, we limit some rights there, each of these responses to modern life flying in the face of our Blackstonian conception of property.

If Blackstone could impose his view of property on the United States today, the income tax could be easily and fairly applied. Whoever owned a piece of property, and only one person could, would be taxed on the income that the property produced. Property owners' ability to convey away limited rights to property complicates this story. Congress did not consider this complication when it drafted the 1913 income tax, notwithstanding growing understanding in many quarters that property was a "bundle of rights."[2] In roughly the same period as the modern income tax's enactment, policymakers began to realize that different people could have different rights to portions of property. Nevertheless, Congress imposed on the tax a conception of property consistent with the earlier Blackstonian vision.

[1] 1 WILLIAM BLACKSTONE, COMMENTARIES *2.

[2] The metaphor has been traced to the late nineteenth century. *See* GREGORY S. ALEXANDER, COMMODITY & PROPRIETY 322 n.40 (1997). The term was not used by Wesley Hohfeld who is often credited with this conception of property. *See generally* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16 (1913).

Property as an abstract compilation of different types of rights could be, and often was, owned by different people. To the extent that property was owned by more than one person, whether what a person owned was appropriate to be taxed was open to debate. Despite this issue, Congress originally ignored the potential complexity of ownership when it taxed the income "of" an individual.[3] That phrasing presupposed Blackstone's understanding of ownership, and for a significant period of time no one felt the need to determine ownership for tax purposes.[4] That this fundamental issue was ignored might not be surprising in the world of congressional politics when income tax rates were low and the amount of revenue it raised was small compared to the other federal taxes. Nevertheless, the failure of Congress to grapple head-on with this issue of taxation in the midst of an evolving understanding of ownership has resulted in legal confusion and costly litigation over the application of the federal income tax.

Soon after the 1913 income tax's enactment, the Treasury Department was confronted with numerous tax returns, the tax liability of which turned on the ownership of property. In the early decades of the income tax, the potential to fracture ownership was contested most often with respect to family property (as many of the business arrangements and financial products that currently utilize complex ownership structures were not yet imagined). Partnerships, trusts, contracts, community property laws, all provided the opportunity for interested parties to argue about who owned what and what ownership meant. Although ownership evoked consideration of power and control, dispersing ownership, if only for tax purposes, allowed families as a collective to have more income taxed in lower tax brackets, thereby encouraging the fracturing of ownership as a means of tax reduction. In the face of these contests, the question arose whether the federal government would develop a federal common law of ownership for income tax purposes to answer the question of who should be taxed on what.

This Article progresses in three parts. First, this Article briefly discusses the political and judicial history of the income tax. The antecedent to the modern income tax was enacted in 1913, at the height of the Progressive Era. In a time of reform and dreams of reform, Congress passed an income tax based on the idea of a redistributive tax but without a plan for how the tax would actually work.[5] The rhetoric of class legislation and redistributing from the rich to the poor that permeated earlier debates over the income tax was common to Progressive Era politics. Since there

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3 *See* Tariff of 1913, Pub. L. No. 63-16, § 2, 38 Stat. 114, 166–81.

4 Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1396, 1400–01 (1975).

5 Stephanie Hunter McMahon, *A Law with a Life of Its Own: The Development of the Federal Income Tax Statutes Through World War I*, 7 PITT. TAX REV. 1, 4 (2009).

was an established focus on the income tax as class legislation, that focus allowed Congress to either miss or ignore the importance of the ownership question. Second, this Article discusses the evolution in the Progressive Era of the idea of ownership and the expansiveness of property interests. Although Congress was not focused on this issue when it enacted the 1913 income tax, the ensuing complications in the development of this legal concept nevertheless shaped what the income tax would become. Developments in legal theory independent of taxation provided the arguments necessary for taxpayers to minimize their taxes. It appears that Congress did not anticipate this cross-pollination of ideas between the law of property and taxation.

Finally, examining first family partnerships and then synthetic leases, this Article evaluates the consequences of Congress's position (or lack thereof) on the meaning of ownership. In each, the government's desire to apply the tax consistently on a national level required it to define ownership broadly, not only as legal title but also, at times, as control or beneficial enjoyment. Moreover, acknowledgement that something was owned was sometimes dismissed because of the focus on how or why the interest was created. With respect to family partnerships, the Supreme Court often focused on the creation of the partnership and whether its creation was valid rather than examining the rights purported partners had in the partnership. The result was less deference to state partnership law, but this lack of deference risked creating situations where state law owners were not taxed on their property interests' income. For synthetic leases, the Treasury Department focuses on the benefits and burdens created by these transactions as opposed to following legal title. The results are that the transactions produce favorable tax results with corresponding favorable, but different, results for financial accounting purposes.

Thus, although "ownership of income and property is the lodestar" of taxation, it contains its own ambiguities.[6] This Article's examination of this issue does not mean that a definitive rule for determining ownership can or will be found. As a nation, we have not yet defined what it means to own something. Therefore, it may be too much to expect Congress to define it in a satisfactory way for federal tax purposes. Nevertheless, the Article's lesson should caution against creating an income tax regime that assumes ownership is understood and quantifiable.

II. HISTORY OF THE INCOME TAX

Scholars debate the causes for the United States' ratification of the Sixteenth Amendment and its enactment of the modern income tax. Sidney

[6] Dennis J. Ventry, Jr., *Saving* Seaborn*: Ownership Not Marriage as the Basis of Family Taxation*, 86 IND. L.J. 1459, 1462 (2011). Ventry notes the Court's imposition of an "expansive definition of ownership" for tax purposes. *Id.* at 1464.

Ratner portrays a progressive struggle between the forces of societal justice and those protecting private gain.[7] Robert Stanley, on the other hand, argues that the tax reflects a statist attempt to prevent real economic redistribution; therefore, the enactment of the mild income tax was no more than the guileful use of political rhetoric.[8] A stronger neoconservative interpretation by Robert Higgs argues the income tax was an opportunity for interest groups to gain for themselves through the redistribution of income and special funding.[9] Finally, W. Elliot Brownlee takes what he terms a "democratic institutionalist" perspective, arguing the progressive income tax reflected developing ideas and values but was limited by institutional restrictions in the final shaping of the income tax.[10] Each theory examines the ideas that policymakers and the public discussed at the time of the enactment of the 1913 income tax, and each theory underscores that few cared about the details of the income tax's operation.

The income tax, a tax that currently wields tremendous political and economic power, was initially adopted more for rhetorical than redistributive goals.[11] The *Congressional Record* reflects the income tax's relative insignificance to Congress in the second half of the nineteenth century, when debates over the tax were repeatedly abandoned in favor of discussion of more pressing tax issues, namely tariffs.[12] The debates on the income tax that did occur centered most often on the tax's class-based elements. The question of redistribution, and whether this was a permissible objective for Congress, meant that operational issues of the new income tax were given short shrift. Thus opportunities for debating, and perhaps resolving, issues of ownership and property as they would arise under the income tax were missed. Similarly, the two previous times Congress had enacted an income tax provided little evidence of how the tax actually worked when it was challenged. For example, the Civil War individual income tax, as a war measure, faced fewer challenges than the modern tax. Only two cases reached the Supreme Court in the eleven years between its enactment and repeal, whether for reasons of patriotic taxpaying or for want of enforcement.[13] On the other hand, in the same time

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7 SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 298–340 (1967); *see also* RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 77–104 (1954).

8 ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER 13 (1993).

9 ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT 112–13 (1987); *see also* Ben Baack & Edward John Ray, *The Political Economy of the Origin and Development of the Federal Income Tax*, *in* EMERGENCE OF THE MODERN POLITICAL ECONOMY 121, 135 (Robert Higgs ed., 1985).

10 W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA 265–68 (2d ed. 2004).

11 McMahon, *supra* note 5, at 2–3.

12 *Id.* at 10–11, 16–17, 21–22.

13 *See* Gray v. Darlington, 82 U.S. (15 Wall.) 63 (1872) (evaluating the ability to tax gain on the sale of U.S. bonds); Collector v. Day, 78 U.S. (11 Wall.) 113 (1870) (assessing the ability to tax members of state governments).

frame after enactment of the 1913 income tax, almost forty cases reached the highest Court.[14] Taxpayers challenged the earlier income tax less frequently, putting less pressure on defining the details of the tax.

When Congress enacted the income tax first during the Civil War, and then again during a major depression, it regarded these small revenue raisers as ancillary components of larger revenue bills.[15] These early income taxes crystalized the debate regarding the tax's class-based features. The continuing debate of this issue meant the focus remained on the justification for the tax itself. For example, during the Civil War, Chairman of the House Ways and Means Committee Justin Morrill, who otherwise argued Congress would have to accept the income tax even if it was the "least defensible" part of the revenue bill, questioned: "Ought not men, too, with large incomes to pay more in proportion to what they have than those with limited means, who live by the work of their own hands or that of their families?"[16] Supporters of the Civil War income tax portrayed it as a balance to the otherwise regressive national tax regime:

> We tax the tea, the coffee, the sugar, the spices the poor man uses. We tax every little thing that is imported from abroad, together with the whisky that makes him drunk and the beer that cheers him and the tobacco that consoles him. Everything that he consumes we call a luxury and tax it; and yet we are afraid to touch the income of Mr. Astor. Is there any justice in that?[17]

Opponents focused on perceived inequity in the income tax itself. Thaddeus Stevens argued, "It seems to me that it is a strange way to punish men because they are rich."[18]

Thereafter, reformers proposed the income tax intermittently to fund new programs and to demonstrate—both to reform's friends and foes alike—a desire for change.[19] With the focus on reforming the fiscal program, the class-based debates continued. At the time of the enactment of the second income tax during the Panic of 1893, when many believed that money, monopoly, and the concentration of wealth threatened the foundation of democracy, a limited income tax was viewed as "a check that

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[14] *See, e.g.*, Evans v. Gore, 253 U.S. 245 (1920) (denying ability to tax federal judges); S. Pac. Co. v. Lowe, 247 U.S. 330 (1918) (denying ability to tax income earned prior to enactment of the tax); Towne v. Eisner, 245 U.S. 418 (1918) (denying stock dividend is taxable income); Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916) (denying shareholder the ability to restrain corporation from complying with the tax).

[15] McMahon, *supra* note 5, at 10–11, 16–17, 21–22. This is not to dismiss earlier theoretical work regarding the equity of an income tax but to highlight the sparseness of intelligence on the working of such a tax.

[16] CONG. GLOBE, 37th Cong., 2d Sess. 1196 (1862); *see also* CONG. GLOBE, 38th Cong., 1st Sess. 1876, 2513–14 (1864) (additional statements regarding class-based taxation).

[17] CONG. GLOBE, 41st Cong., 2d Sess. 4715 (1870) (statement of Roger Sherman).

[18] CONG. GLOBE, 38th Cong., 1st Sess. 1876 (1864).

[19] *See, e.g.*, HARRY EDWIN SMITH, THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871, at 74–75 (1914); *see also* HIGGS, *supra* note 9, at 97.

will measurably stop these vast accumulations."[20] The focus, however, was not always on the tax's impact on the wealthy. One critic complained, "I oppose this bill because I will not consent by any act of mine to place the humblest or the poorest of my fellow-citizens on a political plane one shade lower than that occupied by the richest and the proudest."[21]

The Supreme Court's invalidation of the 1894 income tax a scant five months after the tax's enactment demonstrated the Court's focus on the class-based features of the tax.[22] Although the Court's holding in *Pollock v. Farmers' Loan & Trust Co.* was narrow, in dicta the majority took a broader and more hostile view toward income taxation, arguing that "[n]othing can be clearer than that what the Constitution intended to guard against was the exercise by the general government of the power of directly taxing persons and property within any State through a majority made up from the other States."[23] Justice Stephen Field opined, "The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich . . . ."[24] The dissents of Justices Edward Douglass White and John Marshall Harlan characterized the majority as a self-conscious, economic class acting in its own interests.[25]

With the new century and the rise of progressivism, people increasingly questioned economic divisions within the nation and searched for ways to reduce them. In the 1908 presidential election, both Democrats and Republicans supported some version of a federal income tax.[26] Some supporters advocated "an income tax not as a temporary measure for the purpose of securing revenue for temporary purposes, but because we believe it should be a permanent part and portion of the revenue system of the United States."[27] No longer was the income tax seen solely as a revenue stopgap, but it was seen by some at least as a viable long-term method of inserting the federal government into the national economy.[28] However, this

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[20] 26 CONG. REC. 1730 (1894) (statement of Joseph Sibley); *see* GERALD T. WHITE, THE UNITED STATES AND THE PROBLEM OF RECOVERY AFTER 1893 (1982) (not even mentioning the income tax); *see also* HIGGS, *supra* note 9, at 79–97.

[21] 26 CONG. REC. app. 465 (1894) (statement of William Bourke Cockran).

[22] Pollock v. Farmers' Loan & Trust Co. (*Pollock I*), 157 U.S. 429, 583, *modified on reh'g*, 158 U.S. 601 (1895).

[23] *Id.* at 582.

[24] *Id.* at 607 (opinion of Field, J.).

[25] Pollock v. Farmers' Loan & Trust Co. (*Pollock II*), 158 U.S. 601, 671–75 (1985) (Harlan, J., dissenting); *id.* at 712–13 (White, J., dissenting).

[26] Paolo E. Coletta, *Election of 1908*, *in* HISTORY OF AMERICAN PRESIDENTIAL ELECTIONS 841, 866 (Gil Troy et al. eds., 4th ed. 2012).

[27] 44 CONG. REC. 1680 (1909) (statement of Sen. Borah); *see also* William E. Borah, *Income-Tax Amendment*, 191 N. AM. REV. 755, 755–61 (1910) (urging adoption of the Sixteenth Amendment).

[28] STANLEY, *supra* note 8, at 195–98.

proposal failed to win sufficient support in Congress until passage of a constitutional amendment.

By the 1912 presidential election, with ratification of the Sixteenth Amendment still uncertain, the progressive movement peaked.[29] Coming to power after the extravagance of the Gilded Age, Progressives and radical Democrats openly opposed big business and increasingly targeted the concentration of wealth and power. As part of this policy change, the Progressive Era witnessed a paradigmatic shift to recognizing a need to fund government based on taxpayers' ability to pay. The income tax was a necessary component of this new system. Although President Woodrow Wilson urged moderation,[30] in his 1913 inaugural address he also called for tariff reform, a hot political topic.[31] Many expected Wilson to use the income tax to make up revenues lost from this reform.[32] Then, after the ratification of the Sixteenth Amendment, Wilson called a special congressional session, and the House Ways and Means Committee reported a bill less than a week later.[33]

In developing their ideas on taxation, Progressive Era politicians looked to economists and political theorists who were working through the ideas of the income tax.[34] New tax policies advocated by this first generation of professionally trained academics focused on the "mutual interdependence of modern social relations."[35] Commentators, such as Edwin R.A. Seligman, softened the rhetoric used to describe the benefits and burdens of the tax, and the tax came to be perceived as a respectable revenue measure.[36] "The history of finance . . . shows the evolution of the principle of faculty or ability to pay—the principle that each individual should be held to help the state in proportion to his ability to help himself."[37] Despite the evolution in the supporting arguments for the tax, many practical issues were left open. Seligman, for example, questioned

[29] George E. Mowry, *Election of 1912*, *in* HISTORY OF AMERICAN PRESIDENTIAL ELECTIONS, *supra* note 26, at 877, 877.

[30] Letter from Woodrow Wilson to Furnifold M. Simmons (Sept. 4, 1913), *in* 28 THE PAPERS OF WOODROW WILSON 254, 254 (Arthur S. Link ed., 1978).

[31] H.R. DOC. NO. 63-1, at 3–5 (1913) (address by President Wilson to a joint session of Congress); *see also* S. DOC. NO. 63-3, at 3–6 (1913) (inaugural address of President Wilson).

[32] *See, e.g.*, *Cuts Message Short*, WASH. POST, Mar. 29, 1913, at 4; *Holland's Letter*, WALL ST. J., Feb. 7, 1913, at 1.

[33] H.R. DOC. NO. 63-1, at 3–5 (1913) (President Wilson's address to Congress); *accord* H.R. 10 (1913) (bill reported by the House Committee).

[34] Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793, 1798 (2005); M. Susan Murnane, *Selling Scientific Taxation: The Treasury Department's Campaign for Tax Reform in the 1920s*, 29 LAW & SOC. INQUIRY 819, 824 (2004).

[35] Mehrotra, *supra* note 34, at 1811.

[36] *Compare* EDWIN R.A. SELIGMAN, THE INCOME TAX 631–73 (2d ed. 1914), *with* Edwin R.A. Seligman, *The Theory of Progressive Taxation*, 8 POL. SCI. Q. 220, 244–51 (1893).

[37] SELIGMAN, INCOME TAX, *supra* note 36, at 4.

what constituted income in the new tax and whether all sources of income should be treated equally.[38] Because the debate was framed as an attack on earlier forms of taxation, it remained a political science and economics issue instead of also being a legal one that should involve those interested in questions of property.

There was no opposition voiced to the income tax in the House; the strongest opinions attempted either to raise or lower the exemption level.[39] Likewise in the Senate, where there was a smaller but more radical Democratic majority, there was relatively little debate. Republicans generally ignored the income tax.[40] The tax that was enacted imposed a graduated tax on individual incomes above a $3000 exemption for individuals and a $4000 exemption for married couples.[41] These exemptions were high when the mean adult male income was only $578.[42] The tax rate was 1% on all taxable income after deductions and the exemption. An additional surtax ranged from 1% to 6% on amounts in excess of $20,000. The highest combined rate was 7% on incomes above $500,000.[43] This income tax was less progressive and less ambitious than the Civil War legislation, and it gave little hint that the income tax would become the dominant source of federal revenue.[44]

Notwithstanding the ratification of the Sixteenth Amendment, public sentiment was never solidly in support of a federal income tax, possibly because of its limited impact.[45] At first the revenue generated by the income tax was minimal, yielding only $71 million, or 9.7% of the federal government's ordinary revenue, in 1914.[46] In 1913, only 1.5% of all households paid federal income taxes, and only 2% of the labor force paid income taxes each year from 1913 through 1915.[47] The yield grew but remained relatively low until World War I limited other sources of revenue, forcing Congress to increase income tax rates and lower its exemptions.[48]

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38 *See id.* at 16 (considering ability to pay).

39 *See, e.g.*, 50 CONG. REC. 1252, 1254–55, 3851–52 (1913) (remarks of Rep. Murray (D–OK), Rep. Britten (R–IL), Rep. Bristow (R–KS), and Rep. Williams (D–MS)).

40 50 CONG. REC. 3839–40 (1913) (not entering the debate).

41 Tariff of 1913, ch. 16, Pub. L. No. 63-16, § 2, 38 Stat. 114, 168.

42 STANLEY, *supra* note 8, at 249.

43 § 2, 38 Stat. at 166.

44 See Joseph A. Hill, *The Income Tax of 1913*, 28 Q.J. ECON. 46 (1913), for a discussion written at the time.

45 STANLEY, *supra* note 8, at 225–26; *see also The Income-Tax Amendment*, 46 LITERARY DIG. 325, 326 (1913); *The Income-Tax Plan*, 46 LITERARY DIG. 877, 877–78 (1913); *The Income Tax Under Fire*, 46 LITERARY DIG. 1163, 1163–64 (1913).

46 STANLEY, *supra* note 8, at 227.

47 W. Elliot Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 29, 41–42 (Joel B. Slemrod ed., 2000).

48 For a discussion of World War I financing, see CHARLES GILBERT, AMERICAN FINANCING OF WORLD WAR I 75–116 (1970); W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. AM. PHIL. SOC. 173, 191 (1985); Ajay K. Mehrotra, *Lawyers, Guns,*

A $177 million budget deficit—rather than concerns for the equity of the tax system's operation—caused Congress to push down personal exemption levels and raise income tax rates during World War I.[49] More than $1 billion was raised by the federal income tax, with exemptions reduced from $4000 for heads of families and $3000 for single individuals to $2000 and $1000 respectively, and top rates raised to 67% in 1917 and 77% in 1918.[50] Those shouldering the burden of this much stiffer income tax were only a small percentage of the population. In 1918, approximately 15% of American families had to pay some amount of personal income tax, but the wealthiest 1% paid 80% of the revenues raised.[51] The average effective rates for this elite group increased from 3% in 1916 to 15% in 1918.[52]

Despite ensuing tax cuts, the nation did not bounce back from the war by reducing taxes to prewar levels.[53] Scholars have shown that, although income tax rates were reduced in the 1920s, World War I permanently changed the federal tax system. By the 1920s, many in the Treasury Department were pushing what they viewed as scientific taxation, and their policy did not entail elimination of the income tax.[54] Not accepting scientific claims behind tax policy, economist Thomas S. Adams opined, "In taxation . . . let me make the deals and I care not who makes the ideals."[55] One of the greatest of the early American tax experts, Adams had no illusions about altruistic or even equitable principles driving the tax law. Rather, he saw policymaking as a "group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens."[56] In Adams's view, these interest groups divided largely on economic or class lines, leading him to conclude that "[c]lass politics is of the essence of taxation."[57]

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and Public Moneys: The U.S. Treasury, World War I, and the Administration of the Modern Fiscal State, 28 LAW & HIST. REV. 173, 181 (2010).

49 President Wilson and leading members of the Democratic Party did attack concentrations of wealth, although primarily wealth held in corporate form, in order to finance government spending on the War on the basis of highly progressive taxation. ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 48–50 (1940); BROWNLEE, *supra* note 10, at 60–63.

50 Revenue Act of 1918, ch. 18, Pub. L. No. 65-254, §§ 210–211, 216, 40 Stat. 1057, 1062–64, 1069 (1919).

51 BROWNLEE, *supra* note 10, at 63.

52 *Id.*

53 Anne Alstott & Ben Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans' Bonus and the Defeat of the Mellon Plan*, 59 TAX L. REV. 373, 374 (2006).

54 Thomas S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 Q.J. ECON. 527, 537–40 (1921); Murnane, *supra* note 34.

55 T.S. Adams, *Ideals and Idealism in Taxation*, 18 AM. ECON. REV. 1, 1 (1928).

56 *Id.*

57 *Id.*

Although issues of redistribution still pervaded debates, people were increasingly aware of implementation issues, including questions of who should be taxed on particular items of income.[58] After complaining that the Internal Revenue Code did not define property, one practitioner concluded, "It would do well enough for a primitive civilization, . . . but it does not suffice under our complex doctrines of successive estates and interests splitting up the absolute ownership of property."[59] Property held in trust or on a chain of legal limitations was recognized to change in value, and the question remained what should be taxed and at what valuation.[60] Some problems took a while to be recognized in their entirety. For example, only once the Supreme Court conclusively ruled in 1921 that the appreciation of capital assets must be included in income could the issue of who should be taxed on the realization of future interests be assessed.[61]

How the federal government would respond to tax planning based on splitting the ownership of property among various taxpayers was not foreordained. As discussed in Part IV below, in cases involving taxpayers and their returns that made their way to the highest court, the Supreme Court went back and forth between federal and state law to give substance to the federal tax as it sought to determine ownership. The Supreme Court began by imposing a Blackstonian sense of ownership. However, as the old Blackstonian theory of ownership lost ground as the governing theory of property, the Court began to recognize that it must alter its approach to these questions. Thus, despite a consistent reference to ownership, how the courts interpreted ownership changed over time and in different contexts, and it remains an undefined term. The focus on different indicia of ownership (whether title, benefit, or control) highlights the evolving, and ultimately uncertain, meaning of ownership within income taxation. Attempting to characterize ownership as a simple rule minimizes the difficult choices that necessarily arise when applying the concept. This recognition continues to have consequences in everything from family transfers of property to complex financial products. In other words, ownership remains a complicated concept for the income tax.

III. EVOLVING SENSE OF PROPERTY

Conceptions of property can be placed on a spectrum between, on one hand, the Blackstonian asset model and, on the other, a bundle of rights and

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[58] *See, e.g.*, Adams, *Fundamental Problems*, *supra* note 54; Alexander M. Hamburg, *Exemption of State and Municipal Securities from Federal Income Taxation*, 7 VA. L. REV. 195, 198–200 (1921); John M. Maguire, *Income Taxes on the Realization of Future Interests*, 31 YALE L.J. 367, 369–72 (1921); Edward Rightor, *Are Inheritance Taxes Deductible?*, 2 LOY. L. REV. 20, 20–22 (1921); Arthur L. Corbin, Comment, *Taxation of Seats on the Stock Exchange*, 31 YALE L.J. 429, 429 (1921).

[59] Maguire, *supra* note 58, at 373.

[60] *Id.*

[61] *Id.* at 367.

obligations. These two paradigms reflect different understandings of what property is and what property provides to its owner.[62] The Blackstonian view envisions an owner who has almost total power over his or her property. Conversely, focusing less on the thing itself, the bundle theory emphasizes the interrelationships among societal actors and the property plus the rights and obligations that property creates for its owners. Accepting that property is a bundle of rights means that not only is the owner's relation to the property at issue but, more importantly, the owner's relation to other stakeholders is at issue.

Although this Article opened with Blackstone's broad definition of ownership, any attachment to that view was relatively short lived in the United States. The push against this monolithic notion of property began in the nineteenth century in order to facilitate that century's economic growth.[63] In a capital-scarce society, there was a need for the judicial philosophies underpinning property rights to encourage economic development. Post-Civil War growth only spurred the developing meaning of property. Morton Horwitz once explained, "The basic problem of legal thinkers after the Civil War was how to articulate a conception of property that could accommodate the tremendous expansion in the variety of forms of ownership spawned by a dynamic industrial society."[64]

Despite economic development pushing the concept of property to accommodate new ownership forms, the change was not instantaneous. The concept of property evolved over the nineteenth century from a physical entity to something that was more abstract and relative.[65] This was, at first, a minority opinion. Justice Noah Swayne dissented in 1872 that "[p]roperty is everything which has an exchangeable value."[66] By 1890, in the first *Minnesota Rate Case*, the Supreme Court had accepted that property was the exchange value of anything.[67] The de-physicalization of property in the rate cases produced radical changes in the law of property because these cases forced judges to explain abstract notions of property.[68] In *Smyth v. Ames*, for example, the Court struggled to define the value of the railroad's property interest in its transit runs—the actual trips that it took over its

[62] Thomas C. Grey, *The Disintegration of Property*, *in* NOMOS XXII: PROPERTY 69, 70–71 (J. Roland Pennock & John W. Chapman eds., 1980).

[63] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780–1860, at 31–34 (1977); Kenneth J. Vandevelde, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325, 328–30 (1980).

[64] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870–1960, at 145 (1992).

[65] *Id.*

[66] The Slaughter-House Cases, 83 U.S. 36, 127 (1872) (Swayne, J., dissenting).

[67] *See* Chi., Milwaukee & St. Paul Ry. v. Minnesota, 134 U.S. 418, 458–59 (1890) (Miller, J., concurring).

[68] Stephen Siegel, *Understanding the* Lochner *Era: Lessons from the Controversy over Railroad and Utility Rate Regulation*, 70 VA. L. REV. 187, 193 (1984).

rails.[69] Although *Smyth* became a subject of controversy among economists by the 1920s regarding the appropriate valuation of the new property, that it was property was no longer in doubt.[70]

The conception of property as a bundle of abstract rights was further developed when the government made expansive use of its eminent domain power to take property to aid economic development. It was in the evolution of the jurisprudence of eminent domain that property first developed into a bundle of rights.[71] In the prior century, judges focused on compensated versus inconsequential damages when they policed the taking of property. As the law evolved beyond the idea of physical property, and value became increasingly concentrated in commercial and intangible property rights, theorists attempted to redefine the "taking" involved in eminent domain cases away from the idea of a physical invasion of space toward the reduction of market value.[72] Market value had become one stick in the bundle that was property. As a result of the pressure brought to bear by eminent domain, one treatise claimed in 1888, "The dullest individual among the *people* knows and understands that his *property* in anything is a bundle of rights."[73]

Although property has since lost ground in the popular imagination to other legal issues, such as free speech and the right to bear arms, throughout the early period of the income tax, property was a central value in American legal thought.[74] It was in the Progressive Era that scholars recognized the bundle concept as a means of reconciling the competing needs of property. Individuals and the government wanted property to mean much more than the Blackstonian conception allowed. Property rights were no longer merely a negative right to exclude others but included some degree of obligation to others.

These new demands clouded the meaning of property as legal theorists worked through the conception of property to accommodate Progressive and, later, Realist reforms. Wesley N. Hohfeld noted that:

> Both with lawyers and with laymen this term [property] has no definite or stable connotation. Sometimes it is employed to indicate the physical object to which various legal rights, privileges, etc., relate; then again—with far greater discrimination and accuracy—the word is used to denote the legal interest (or aggregate of legal relations) appertaining to such physical object.[75]

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69 169 U.S. 466, 517–22 (1898).

70 Siegel, *supra* note 68, at 234.

71 HORWITZ, 1870–1960, *supra* note 64, at 146–48.

72 JOHN LEWIS, 1 A TREATISE ON THE LAW OF EMINENT DOMAIN IN THE UNITED STATES 57 (3d ed. 1909).

73 *Id.* at 55 (emphasis added).

74 *Id.*

75 Hohfeld, *Fundamental Legal Conceptions*, *supra* note 2, at 21.

Hohfeld recognized a need to define various legal interests and relations in property through the creation of a schema for analyzing what makes up these legal conceptions.[76] Hohfeld pushed a "radical reconstruction" of American society and, in the process, analyzed property in furtherance of society's "underlying policies and purposes" in a manner that made popular the bundle of rights conception.[77]

As a result of Hohfeld's work, Arthur L. Corbin stated in 1922, "Our concept of property has shifted; . . . property has ceased to describe any *res*, or object of sense, at all, and has become merely a bundle of legal relations—rights, powers, privileges, immunities."[78] For these early Realists, the bundle of rights was malleable so that sticks of the bundle could be adjusted and rearranged to fit the needs of the day.[79] To the extent the sticks described infinitely variable relations between people and there was no requirement of what must be in the bundle itself, policy concerns were expected to drive changes to the notion of property itself.

These radical ideas were developing in the era of the 1913 income tax and yet the tax did not acknowledge these evolving issues.[80] Instead, tax policymakers focused more on the issues proposed by other academic leaders.[81] For example, Robert L. Hale argued, also in 1922, that "[o]wnership is an indirect method whereby the government coerces some to yield an income to the owners. When the law turns around and curtails the incomes of property owners, it is in substance curtailing the salaries of public officials or pensioners."[82] According to Hale, if property law strongly limits others' ability to use one's property by broadly construing property rights and punishing infringements, the owner may demand high prices for the use of his property; if the limits imposed by property law are light, his prices must be low.[83] Under this view, property was a form of theft; ownership of its income rested on legal rights, and, therefore, this ownership could be altered at any time.[84] Taxation of income, so Hale

[76] *Id.* at 30.

[77] *See generally* Wesley Newcomb Hohfeld, Professor of Law, Yale Univ., Address Before the Association of American Law Schools: A Vital School of Jurisprudence and Law: Have American Universities Awakened to the Enlarged Opportunities and Responsibilities of the Present Day? (Dec. 28, 1914).

[78] Corbin, *supra* note 58 (alteration in original) (internal quotation marks omitted).

[79] Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 815–17 (1935).

[80] Merrill and Smith attribute the change more to Ronald Coase's arguments from the 1960s that property has no function other than as a baseline for contracting. Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 359–60 (2001).

[81] See *supra* Part II for more on the period's focus on redistribution.

[82] Robert L. Hale, *Rate Making and the Revision of the Property Concept*, 22 COLUM. L. REV. 209, 214 (1922).

[83] *See id.* at 214–15.

[84] *See* BARBARA H. FRIED, THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE 97 (1998).

argued, should redistribute income from the rich to the poor to correct the theft that was property.[85] Hale's discussion of property was more consistent with the class-based arguments surrounding the income tax, rather than the more nuanced ideas of Hohfeld.

Over fifty years after Corbin and Hale weighed in on property, long after the enactment of the income tax in 1913, Thomas Grey proclaimed the "disintegration" of property and the completion of the "substitution of a bundle-of-rights for thing–ownership conception of property."[86] Realists continued in their desire to use the evolving notions of property rights to mitigate the harms created by prior economic development. Grey argued the disintegration of property was "intrinsic to the development of a free-market economy into an industrial phase."[87] The dissolution of the traditional concept of property could be said to have eroded the moral basis of capitalism because, to the extent property was not an absolute right, redistribution from rich to poor might no longer be objectionable.[88] If the state was no longer a neutral enforcer of the private relations of ownership and contract, but had become a player that uses collective force on behalf of haves and have-nots, the use of complex property ideas would allow peaceful redistribution.[89]

This developing conception of property, which had begun by the time of the 1913 income tax's enactment, allowed people to divide the rights, duties, and power, plus the other attributes of property, among various people. For example, it was settled by 1938 that, with the power of alienation, "[a]ctually the 'transferor' simply destroys certain rights and powers in himself and creates others—not necessarily the same ones—in someone else."[90] Property could no longer fit within the earlier Blackstonian mold.

A constraining force on this conceptual evolution in the early twentieth century was the relative lack of private pressure to fracture property interests. At the end of the nineteenth century, most forces pushing the definition of property interests were from the government through rate setting and eminent domain. In this period, there were fewer needs, or opportunities, for individuals to separate the bundle of property rights. For example, trusts were generally limited to provide for disadvantaged family members, to bind an estate within a family, or for

85 *Id.* at 96–97.
86 Grey, *supra* note 62, at 81.
87 *Id.* at 74.
88 *Id.* at 76–77.
89 *Id.* at 79.
90 Max Radin, *A Restatement of Hohfeld*, 51 HARV. L. REV. 1141, 1160 (1938).

charities.[91] Similarly, partnerships between spouses were not recognized by many states until the 1920s and 1930s.[92] Studies have not yet shown why states changed their laws at this time, whether it was solely in recognition of the women's rights movement or in part to seek tax minimization.[93] Nevertheless, the opportunities for taxpayers to fracture their property grew in conjunction with the income tax, building on a relatively broadly accepted conception of property as a bundle of rights.

Regardless of whether members of Congress accepted some, or none, of this conception of property, ownership for income tax purposes could have been based on a number of characteristics of property recognized long before 1913. These characteristics were more easily identified as separate with the fracturing of ownership and have since become sticks in the bundle of property rights. Legal title is an obvious element on which to impose the income tax. Objectively easy to measure, inequities may arise if those with the power and the benefit of the property can transfer legal title without losing those benefits. One alternate test is a control test: whoever controls the property that generates the income should be taxed on it. Although this test sounds straightforward, it could raise complicated issues of what "control" itself means. For example, within marriage, does the spouse who controls family finances own all of the family's property? Another test looks to who benefits from income or the underlying property. This most abstract of the tests would require an analysis of benefit, after defining some measure of benefit. Each of these tests—focused on different attributes of ownership—has been used by courts at different times to determine ownership for income tax purposes.[94]

Not everyone accepted, or accepts today, the idea of property as a bundle of rights. Laymen's perception of property as akin to the Blackstonian ideal has likely not evolved since Bruce Ackerman noted it as such in 1977 or Thomas Grey in 1980.[95] As for scholars, in particular over the last several decades, there has been a reaction against the bundle conception.[96] One critic argued that at its extreme the bundle has "no

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[91] *See* LAWRENCE M. FRIEDMAN, THE HISTORY OF AMERICAN LAW 256–57 (3d ed. 2005); Gregory S. Alexander, *The Transformation of Trusts as a Legal Category, 1800–1914*, 5 LAW & HIST. REV. 303, 319–22 (1987).

[92] *E.g.*, W.A. Coutts, *Can Husband and Wife Be Partners?*, 33 AM. L. REV. 215, 216–17 (1899); Carolyn C. Jones, *Split Income and Separate Spheres: Tax Law and Gender Roles in the 1940s*, 6 LAW & HIST. REV. 259, 278 (1988).

[93] States acting to minimize residents' federal taxes was an element in California's changes to its community property laws. Stephanie Hunter McMahon, *California Women: Using Federal Taxes to Put the "Community" in Community Property*, 25 WIS. J.L. GENDER & SOC'Y 35, 38–39 (2010).

[94] *See, e.g.*, text accompanying notes 100–06.

[95] BRUCE A. ACKERMAN, PRIVATE PROPERTY AND THE CONSTITUTION 26–29, 93–110 (1977); Grey, *supra* note 62, at 69.

[96] *See, e.g.*, Abraham Bell & Gideon Parchomovsky, *A Theory of Property*, 90 CORNELL L. REV. 531 (2005); Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1193–94 (1999); Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L.

independent or essential content."[97] Scholars warn that we should not take the bundle imagery too seriously and that, even for those trained in the law, the absolutist notion of property prevails.[98] Nonetheless, these critiques of the paradigm in the property law context risk dismissing the value of the bundle conception, especially with respect to taxation. One study completed in 2009 found that a difference in the understanding of the term "property" does exist and that those who view their rights to property in a Blackstonian way are less likely to part with their rights than those who accept the bundle of rights paradigm.[99] Consequently, framing property as a bundle of rights weakens perceptions of absolute ownership. With this rethinking of property, taxation is more complicated in operation but is less likely to be resisted.

To the extent one accepts some version of the bundle of rights, presumably any attribute of property, such as title, control, or benefit, associated in some way with the property's income could be taxed under the income tax. To guide tax authorities as to which stick is appropriate for income taxation, the tax system should incorporate an overt definition of property in order for the tax to apply properly to the income "of" the taxpayer. This clarification is unlikely to come soon. That the old Blackstonian concept of property was adopted in 1913 is unfortunate because it allowed Congress to forego debate on this issue. The abstract rights since created by sophisticated contracting and financial engineering threaten a tax system that is built on the conception of property as a physical res. Back then, however, Congress was stuck in the mode of thinking of property as a physical thing, for which ownership was clear, and did not address the bundle of issues that have since become important.

IV. CONSEQUENCES OF THE BUNDLE OF CONFUSION

Soon after enactment of the income tax, it became clear that issues of ownership would have to be unraveled by the Treasury Department and the courts. The lack of a congressionally crafted, nuanced understanding of property made it difficult to decipher who should be taxed on particular sums of income. Families were often the locus of these early debates. Because of the income tax's progressive rates, families had an economic incentive to have as many members as possible "own" parts of the property

REV. 711, 751–64 (1980); J.E. Penner, *The "Bundle of Rights" Picture of Property*, 43 UCLA L. REV. 711 (1996); Jeanne L. Schroeder, *Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property*, 93 MICH. L. REV. 239 (1994); Henry E. Smith, *Property as the Law of Things*, 125 HARV. L. REV. 1691, 1691–92 (2012).

97 Smith, *supra* note 96, at 1722.

98 *E.g.*, Joan Williams, *The Rhetoric of Property*, 83 IOWA L. REV. 277, 284 (1998).

99 *See* Jonathan Remy Nash, *Packaging Property: The Effect of Paradigmatic Framing of Property Rights*, 83 TUL. L. REV. 691 (2009); *see also* Jonathan Remy Nash & Stephanie M. Stern, *Property Frames*, 87 WASH. U. L. REV. 449 (2010).

that generated families' livelihood. Today issues of ownership extend far beyond the family. As an example, in synthetic leases the IRS must determine whether the lessor or lessee should be treated as the owner of the leased property for tax purposes. Thus the Treasury Department and the courts parse the meaning of ownership after the fact in various economic arrangements.

Initially the Supreme Court took positions on ownership that aggregated ownership attributes under the Blackstonian conception of property. The Court argued that if the taxpayer "retains for himself so many of the attributes of ownership," he could not claim to be "the victim of despotic power when for the purpose of taxation he is treated as owner altogether."[100] When this theory conflicted with legal title, the Court held that Congress "may tax not only ownership, but any right or privilege that is a constituent of ownership."[101] Slowly developing a federal common law of ownership for federal income tax purposes, Justice Oliver Wendell Holmes, Jr. led the Court to standardize the income tax treatment of disparate ownership forms.[102] Justice Benjamin Cardozo agreed that the purpose for devices that fractured ownership was to make it possible "for the taxpayer to surrender title to another and to keep dominion for himself, or if not technical dominion, at least the substance of enjoyment."[103]

The Court was not making control or benefit a substitute for ownership but instead was recognizing, at least in some cases, that control and benefit were sticks in the bundle of property rights. On the other hand, they were not the only permissible sticks to tax. In *Poe v. Seaborn*, the Court found that community property law's designation of the husband as manager of community property "was but a recognition of the ownership of another."[104] H.G. Seaborn's salary was therefore owned one-half by his wife at the time it was earned. Thus, ownership for tax purposes was certainly more than legal title; what more had to be worked out for each property-dividing arrangement.

At times the Supreme Court created rules to define ownership—as it did with respect to community property—that were based on specific sticks in the property bundle. In *Lucas v. Earl*, Guy Earl failed to convince the Court that his contract with his wife giving her one-half of his wages changed the ownership of the property for income tax purposes.[105] Thereafter, control over the creation of wage income has been a sufficient

[100] DuPont v. Comm'r, 289 U.S. 685, 689 (1933).

[101] Burnet v. Wells, 289 U.S. 670, 678 (1933).

[102] Stephanie Hunter McMahon, *Political Hot Potato: How Closing Loopholes Can Get Policymakers Cooked*, 37 J. LEGIS. 142, 165–66 (2012).

[103] *Burnet*, 289 U.S. at 677.

[104] Stanley S. Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COLUM. L. REV. 791, 828 n.147 (1933); *see also* Poe v. Seaborn, 282 U.S. 101, 113 (1930).

[105] 281 U.S. 111, 114–15 (1930).

interest for income taxation, except for those married couples governed by community property and *Poe v. Seaborn*. In *Corliss v. Bowers*, the Court held that although a revocable trust's income accrued completely and irrevocably to the beneficiary, the creator of the trust could shift income through use of the trust without losing any control over the underlying property and therefore the creator of the trust should be taxed on income he did not legally own.[106] Ownership has thus been based on many different attributes of property. The complexities of knowing what will trigger an income tax obligation continue to trouble the system.

A. Family Partnerships

Family partnerships have historically forced questions of who owns what, although the question today arises more for estate than income tax purposes.[107] In answering this question, the IRS and the courts focus on whether the creation of the partnership was for tax avoidance purposes or for business reasons. Focusing on the purpose rather than the state law property interests that are created means the government has effectively created a federal common law of family partnership taxation. The result might be a political necessity. State law originally did not permit spousal partnerships, and when that policy changed,[108] some families sought to use the partnership form, as they did with contracts and trusts, to reduce their collective taxes. One example of this perceived abuse is the use of a family partnership to avoid hundreds of thousands of dollars in federal income tax by James W. Cannon, one of the richest men in North Carolina in the 1920s.[109] Cannon's perceived abuse drew significant public attention to the arrangement because his son-in-law worked for the Treasury Department, illustrating the tax avoidance of those connected, albeit indirectly, to the tax system.

In the early decades of the federal income tax, the Treasury Department performed a case-by-case analysis of each partnership's often-murky facts and circumstances to determine whether the partnership was impermissibly formed for tax avoidance purposes. Consequently, cases involving these arrangements tended to rely very precisely on their particular facts.[110] In one early case, *Burnet v. Leininger*, the Court held that income from a husband–wife partnership remained taxable to the

[106] 281 U.S. 376, 377 (1930).

[107] *See, e.g.*, Katherine D. Black et al., *When a Discount Isn't a Bargain: Debunking the Myths Behind Family Limited Partnerships*, 32 U. MEM. L. REV. 245 (2002); Wendy C. Gerzog, Erickson*: A Primer on FLPs*, 116 TAX NOTES 201 (2007).

[108] *See* McMahon, *California Women*, *supra* note 93.

[109] *Blair as Tax Chief Blocked in Senate*, N.Y. TIMES, May 4, 1921, at 3.

[110] *Compare* Knapp v. Comm'r, 5 B.T.A. 762 (1926) (holding that partnership interests were not vested in minor children), *with* Kelley v. Comm'r, 9 B.T.A. 832 (1927) (holding that partnership interests were vested in children).

husband.[111] Charles P. Leininger had agreed with his wife that she should share equally in the partnership's profits and losses; however, the partnership books never reflected Mrs. Leininger's alleged interest and she had not taken part in the management of the business or contributed to its capital.[112] The Supreme Court characterized the agreement as an assignment of the husband's income—using *Earl* as the operative analogy.[113] The mere presence of a permissive state law and an interspousal agreement was not enough to give a family partnership tax effect if the Court determined that the partnership lacked substance.

In their attempts to evaluate the formation of partnerships, courts found it difficult to apply local law consistently when examining whether husbands and wives, in particular, formed valid partnerships. At times courts were deferential to state law and at other times they were dismissive. In *Sunlin v. Commissioner*, for example, a Michigan law forbidding husbands and wives from forming partnerships was held to enlarge the rights of women, not to deprive them of property, and therefore it seemed incongruous to the court that wives would lose their interests in preexisting businesses because of their marriages.[114] As a result, the wife in the case was held to have a valid property interest for tax purposes although she did not have one for state property law purposes.[115] Looking at the policy of state law, the court ignored the letter of state law. It was, however, a step toward uniform application of ownership in the federal income tax system.

This "facts and circumstances" test of ownership could be problematic for taxpayers because they lacked assurance that the IRS would recognize their partnerships as effectively shifting income. Partnerships risked having their favorable tax treatment denied if they were found not to convey real property interests under the federal test. This was a real risk; family partnerships were found valid in only 35% of the cases brought to test their income-shifting ability.[116] And if a family failed to convince the government of the validity of its actions, the family could be liable not only for back taxes but also for penalties and interest covering the period it employed the device.[117] This created uncertainty in the application of the

[111] 285 U.S. 136, 141 (1932).

[112] *Id.* at 138.

[113] *Id.* at 141–42.

[114] 6 B.T.A. 1232, 1234–35 (1927); *see also* Hamilton v. Comm'r, 24 F.2d 668, 671 (1st Cir. 1928); Pugh v. United States, 48 F.2d 600, 602 (S.D. W. Va. 1931); Brackman v. Comm'r, 24 B.T.A. 259, 262 (1931); Stryker v. Comm'r, 17 B.T.A. 1033, 1037 (1929); Kahn v. Comm'r, 14 B.T.A. 125, 129 (1928); Klise v. Comm'r, 10 B.T.A. 1234, 1236 (1928); Crossman v. Comm'r, 10 B.T.A. 248, 250 (1928).

[115] *Sunlin*, 6 B.T.A. at 1235.

[116] The 49% record for all partnerships also seems low. Jones, *supra* note 92.

[117] See I.R.C. §§ 6601–6751 (2012) for interest and penalties provisions.

income tax. Despite this risk, couples took aggressive positions with partnerships in the hopes of securing lower collective income taxes.[118]

To manage a growing number of family partnerships in the mid-1940s as tax rates rose during World War II, the Court drew more specific standards for when family partnerships created new property interests for income tax purposes. As a result of these changes, taxpayers' ability to split ownership of income between family members was severely limited. In *Commissioner v. Tower* and *Lusthaus v. Commissioner*, the Court reiterated that the income from a family partnership was taxable to the partner who originally owned the business unless it was a bona fide partnership; that the partnership was valid under state law was insufficient.[119] Moreover, the Court ruled that, although the Internal Revenue Code does not require the contribution of services or capital in its definition of a partner, the existence of one or the other was necessary for determining whether the partnership was bona fide.[120]

This ownership test still focused on the creation of the entity under a national standard, rather than the property interests existing thereafter under state law, and in neither case did the Court look to the attributes of the interest the wife held. Justice Stanley Reed dissented in both *Tower* and *Lusthaus*, with then-Chief Justice Harlan Stone joining him, arguing that the Court was inexcusably ignoring state law as to what created a property interest.[121] One commentator complained that "we may have a business organization which is a valid partnership by state law, and is not recognized as such for income tax purposes; and conversely, though not recognized by local law it may be a valid partnership under the Internal Revenue Code."[122] A legitimate concern was that if the partnership was valid under state law and did vest an ownership interest, a taxpayer might be taxed on income that he did not receive, was not entitled to, and did not own.[123]

[118] *See, e.g.*, Rossmoore v. Comm'r, 76 F.2d 520, 520–21 (2d Cir. 1935); Rossmoore v. Anderson, 67 F.2d 1009 (2d Cir. 1933) (per curiam); Mitchell v. Bowers, 9 F.2d 414, 415 (S.D.N.Y. 1925). *But see* I.R.S. Gen. Couns. Mem. 3421, 7-1 C.B. 106 (1928) (finding that husband and wife "should be permitted to report in their separate returns the income to which they are legally entitled").

[119] Comm'r v. Tower, 327 U.S. 280, 287–88 (1946); Lusthaus v. Comm'r, 327 U.S. 293, 297 (1946).

[120] *Tower*, 327 U.S. at 290; *see also* Vernon J. Veron, *Taxation of the Income of Family Partnerships*, 59 HARV. L. REV. 209, 247 (1945); *cf.* Johnston v. Comm'r, 3 T.C. 799, 807 (1944) (finding the wife was a "bona fide" partner because she invested capital into the partnership). *But see* Phelps v. Comm'r, 13 B.T.A. 1248, 1250 (1928) (finding that although the "wives contributed no capital," that in and of itself "does not disprove the fact that a partnership agreement was entered into").

[121] *Lusthaus*, 327 U.S. at 297–304 (Reed, J., dissenting); *Tower*, 327 U.S. at 292 (Reed, J., dissenting).

[122] Yale A. Barkan, *Family Partnerships Under the Income Tax*, 44 MICH. L. REV. 179, 182 (1945) (citation omitted).

[123] *See* Comment, *Comments on Avoidance of Family Partnership Gifts*, 12 U. DET. L.J. 124, 126 (1949).

Despite the Court's tests, the Treasury Department tried to issue its own guidance for the income tax treatment of family partnerships.[124] The IRS worried that "[a]ttempts to escape surtaxes by dividing one income into two or more incomes through the device of family partnerships present an acute problem in the administration of the Federal income tax."[125] As a result, the IRS argued the Internal Revenue Code taxed income to the person who earned it or created the right to receive it or who controlled its use.[126] Even more so than the Court's ruling, this broad definition of ownership would allow the Treasury Department to aggregate the income of property to one owner.

Not long thereafter, the Court backtracked from its specific requirements of *Tower* and *Lusthaus*, but in the process the Court made it harder to determine ex ante when a property interest for income tax purposes had been created. In *Commissioner v. Culbertson*, an owner of a cattle business financed his four sons' partnership interests in the business.[127] The Court held that the future contribution of services could not vest ownership of a portion of the partnership's property in the new partners. However, property interests would be created if "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[128] As in earlier cases, the goal was to determine not whether there was a property interest per se but whether the creation of the partnership was bona fide. The fact that there was no contribution of original capital or the provision of vital services to the partnership was to be taken into consideration but was not conclusive.[129] What was necessary to create a new property interest for purposes of the federal income tax was less clear than before.

When Congress mandated in 1948 that married couples filing joint returns artificially split their income, spouses had less economic incentive to divide "their income through such devices as trusts, joint tenancies, and family partnerships."[130] Nonetheless, family partnerships remained a method for tax minimization because of the ability to shift income to other family members. In response to the continued demand for family partnerships, after a bill failed in 1948, Congress in 1951 introduced new rules for determining when property interests in family partnerships were created for income tax purposes.[131] The principles were the same as those

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[124] I.T. 3845, 1947-1 C.B. 66.

[125] *Id.*

[126] *Id.*

[127] 337 U.S. 733, 736 (1949).

[128] *Id.* at 742.

[129] *Id.* at 741–45.

[130] S. REP. NO. 80-1013, at 25 (1948).

[131] Revenue Act of 1951, ch. 521, sec. 340, Pub. L. No. 82-183, 65 Stat. 452, 511; *see* Revenue Revision Act of 1948, H.R. 6712, 80th Cong. (1948); *see also* I.R.C. § 704(e) (2006); H.R. REP. NO.

that govern the attribution of other income, namely, "income from property is attributable to the owner of the property."[132] The same uncertainties also applied. The reports of the House Committee on Ways and Means and the Senate Committee on Finance both provided that the IRS and the courts were still

> free to inquire in any case whether the donee or purchaser [of a partnership interest] actually owns the interest in the partnership . . . . [C]ases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away . . . .[133]

The new provision provided for the reallocation of income among partners, even if found to own a property interest in the partnership, if the former owner did not receive reasonable compensation for his services and a proportionate return for his capital.[134] It is likely that lower taxpayer demand for family partnerships or reduced enforcement, rather than the inherent clarity of this new ownership standard, has quieted debate over the ownership of family partnership interests.[135]

The issue was, and remains, what creates a property interest in a partnership for federal tax purposes. Focusing on the interests instead of the partnership's creation, and recognizing that ownership consists of several rights in property, one author suggested that the income of family partnerships only be amalgamated if one person has the right to acquire the interests of the other partners at no cost.[136] Control, according to this advocate, should not otherwise be considered as an ownership attribute because many partnerships delegate management to one partner.[137] This approach is unlikely to be adopted. As with most other income-shifting devices, the Court worries that retention of control or enjoyment of direct or substantial benefits of the property "blend so imperceptibly with the normal concepts of full ownership" to be sufficient to direct the incidence of the tax.[138]

82-586, at 32–34 (1951). The 1951 Act only applied to partnerships in which capital is a material income-producing factor.

132 H.R. REP. NO. 82-586, at 32.

133 *Id.* at 33; S. REP. NO. 82-781, at 39 (1951).

134 For a discussion, see Israel Packel, *The Next Inning of Family Partnerships*, 100 U. PA. L. REV. 153, 161–62 (1951).

135 To recognize a family partnership for estate tax purposes, the Tax Court requires a substantial, nontax motive, plus the partnership interests must be proportionate to the value of the property the partner transfers to the partnership. Estate of Bongard v. Comm'r, 124 T.C. 95, 118 (2005); *see also* Wendy C. Gerzog, Bongard*'s Nontax Motive Test: Not Open and* Schutt, 107 TAX NOTES 1711, 1711 (2005).

136 Veron, *supra* note 120, at 259–62, 266.

137 *Id.* at 259.

138 Helvering v. Clifford, 309 U.S. 331, 336 (1940).

B. Synthetic Leases

As in family partnerships, people work together to shape the determination of who owns what in synthetic leases.[139] Synthetic leases that led, in part, to the collapse of Enron, are best known for their accounting treatment.[140] Nonetheless, the tax consequences of synthetic leases raise interesting questions of ownership because taxpayers are allowed to ignore the form they use in these transactions. In synthetic leases, a lessee qualifies a lease as an operating lease for financial accounting purposes so that it remains off the books whereas the lease qualifies as a purchase with a mortgage for federal income tax purposes. The lessor, as nominal owner, borrows money to buy the leased property based on the lessee's agreement to pay rent. The lessor then makes mortgage payments from the lessee's rent. Disregarding the form of these transactions, the lessor is disregarded for tax purposes (although treated as the actual owner for accounting purposes). Based on the economic reality of the transaction, the lessee is treated as the tax owner of the leased property, despite not holding legal title. This determination of ownership allows the lessee to claim depreciation deductions on the property based on an amount including the borrowed funds. Additionally, the lessee deducts the portion of the rental payments attributable to interest (but not the payments traceable to the principal of the loan) on the lessee's deemed property. In the early years of this type of arrangement, the depreciation deductions plus interest deductions claimed by a lessee typically exceed the forgone rental deduction.[141] Depending upon the facts and circumstances, the IRS has affirmed this tax treatment.[142]

This tax result is not surprising. Since the 1930s, lessees have been allowed to disregard a lease's form if the transaction is, in substance, a purchase with a mortgage.[143] In other words, depending upon the facts and

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[139] Synthetic leases are generally short, three to five years, in which the lessor must have a 3% equity investment in the property in order for the lessee to enjoy the accounting rule benefits, and the lessee has virtually all residual risk and rewards. Steven G. Frost & Paul Carman, *Federal and State Tax Consequences of Synthetic Leasing—Multiple Benefits, Minimal Risks*, 95 J. TAX'N 361, 365 (2001).

[140] *See* Cheryl D. Block, *Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 440–41, 446–47 (2003); José Gabilondo, *Financial Moral Panic! Sarbanes–Oxley, Financier Folk Devils, and Off-Balance-Sheet Arrangements*, 36 SETON HALL L. REV. 781, 816–19 (2006); Daniel Austin Green, *Accounting's Nadir: Failures of Form or Substance?*, 12 U. PA. J. BUS. L. 601, 645–46 (2010); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 57–59, 68; Neal Newman, *Enron and the Special Purpose Entities—Use or Abuse?—The Real Problem—The Real Focus*, 13 LAW & BUS. REV. AM. 97, 104–05, 118 (2007); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445, 486–87 (2000).

[141] Weidner, *supra* note 140, at 447–48.

[142] I.R.S. Priv. Ltr. Rul. 199920003 (Jan. 12, 1999); Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, 1156–60.

[143] Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939).

circumstances, a lessee may be taxed as the owner of property despite not having legal title.[144] But the road to the favorable tax treatment of synthetic leases has not been easy, in part because of the complicated issues of ownership. The IRS and the courts consider numerous factors when deciding who has the "significant and genuine attributes" of ownership for tax purposes.[145] The "substance of a transaction, rather than its legal form, is controlling," with the question being who "has all the burdens and benefits of ownership."[146] The IRS compiled a list of factors based on several Tax Court cases that should be analyzed when evaluating a synthetic lease.[147] No one factor is dispositive; therefore, a factor-by-factor analysis is necessary. As with family partnerships, the IRS focuses more on whether the transaction is abusive than whether taxpayers have legitimate ownership interests.[148]

The IRS has not always looked at the substance of the lease arrangement in these transactions when determining ownership, and the prior position created inequitable results. In *Bolger v. Commissioner*, a commercial user of real estate was able to lease property with the payment to the financier (in addition to the payment of the property's mortgage) being the entitlement to the building's tax depreciation deductions instead of a cash payment.[149] The IRS conceded the form of the transaction.[150] The Tax Court expressed frustration that the IRS failed to argue that the transaction was a mortgage by the lessee.[151] Because the IRS never argued that the lessee was the owner–mortgagor, and hence the proper party to report the depreciation deductions, the depreciation deductions were stripped from the true owner–borrower and assigned first to the financing corporation, which in turn assigned them to the financier.[152]

The IRS now generally accepts that the lessee is the owner of synthetic leases but this requires a complex weighing of the facts. In *Sun Oil Co. v. Commissioner*, the question was whether the lessee could deduct the "rent" it paid when the tax-exempt status of the lessor precluded an offsetting inclusion in income.[153] The IRS argued that the lessee retained an equity interest in the property and therefore could not obtain a Section 162(a) deduction for the rental "of property to which the taxpayer has not taken or

144 Rev. Rul. 55-540, 1955-2 C.B. 39, 41.
145 Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978).
146 Rev. Rul. 72-543, 1972-2 C.B. 87, 88.
147 *See* Rev. Rul. 55-540, 1955-2 C.B. 39, 41–42.
148 *Id.*
149 59 T.C. 760, 762–63 (1973).
150 *Id.* at 761.
151 *Id.* at 767 n.5, 769 n.8.
152 *Id.* at 767–68.
153 562 F.2d 258, 259 (3d Cir. 1977).

is not taking title or in which he has no equity."[154] Because the lessee retained all the benefits and burdens of ownership, the lessee could deduct only the portion of the "rent" that was traceable to a payment of interest and not the portion attributable to the repayment of principal.[155] The Third Circuit accepted that the benefits and burdens of ownership could be allocated any number of ways between a landlord and a tenant of commercial real estate: "The usual business bargain between a commercial lessor and lessee is far more complex. Real estate interests between a lessor and lessee normally are divided into a number of parts, each of which represents an ownership interest in property."[156]

Because of this complex weighing of facts, the IRS has at times lost the ownership classification, resulting in the taxpayer winning an unjust income tax reduction. In *Frank Lyon Co. v. United States*, a bank entered into a sale–leaseback of a building with the Frank Lyon Company, a closely held corporation whose majority shareholder and board chair was also a member of the bank's board.[157] The bank "sold" the building as it was constructed to the Lyon Company and "leased" the building back, also receiving a number of options to repurchase the building.[158] The bank, as lessee, was obligated for rent and to pay all maintenance, repairs, taxes, and insurance on the building.[159] In addition, the bank's obligation to pay net rent was absolute and unconditional, even in the event of destruction of the building.[160] The bank could repurchase the building at any time by prepaying the mortgage with accrued interest.[161] Consistent with its formal ownership of the building, the Lyon Company reported depreciation deductions on its cost.[162]

The IRS took the position that the lease and options made the bank the owner of the building such that the bank, rather than the Lyon Company, was entitled to its depreciation deductions.[163] The Eighth Circuit agreed.[164] The Eighth Circuit held that ownership was a "bundle of sticks" and that the Lyon Company "totes an empty bundle and that the term 'owner' for tax purposes cannot reasonably be attached to the empty wrapping taxpayer has retained."[165] The Lyon Company's only economic advantage for its

[154] *Id.* at 259 n.1.
[155] *Id.* at 269.
[156] *Id.* at 262.
[157] 435 U.S. 561, 563, 565 (1978).
[158] *Id.* at 566–67.
[159] *Id.* at 567.
[160] *See id.* at 570–71.
[161] *Id.* at 561.
[162] *Id.* at 568.
[163] *Id.* at 568–69.
[164] Frank Lyon Co. v. United States, 536 F.2d 746, 747 (8th Cir. 1976), *rev'd*, 435 U.S. 561 (1978).
[165] *Id.* at 751.

"ownership" was the income tax advantages it claimed from the depreciation deductions in the early years of the lease.[166]

The Supreme Court reversed the Eighth Circuit.[167] The Court concluded that none of the parties owned the building in any simple sense and, therefore, as long as the lessor retained significant attributes of a traditional lessor status the parties could allocate depreciation deductions within reasonable limits.[168] The Court's summary of the facts focused on the Lyon Company's risk: the Lyon Company, not the bank, was liable for the note, and the Lyon Company was not even assured of a return of its money plus interest.[169] "This possibility brings into sharp focus the fact that Lyon [Company], in a very practical sense, is at least the ultimate owner of the building."[170] However, the Lyon Company was not a traditional owner–lessor. The bank controlled the use of the building, and the structure of its options to purchase the building captured all of its potential appreciation in value unless the new building was condemned prior to the date of the bank's first repurchase option.[171] In addition to having the benefits of ownership, the bank also bore the burden of the building's operating costs and an unconditional promise to pay rent.[172] The Court did not consider these attributes of ownership persuasive.[173]

C. Broader Implications

The consequences of applying complex and undefined tests to determine ownership and property for the application of the federal income tax extend beyond the revenue raised or foregone. One consequence is pressure applied to change interpretations of state property law. For example, with respect to family partnerships, failure to secure favorable tax results caused some families to invalidate state law property interests. In *Stone v. Stone*, Michigan courts allowed a husband and wife to set aside gifts of partnership interests to their eleven-year-old children when the federal tax savings did not materialize.[174] According to the court, "The consequences of requiring the father to pay the income tax on the entire income of a partnership in the earnings of which he has but a one quarter

[166] *Frank Lyon*, 435 U.S. at 571–72.

[167] *Id.* at 584.

[168] *Id.*

[169] *Id.* at 566–68.

[170] *Id.* at 567 n.3.

[171] *Id.* 581–82.

[172] *Id.*

[173] *See id.* at 582–83.

[174] 29 N.W.2d 271, 273 (Mich. 1947); *see also* Rubardt v. Salzman, 40 N.E.2d 846, 847 (Ill. App. Ct. 1942); Heaton v. Heaton, 55 N.Y.S.2d 154, 156 (Sup. Ct. 1945). *But see* Lowry v. Kavanagh, 34 N.W.2d 60, 61 (Mich. 1948) (finding gift to wife could not be set aside simply because no tax reduction resulted).

interest can readily be imagined."[175] Thus, the federal income tax has altered the application of property law in the states.[176] Notwithstanding this risk, no single model of "ownership" has been crafted that applies for tax purposes, and determining who is the appropriate owner of a given piece of income-producing property often remains a "close call."[177] A consequence of this is that for taxpayers and the IRS, determining ex ante if a particular attribute of ownership is sufficient to produce taxable income is confusing, at best. This confusion may confound taxpayers' ability to plan for other, non-tax-related matters.

CONCLUSION

Congress has not grappled with what it means to own something for federal income tax purposes even though the conception of property as a bundle of rights gained traction as the new tax developed. Congress failed to anticipate that the bundle of rights concept would result in the proliferation of property interests in income-producing assets. As a result, taxpayers can use the existence of myriad property interests in the same taxable item to minimize their income taxes. The result has been problematic for the tax. In response to these problems, Congress could adopt a definition of ownership that would override state law issues and clarify what ownership attributes are sufficient to trigger the tax. However, it would be difficult (and politically unlikely) for congressional action to override the different conceptions of what property is. In the face of likely inaction on this issue, policymakers need to be aware of the complications for income tax purposes inherent in the idea of ownership and property.

There are consequences to not basing taxation on a well-thought-out and consistent definition of ownership. First, what happens if two people should be subject to tax on the same income or if the person subject to tax on a given amount of income is unable to access the income to pay the taxes owed? The Treasury Department once declared, "[T]he Internal Revenue Code taxes income to the person who earns it, or who creates the right to receive it, or who controls its use."[178] This could be many people at the same time. Consider *Helvering v. Clifford*, when a husband created a trust to pay the income earned on securities to his wife, but the husband retained the right to change the trust's terms. The Court held that the husband was the owner of the corpus.[179] However, if the wife had an ownership interest under state law, arguably she should be taxed on the trust's income, as was her husband under the Court's decision. Moreover, she might not be legally obligated to provide him the revenue to pay the

[175] *Stone*, 29 N.W.2d at 271–72.

[176] *See also* McMahon, *California Women*, *supra* note 93.

[177] I.R.S. Field Serv. Adv. 199920003, at 8 (Jan. 12, 1999).

[178] I.T. 3845, 1947-1 C.B. 66.

[179] Helvering v. Clifford, 309 U.S. 331, 336 (1940).

taxes he owed on her income. Thus the trust's income is "of" both spouses for income tax purposes but not necessarily any other purpose. This multiple taxation has occurred in the past. As noted in 1921, the government taxed two people on the same income earned from a trust because the rules were not based on a singular view of property or ownership.[180]

To the extent that we adopt a more nuanced view of ownership for tax purposes, it is possible that other issues for the income tax, such as tax shelters, could be more easily addressed. Using a settled definition of who really owns and should be taxed on income generated by property may be less convoluted than trying to undo or negate transactions. Additionally, employing a real sense of ownership for the imposition of the income tax would allow taxpayers to be taxed more accurately according to their ability to pay taxes. Ownership of any type of property rights carries with it other benefits, such as increased political and social power, that may have far-ranging effects beyond the piece of property itself. These other privileges cannot be taxed directly under the current system, or indirectly by taxing the property interest that gives rise to that power, if the interest is held to be owned by someone else. Linking ownership to the correct person best provides the government the tools to tax everyone according to their real ability to pay.

Developing a theory of ownership for tax purposes is beyond the scope of this Article. Therefore, this inquiry may raise more questions than it answers. Does property for tax purposes have to be the same as for other purposes? If property must have a limited number of standard forms, if only to reduce the transaction costs of knowing who owns what property, do those limits apply in the world of tax? If so, is the objective to limit the cost to the government of ascertaining who owns what, and is that a fair limitation on property? These questions need to be answered if we want to operate in a world where the federal income tax applies correctly to the income of an individual.

[180] *See* Maguire, *supra* note 58, at 373.